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Governing the Purpose of Investment Management: How the 'Stewardship' Norm is being (Re)Developed in the UK and EU

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Abstract

From the introduction of shareholder engagement as a ‘norm’ for stewardship, the regulatory governance of investment management conduct has been ramping up. As investment funds and asset managers assume control of increasing global assets under management and enjoy significant allocative power, public interest in the exercise of such power increases correspondingly. It is inevitable that societal and public expectations would be augmented and the governance needs for the industry would rise. This article argues that the UK Stewardship Code 2020 is a ‘graduation’ from an earlier experimental period which focused on the narrower and process-based ‘norm’ of shareholder engagement. The Code has broken new ground by articulating purpose-based steers for investment management, providing the starting point for a type of governance that may come to define the regulation of investment management in the future. Indeed, sustainable finance reforms such as in the EU and UK may provide the crucial kickstart to introducing non-optional integration of sustainability risks and goals into mainstream investment management in due course. Purpose-based governance, albeit in its soft law beginnings, is arguably a new trajectory for calibrating the relationship between private investment management and regulation, reflecting the public interest and expectations for the future of the industry.

Keywords: institutional shareholders, stewardship, sustainable finance, shareholder engagement

JEL Classifications: K20, K22

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Iris H-Y Chiu*

Introduction

Since the development of the UK Stewardship Code in 2010 as a result of both private sector and public sector coordination,[1] the practice of institutional shareholder engagement has become 'normified' for investment management conduct, in the UK and globally. Commentators show that such 'normification' is not limited to the UK, as bodies with transnational reach such as the International Corporate Governance Network (ICGN) and European Fund and Asset Management Association (EFAMA) have also spurred the global 'normification' of shareholder engagement as 'stewardship', and have influenced the adoption by many jurisdictions of Stewardship Codes.[2]

However, over the last decade, a plethora of critique has been levied at institutions[3] in relation to how the expectations of stewardship have been met (or otherwise). Such critique range from theoretical discussions of the nature of engagement (or lack of incentives to so engage),[4] to empirical research findings showing that engagement is 'feeble',[5] symbolic,[6] or makes little difference to corporate behaviour[7] or performance.[8] The UK Kingman Review,[9] which was commissioned to examine the role of the Financial Reporting Council (FRC),[10] also levied critique at the Stewardship Code, viz-

> A fundamental shift in approach is needed to ensure that the revised Stewardship Code more clearly differentiates excellence in stewardship. It should focus on outcomes and

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[1] The Code was adapted from the Institutional Shareholder Committee's statement on the responsibilities of institutional shareholders. It was introduced by the Financial Reporting Council; Iris H-Y Chiu, 'Turning Institutional Investors into "Stewards"- Exploring the Meaning and Objectives in "Stewardship"' (2013) 66 *Current Legal Problems* 443 for a general introduction and critical discussion of the meaning of 'stewardship'.

[2] Dionysia Katelouzou and Matthias Siems, 'The Global Diffusion of Stewardship Codes' (2020), http://ssrn.com/abstract_id=3616798.

[3] Pension and mutual funds, their asset managers, excluding alternative funds such as hedge or private equity funds which employ different strategies.

[4] Ronald J Gilson and Jeffrey N Gordon, 'The Agency Costs of Agency Capitalism Activist Investors and the Revaluation of Governance Rights' (2013) 113 *Columbia Law Review* 863 on institutions' reticent corporate governance roles, contrasting with shareholder activists; also Lucian Bebchuk and Scott Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Policy and Evidence' (2019) 119 *Columbia Law Review* 2029 on the lack of incentives to engage by index funds.

[5] Jan Fichtner & Eelke M. Heemskerk, 'The New Permanent Universal Owners: Index Funds, Patient Capital, and the Distinction Between Feeble and Forceful Stewardship' (2020) 49 *Economy and Society* 493.

[6] Ibid, for ESG engagement, Jun Li and Di (Andrew) Wu, 'Do Corporate Social Responsibility Engagements Lead to Real Environmental, Social, and Governance Impact?' (2021) 66 *Management Science* 2564.

[7] Li and Wu (2021), ibid.

[8] Matthew R Denes, Jonathan M Karpoff and Victoria B McWilliams, 'Thirty Years of Shareholder Activism: A Survey of Empirical Research' (2015), http://ssrn.com/abstract=2608085.

[9] Sir John Kingman, *Independent Review of the Financial Reporting Council* (2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf.

[10] Audit and financial reporting watchdog in the UK, oversight body for the UK Corporate Governance Code for listed companies and UK Stewardship Code for institutional shareholders.

effectiveness, not on policy statements. If this cannot be achieved, and the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition.[11]

The FRC has issued a majorly revised Stewardship Code in 2020.[12] The Stewardship Code 2020 seems to be a product of tacit acknowledgment that the earlier 'normification' of shareholder engagement needs to be refined. As the Stewardship Code 2020 has taken a markedly different approach from previous iterations, the investment management community may not be entirely certain what signals are being sent to the them regarding the expectations of 'stewardship'. This article argues that the earlier 'normification' of 'shareholder engagement' reflects a relatively narrow understanding of stewardship. [13] This seems to be giving way to an acceptance of a variety of investment management practices that can also deliver good stewardship. In this manner, regulators and policy-makers seem to be moving away from their earlier fixation upon the 'normification' of shareholder engagement.

The UK Stewardship Code 2020 may be regarded as returning to a point of re-setting 'normification'. This move has nevertheless been criticised to be a 'weakening' of the Stewardship Code.[14] This paper however takes a different perspective, and regards the Stewardship Code 2020 as providing for a more holistic platform for norms of investment management conduct to be developed and scrutinised. The Stewardship Code 2020 is poised to facilitate discourse for a richer slate of eventual 'normification' in investment management practices, from its starting point as soft law. The meta-governance provided by soft law can give rise to ripples of discourse and change in various aspects of investment management conduct and through the investment chain. Further, we see the Stewardship Code 2020 as being poised to facilitate discourse that encompasses the range of private, contractual interests as well as social interests and regulatory objectives.

Finally, 'normification' in investment management is far from being relaxed, although the new Stewardship Code takes a more flexible and expansive view of investment management practices as 'stewardship'. This is because the Code is increasingly clearer on the purpose of investment management, articulating public interest objectives to be internalised within investment management mandates. The articulation of public interest objectives in investment management has also been significantly ramped up in the area of sustainable finance, hence this area of reform may provide a significant impetus for the increasing framing of investment management within public interest terms. Arguably the EU has provided regulatory leadership in this area, and the article discusses the EU's and UK's reforms in sustainable finance and the potential such regulatory initiatives may have for more purposefully re-orienting investment management practices.

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[11] Kingman review (2018), p10.

[12] https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf.

[13] ch3, Roger M Barker and Iris H-Y Chiu, *Corporate Governance and Investment Management: The New Financial Economy* (Cheltenham: Edward Elgar, 2017), arguing that fixation on engagement may be misplaced as investment management practices can be optimal in a variety of models.

[14] Bobby V Reddy, 'The Emperor's New Code? Time to Re-Evaluate the Nature of Stewardship Engagement Under the UK's Stewardship Code' (2021), https://ssrn.com/abstract=3773156.

Section A discusses the initial development of institutional shareholder engagement as a norm in investment management stewardship. This Section discusses the context and explores the unreconciled and sometimes contesting narratives that underlie the expectations of shareholder engagement by institutions. The nature of such unreconciled and contesting narratives has arguably given rise to vagueness and dissatisfaction regarding the characterisation and conceptualisation of engagement behaviour. In unpacking these narratives, the Section shows that assertions that stewardship is sub-optimally carried out may be founded on certain assumptions or preferred narratives, without taking into account of the rich context of unreconciled and contesting discourse.

Section B explores the Stewardship Code 2020 as a platform to 'reset' the 'normification' of investment management behaviour. It argues that the Code should be appreciated against the broader context of governance concerns surrounding the conduct of investment management more broadly. These include (a) market failure findings with regard to relations within the investment chain, in the Financial Conduct Authority (FCA)'s Asset Management Market Study;[15] and (b) policy-makers' expectations of the allocative roles of investment managers and funds in relation to economy and market-building, particularly in long-term,[16] sustainable[17] and developmental finance.[18] This Section argues that the Stewardship Code 2020 articulates certain wider and socially-facing expectations in relation to investment purpose, although it provides only general guidance as to the contractual governance within the investment chain towards these purposes. Although the Code is soft law, it provides a meta-level governance as a starting point to signal policy 'steer'. There is

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[15] FCA, *Asset Management Market Study: Final Report* (June 2017), https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf. Rule changes: FCA, *Asset Management Market Study Remedies and Changes to the Handbook – Feedback and final rules to CP17/18* (April 2018), FCA, *Asset Management Market Study – further remedies* (Feb 2019).

[16] EU Shareholders' Rights Directive 2017/828, Arts 3h and 3i, and Preambles 3, 14 and 15, implemented in the UK for all investment fund entities and managers, FCA Handbook COBS 2.2B.5-9, and The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations for occupational pension schemes.

[17] Led by the EU Sustainability Disclosure Regulation 2019/2088 and EU Taxonomy Regulation 2020/852, see Section C. In the UK, the *Green Finance Strategy* (2019), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf envisages that besides public sector action in mobilising finance, along with the actions of central banks, private sector actors in finance play a part in allocational steering towards green finance, for example by mobilising green exchange-traded funds, p11. The UK may look at industry standards for certifying green investment management rather than rely on regulatory fiat, p27.

[18] 'Social' counterpart to 'green' in sustainable finance, covered in the EU Regulations, ibid. See EU's and UK's commitment to the UN Social Development Goals, one strategy of which is to mobilise private sector finance to achieve SDGs. For UN SDGs, see https://sdgs.un.org/goals. EU Commitment to UN SDGs: 'Sustainable Development: EU sets out its priorities', https://ec.europa.eu/commission/presscorner/detail/en/IP_16_3883. UK commitment to the UN SDGs: 'Implementing the Sustainable Development Goals' (July 2019), https://www.gov.uk/government/publications/implementing-the-sustainable-development-goals/implementing-the-sustainable-development-goals--2. On the role of private finance for UN SDGs alongside public-led finance, Celine Tan, 'Creative Cocktails Or Toxic Brews? Blended Finance and the Regulatory Framework for Sustainable Development' in Clair Gammage and Tonia Novitz (eds), *Sustainable Trade, Investment and Finance: Toward Responsible and Coherent Regulatory Frameworks* (Cheltenham: Edward Elgar 2019), ch13; Jesse Griffiths, 'Financing the Sustainable Development Goals (SDGs)' (2018) 61 Development 62.

nevertheless potential to influence private implementation and transform investment management practices according to purpose-based norms.

Section C then turns to the governance initiatives for sustainable finance and how these further shape new 'normification' in investment management stewardship. The EU has introduced new Regulations for sustainable finance,[19] and the UK will introduce its own version of regulation for sustainable finance.[20] The EU sustainable finance reforms may go further in re-orienting investment management conduct according to the expectations of 'double materiality'.[21] Double materiality refers to the importance of attaining sustainable, non-financial outcomes *as such* and not merely tied to financial outcomes in investment management. We examine whether there is a clear purpose-based pivot in investment management regulation and what this achieves in relation to 'normification' for investment management, or shareholder engagement. This Section reflects on how the articulation of public interest purpose and the regulation of investment management conduct may be taken forward in the future. Section D concludes.

A. The 'Normification' of Institutional Shareholder Engagement and the Narratives that Led to its Re-setting

In the wake of the global financial crisis 2007-9 which also saw the near-failure of two large listed banks in the UK, the Royal Bank of Scotland and Halifax Bank of Scotland, institutional shareholders were accused to have been "asleep"-[22] being too uncritical of risky business practices in their investee banks and neglecting to monitor Board risk management. Although institutional shareholder apathy was not regarded as the key cause of the UK banking crisis,[23] the Walker Review[24] on corporate governance in banks and financial institutions took the view that such institutional shareholder apathy provided a tolerant context for misjudgements of risk made at the Board level of the failed UK banks. The UK banking and global financial crisis provided an opportunity for reflections upon corporate and investment culture, and the role of institutional investors in fostering general economic and social well-being. Against this context, "stewardship" was articulated and developed to characterise in particular, the role of institutional investment. The FRC reframed the Institutional Shareholders' Committees' Principles of Responsibilities in 2010[25] in order to

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[19] note 17.

[20] 'ESG disclosure rules for advisers shelved amid Brexit doubts' (20 Nov 2020), https://citywire.co.uk/new-model-adviser/news/esg-disclosure-rules-for-advisers-shelved-amid-brexit-doubts/a1427945; FCA, *Enhancing Climate-Related Disclosures by Asset Managers, Life Insurers and FCA-Regulated Pension Providers* (22 June 2021), https://www.fca.org.uk/publications/consultation-papers/cp-21-17-climate-related-disclosures-asset-managers-life-insurers-regulated-pensions.

[21] P2, ESMA, 'Response to [IFRS] Consultation Paper on Sustainability Reporting' (16 Dec 2020), https://www.esma.europa.eu/sites/default/files/library/esma32-334-334_esma_response_to_ifrs_foundation_consultation_on_sustainability_reporting.pdf.

[22] "FSA Chief Lambasts Uncritical Investors" (Financial Times, 11 March 2009) and "Myners Lashes out at Landlord Institutional shareholders" (Financial Times, 21 Apr 2009).

[23] Jonathan Mukwiri and Matthias Siems, "The Financial Crisis: A Reason to Improve Shareholder Protection in the EU?" Leeds Law School Conference (6 Dec 2012).

[24] David Walker, *A Review of Corporate Governance in Banks and Financial Institutions* (Nov 2009), https://webarchive.nationalarchives.gov.uk/+/www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

[25] p1, FRC, *Revisions to the UK Stewardship Code Consultation Document* (April 2012), https://www.frc.org.uk/getattachment/69188de6-3dcf-46ab-afd9-050886ef0c5d/-;.aspx.

introduce a Stewardship Code for institutional shareholders on a comply-or-explain basis. The first Stewardship Code contained seven principles which revolved around institutions having policies and implementing engagement with their investee companies, including voting, informal engagement, escalation of engagement and collective engagement. They also needed to disclose how they managed conflicts of interest in carrying out their engagement roles.[26]

The 'normification' of shareholder engagement by institutions is arguably a result of crystallising 'blame' upon the state of institutional shareholder behaviour which had already been subject to criticism prior to the events of the global financial crisis. It has been observed[27] that institutional shareholder holding periods have declined over the years. This is largely due to trading having become a focus for asset management, as trading gains are more easily exploited and quicker to achieve than investing for longer term capital growth.[28] Although dispersed ownership structures quite naturally entail shareholder apathy, as has been pointed out decades ago in Berle & Means' original work,[29] it was not until the 1970s with the rise of law and economics scholarship in corporate governance that the lack of shareholder monitoring in dispersed ownership companies was articulated as a distinct *problem,* in particular, reinforcing the agency problem of the unmonitored corporate management.[30] In the 1990s, Useem's[31] and Hawley & Williams'[32] theses of universal owners and fiduciary capitalism reignited hope in pension funds and pooled entities that invest on behalf of the saving public that they would monitor corporations on behalf of the broad public interest. This vision however did not quite come to pass as empirical evidence[33] continued to reflect shareholder apathy, low voting turnout and institutions' focus on trading on financial instrument markets to generate returns. The latter

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[26] Chiu (2013).

[27] Andrew G Haldane, 'Control Rights (and Wrongs)' (speech, Wincott Annual Memorial Lecture, London, 24 Oct 2011), https://www.bankofengland.co.uk/-/media/boe/files/speech/2011/control-rights-and-wrongs-speech-by-andrew-haldane.pdf, p12.

[28] Karen Ho, 'Corporate Nostalgia? Managerial Capitalism from a Contemporary Perspective' in Greg Urban (ed), *Corporations and Citizenship* (University of Pennsylvania Press 2014).

[29] The separation of ownership from control was described by Berle and Means as the 'atomisation of property'. They observed that as shareholding in a corporation became diffuse, fragmentation into smaller holdings occurred as corporations grew. Shareholders became passive, leaving decision-making into the hands of managers. Berle and Means questioned the appropriateness of the quasi-proprietary fabrication of ownership in light of separation of ownership from control. They opined that shareholders had surrendered the proprietary aspect of control in owning insignificant stakes of a widely-held company, Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property* (1932, Transaction Publishers, 1999 ed), p66.

[30] Michael C Jensen and Wiliiam H Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

[31] Michael Useem, *Investor Capitalism: How Money Managers are Rewriting the Rules of Corporate America* (Basic Books, 1999).

[32] James P Hawley and AT Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (University of Pennsylvania Press, 2000).

[33] Early evidence, Rebecca Stratling, "General Meetings: A Dispensable Tool for Corporate Governance of Listed Companies?" (2003) 11 *Corporate Governance* 74; however, shareholder voting levels around the world have improved after the global financial crisis, Peter Iliev, Karl V. Lins, Darius P. Miller, and Lukas Roth, 'Shareholder Voting and Corporate Governance Around the World' (2012), http://www.bris.ac.uk/efm/media/conference-papers/corporate-finance/shareholder-voting.pdf.

phenomenon has been termed investor 'short-termism',[34] a malaise that entails certain adverse effects for companies too as they respond to the needs of maintaining short-term share price levels. Corporate executives have also tended to bend towards market short-termism, bringing about corporate short-termism[35] as their remuneration packages are usually tied to stock performance.[36] Developments in corporate short-termism include the rise of frequent share buybacks,[37] and shifts in investment in long-term research and development to short-term goals with quicker payoffs.[38]

The confluence of a long-running observation of sub-optimal institutional shareholder behaviour and the global financial crisis 2007-9 brought about policy reform targeted at such behaviour, although some commentators argue that shareholder behaviour was neither key to the problems with excessive risk-taking by banks[39] prior to the financial crisis, nor was increased shareholder engagement necessarily salutary for the specific issue of corporate risk-taking.[40] The Kay Review of 2012[41] in the UK nevertheless articulated that one of the needs of economic recovery post-crisis would be institutional shareholder engagement with their investee companies for the purposes of securing a long-term well-performing corporate economy.

The Review concluded that institutions were undertaking short-termist investment strategies that would ultimately affect the long-term well-being of the corporate sector to serve social and economic good.[42] In this manner, the Kay Review framed market and

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[34] Corporate Values Strategy Group, *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management* (New York: Aspen Institute Business and Society Programs, 2009), http://www.aspeninstitute.org/publications/overcoming-short-termism-call-more-responsible-approach-investment-business-management.

[35] Caitlin Helms, Mark Fox and Robert Kenagy, 'Corporate Short-Termism: Causes and Remedies' (2012) 23 *International and Comparative Company Law Review* 45; Emeka Duruigbo, 'Tackling Shareholder Short-Termism and Managerial Myopia' (2011-12) 100 *Kentucky Law Journal* 531.
However, Roe disagrees that corporations suffer from systemic short-termism, Mark Roe, 'Stock Market Short-Termism's Impact' (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171090.

[36] Helms et al (2012).

[37] José-Miguel Gaspar, Massimo Massa, Pedro Matos, Rajdeep Patgiri and Zahid Rehman, 'Can Buybacks be a Product of Shorter Shareholder Horizons?' (2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649482; Jesse M Fried, 'Open Market Repurchases: Signaling or Managerial Opportunism?' (2001) 2 *Theoretical Inquiries in the Law* 865; 'Informed Trading and False Signaling with Open Market Repurchases' (2005) 93 *California Law Review* 1323.

[38] Marc T Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (2014) 41 *Journal of Law and Society* 416.

[39] Emilios Avgouleas and Jay Cullen, 'Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries' (2014) 41 *Journal of Law and Society* 28.

[40] Lucian Bebchuk and Holger Spamann, 'Regulating Bankers' Pay' (2010) 98 *Georgetown Law Journal* 247; Peter O Mülbert, 'Corporate Governance of Banks after the Financial Crisis - Theory, Evidence, Reforms' (2010) ECGI Law Working Paper, http://ssrn.com/abstract=1448118, arguing that shareholders were incentivised to support banks in higher levels of risk-taking as payoffs would be enjoyed by them but risks are borne by banks' creditors, including depositors. General critique against shareholder engagement as a panacea to corporate ills, Jean-Philippe Robé, 'The Shareholders Rights Directive II: The Wrong Cure for a Deadly Disease' (2016) 17 ERA Forum 45.

[41] John Kay, *The Kay Review of UK Equity Markets and Long-term Decision Making'* (Final Report, July 2012), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf.

[42] paras 5.16ff, ibid.

corporate short-termism as malaises pitted against the optimal goal of long-termism, and recommended that changes in institutional ownership behaviour would be key to reversing the unhealthy trend. The Review in particular recommended that institutional shareholders should be more engaged as monitors of their investee companies for long-term economic well-being which is in the public interest, and such engagement should be of a type that is specific and involves strategic and governance matters at companies. The Review suggested that such behaviour could be incentivised, in terms of lowering the barriers and cost to collective engagement,[43] as well as potentially legalised, in terms of reviewing the fiduciary law that governs investment management.[44] Finally institutions should emulate Warren Buffett's investment ethos of more concentrated holdings in smaller numbers of companies in order to monitor and engage effectively.[45] Hence, the 'issuer-specific' form of shareholder engagement[46] became endorsed. This form of shareholder engagement envisages that institutional shareholders should 'go alongside' in order to monitor corporate management, raise critical questions and exert a benign influence. Issuer-specific engagement has arguably become the optimal norm in institutional shareholder behaviour, as reinforced in the Stewardship Code 2012.

These developments in the UK did not go unnoticed in the EU, where policy-makers were also convinced that institutional shareholders needed to change their behaviour to support the long-term recovery and well-being of the corporate economy in the EU after the global financial crisis.[47] Shareholder engagement came close to being mandated in the Shareholders' Rights Directive 2017.[48] The Directive introduced increased shareholder powers in order to reinforce and support their monitoring role, such as in relation to executive remuneration policies and related-party transactions.[49] In particular, institutional shareholders ie both asset owners and managers need to institute an engagement policy and provide explanation if they choose not to do so.[50] The implementation of the engagement policy relates to long-termism and includes non-financial concerns such as environmental, social and governance issues relating to investee companies. Further, long-termism is itself adopted as the optimal investment management horizon as asset owners and managers need to report on how their investment strategies and mandates meet long-term objectives in equity strategies.[51]

There is however chequered practice on the ground in relation to issuer-specific engagement. The implementation of the Stewardship Code in the UK and shareholder engagement generally under the EU Directive were criticised in many quarters. In the next Section, the key critiques are surveyed, and we argue that these critiques are based on

[43] Paragraphs 7.2-7.7, p51, ibid.
[44] Recommendation 9, p13; paragraphs 9.1-9.25, ibid.
[45] Paragraph 7.28, p55, ibid.
[46] Bobby V Reddy, 'The Emperor's New Code? Time to Re-Evaluate the Nature of Stewardship Engagement Under the UK's Stewardship Code' (2021), https://ssrn.com/abstract=3773156.
[47] Deirdre Ahern, 'The Mythical Value of Voice and Stewardship in the EU Directive on Long-term Shareholder Engagement: Rights Do Not an Engaged Shareholder Make' (2018) 20 Cambridge Yearbook of European Legal Studies 88 commenting on the Commission's Action Plan leading to the Directive.
[48] Directive (EU) 2017/828.
[49] Arts 9a, 9b and 9c, ibid.
[50] Art 3g, ibid.
[51] Arts 3h, 3i, ibid.

unresolved contests of narratives surrounding the norm of shareholder engagement. Shareholder engagement is essentially a means to a purpose or for certain outcomes, not an end in itself. The lack of clarity surrounding what shareholder engagement 'is for' has entailed debates on many sides as to what shareholder engagement 'ought to be for'. The lack of resolution of such debates has left all sides disappointed with the state of implementation of shareholder engagement. Hence, regulators and policy-makers need to step back from the fixation upon the issuer-specific engagement and engage with the normative debates regarding expectations of the investment management industry. The following unpacks the contesting narratives and expectations surrounding shareholder engagement to explain why disappointment has been felt on many sides leading to the resetting of the Stewardship Code 2020..

Contesting Narratives for the Norm of Issuer-specific Shareholder Engagement

The policy discourse surrounding the encouragement towards 'long-termist' investment management behaviour seems to underlie the first iterations of the UK Stewardship Code. Critique against investor and corporate short-termism underpinned the call to shareholder engagement. In this manner, shareholder engagement is arguably synonymous with holding for the long-term, and exercising voice instead of exit in relation to particular investee companies. Yet, this call to optimal investment management conduct using 'voice' is an over-simplification as it cannot be assumed that investment management mandates are homogenous. Even the Kay Review acknowledges that investment managers carry out a range of mandates and states that '[n]ot all investors have long holding periods in mind: nor, necessarily, should they. An activist investor who seeks changes in strategy or management may anticipate that the effects of those actions on the share price will be felt in a short period and plan an early sale.'[52] Although the Kay Review is of the view that a majority of traders rather than long-term investors present in UK equity markets would have a marked adverse effect upon corporations in the long-run, the variety of investment management mandates existing as private arrangements cannot be completely disavowed.

Indeed Pacces,[53] in his critique of the European Shareholders' Rights Directive that favours shareholder engagement for long-termist objectives, argues that whether 'long-termism' is optimal or efficient for a company or otherwise is not susceptible of a standard answer. The question is whether what companies decide to forgo in terms of long-term thinking is wrongly priced and undervalued in markets. For some companies, adopting a near-term strategic change (such as agitated by an activist hedge fund) could be efficient, as consequences of this change could lead to an efficient immediate adjustment in market pricing. While for others, such a strategic change may be a worse trade-off for a long-term decision whose payoffs arrive much later, especially if markets misprice and excessively discount the ultimate payoffs of a long-term decision. However, in light of literature in behavioural economics that highlight the tendency in markets towards under-pricing, and hence mis-pricing, of long-term benefits,[54] can it not be argued that the legislative

[52] Kay Review (2012), paragraph 5.4, p37.
[53] Alessio M Pacces, 'Shareholder Activism in the CMU' in Danny Busch, Emilios Avgouleas and Guido Ferranini (eds), *Capital Markets Union in Europe* (Oxford: OUP 2019), ch23.
[54] David Marginson and Laurie McAulay, 'Exploring the Debate on Short-Termism: A Theoretical and Empirical Analysis' (2008) 29 *Strategic Management* 273.

endorsement of 'long-termism' as a preferred purpose for investment management serves to make a correction for market failure? This market failure also entails social consequences as many ordinary savers and pensioners depend on the long-term financial health of the corporate economy to meet their needs. Nevertheless, it can be counter-argued that mandating long-termism by regulatory fiat is over-inclusive, as this treads upon the freedom for investment management mandates as private arrangements. As both the UK Stewardship Code and the EU Shareholders' Rights Directive provide a comply-or-explain framework for institutions regarding policies on shareholder engagement, it can be argued that even the 'long-termism' purpose is not hardened in law. In this manner, the policy encouragement towards issuer-specific engagement should be clarified as based on compatibility with institutions' investment time horizons.

However, it may be argued that policy-makers, though not explicit, have been implicitly encouraging long-termism as being compatible with wider social good. Hence, the expectations of stewardship reflect a contest between the perception of investment management as a private mandate fulfilled for contractual purposes, and the perception that it should perform as a 'force for public or social interest' in the macro landscape of a healthy and well-performing corporate economy in the long-term.[55] The private-public contesting narrative can also be framed in another way: the perspective that investment management serves the interests of those in the saving relationship and investment chain, hence the exercise of corporate governance roles is a facet of this; versus the perspective that investment management serves corporate governance roles and plays a part in holistically nurturing the investee company and more broadly the corporate economy.[56] The latter is arguably not well-conceived by the investment management community who perceive their enjoyment of shareholder rights and powers but not necessarily duties[57] and responsibilities[58] to the company they invest in.

Although Katelouzou[59] characterises the 'normification' of shareholder stewardship or engagement as a Polanyian moment, where institutions' shareholder roles are not atomistically carried out for merely private purposes but cognisant of a broader social agenda of gatekeeping the health and optimal conduct of the corporate economy, Talbot[60] is more pessimistic. She argues shareholder stewardship or engagement is borne out of private incentives and this 'financialised' lever, in the absence of clearer embedment of societal expectations and norms into investment management conduct, would only be used for the self-interest of the investment management industry. The contest of private-public

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[55] Ahern (2018).

[56] Chiu (2013); also Colin Mayer 'The Future of the Corporation and the Economics of Purpose' (ECGI Working Paper 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3731539 in which is posited that institutions as shareholders ought to consider their responsibilities to the companies they invest in.

[57] Generally Hanne S Birkmose (ed), *Shareholder Duties* (Alphen aan den Rijn: Kluwer Law International, 2017); Hanne S Birkmose and Konstantinos Sergakis (eds), *Enforcing Shareholders' Duties* (Cheltenham: Edward Elgar, 2019).

[58] Mayer (2020).

[59] Dionysia Katelouzou, 'Shareholder Stewardship: A Case of (Re)Embedding the Institutional Investors and the Corporation?' in Beate Sjåfjell and Christopher M. Bruner (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge: CUP 2019), ch41.

[60] Lorraine E Talbot, 'Polanyi's Embeddedness and Shareholder Stewardship: A Contextual Analysis of Current Anglo-American Perspectives on Corporate Governance' (2011) 62 *Northern Ireland Legal Quarterly* 451.

narratives underlying the preference for long-termism and the purpose of shareholder engagement is arguably unresolved.

Further, there are indications that policy-makers also see shareholder engagement as a channel to address issues of corporate behaviour and implications for wider society, i.e. the EU Directive's reference to non-financial considerations[61] such as environmental, social and governance (ESG) concerns, which connect shareholder engagement to a form of gatekeeping towards broader social good or mitigation of social harm.[62] Although the engagement provisions in the Directive are 'comply-or-explain' in nature, the expectations surrounding issuer-specific shareholder engagement[63] raise questions regarding reconciliation between the private law of the fiduciary nature of investment management and the more socially-facing role that institutions are expected to assume. Case law in the UK has clearly supported investment managers discharging their legal duties based on conduct focused on generating financial returns.[64] However, the United Nations Environmental Programme's report[65] has clarified that modern fiduciary duty in investment management should encompass consideration of ESG issues where material or where mandated. This may not extend more generally to ESG issues that matter for wider social good without a clear connection with investment performance. In sum, underlying contesting narratives framing the roles and purposes of shareholder engagement make it highly challenging for institutions to satisfy their critics in relation to their implementation of stewardship. We turn to specific and well-articulated criticisms against institutions and show how these are deeply steeped in the contesting narratives.

The Criticism against Institutions for Formalistic/Symbolic Engagement

Institutions' shareholder 'stewardship' roles have often been criticised to be formalistic and symbolic,[66] lacking real substance in terms of 'outcomes', as mentioned in the Kingman review. However, in the context of the unresolved contesting narratives as to what 'stewardship' is for, can institutions rightly be criticised for performing a 'form' of stewardship, which is largely manifested in terms of having policies[67] for engagement and voting?

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[61] Art 3g, Shareholders' Rights Directive 2017.
[62] Hanne S Birkmose, 'From Shareholder Rights to Shareholder Duties - A Transformation of EU Corporate Governance in a Sustainable Direction' (2018) 5 InterEULawEast: Journal of International and European Law, Economics and Market Integrations 69.
[63] Iris H-Y Chiu and Dionysia Katelouzou, 'From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?' (with Dionysia Katelouzou) in Hanne Søndergard Birkmose (ed), *Shareholder Duties* (Alphen aan den Rijn: Wolters Kluwer International, 2016), ch7.
[64] *Cowan v Scargill* [1985] 1 Ch 270; *Harries and Others V. The Church Commissioners for England and Another* [1992] WLR 1241.
[65] Freshfields Bruckhaus Deringer, 'A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment' (Report for the UNEP Finance Initiative, 2005), https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf, UNEPFI, *Fiduciary Duty in the 21st Century* (2019), https://www.unepfi.org/wordpress/wp-content/uploads/2019/10/Fiduciary-duty-21st-century-final-report.pdf.
[66] Arad Reisberg, 'The UK Stewardship Code: On the Road to Nowhere?' (2015) 15 *Journal of Corporate Law Studies* 217.
[67] Pacces (2019).

Institutions who signed up to the earlier Stewardship Codes were asked to make disclosure of their policies for Stewardship. Hence, having a policy is treated as a proxy for the performance of stewardship. The FRC's evaluation of institutions' compliance with the Code was based on the text of their stewardship policies only, but this inevitably left a sense of vacuum as to discerning what institutions have actually *achieved.* Further, stewardship policies could be written in a boilerplate and meaningless manner. This prompted the FRC to introduce a 'tiering regime'[68] in 2016, so that institutions are ranked in relation to their disclosure quality. The tiering reform at least pushed institutions towards more meaningful articulation of their policies.

What has attracted criticism to institutions' stewardship practices is this sense of vacuum in terms of connecting policy to outcomes, or the lack of demonstration of the difference policies have made. Stewardship achievements can only be meaningfully evaluated against expected purposes and outcomes. Empirical research shows that institutional stewardship activities have little or no impact on companies' operating performance.[69] But is this the yardstick against which we ought to measure stewardship efficacy? Empirical research has also shown that institutional stewardship activities bring about a reduction in audit cost for companies,[70] suggesting that auditors perceive benefits in terms of institutional monitoring and efficacy. However, is the achievement of 'substitute' gatekeeping between external audit and shareholder monitoring the yardstick for evaluating what stewardship or engagement achieves?

For example, if one looks at the critique levied against institutions for the exercise of their 'say on pay' rights,[71] there is significant critique against the ineffectiveness of say on pay, as executive remuneration levels are not perceived empirically to be under control,[72] and pay conditions in the UK or US have not become more egalitarian.[73] But it needs to be questioned what say on pay is exercised for. If shareholders are tasked with gatekeeping pay moderation at executive levels and playing a part in addressing distributive inequalities in society, then this purpose is not articulated as such in the legislative conferment of say on pay to shareholders. More radical transformation of institutions' shareholder behaviour would have to be shaped by institutional change. Hence, can institutions regard themselves as only narrowly assessing whether pay levels are appropriate to the performance of the portfolio company before them?

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[68] FRC, 'Tiering of 2012 UK Stewardship Code Signatories', https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements.

[69] Chun Lu, Jacqui Christensen, Janice Hollindale and James Routledge, 'The UK Stewardship Code and Investee Earnings Quality' (2018) 31 *Accounting Research Journal* 388.

[70] James Routledge, 'Institutional Investors, Stewardship Code Disclosures and Audit Fees' (2020) 29 *Asian Review of Accounting* 61.

[71] s439A, Companies Act 2006 giving shareholders a binding vote for remuneration policies over 3 years, and a backward-looking yearly advisory vote. The Shareholders' Rights Directive 2017 provides for the binding vote over a 4 year period for remuneration policies.

[72] Katarzyna Chalaczkiewicz-Ladna, 'Failed Reform of Say on Pay in the UK? The Future of Shareholder Engagement With Executive Pay' (2019) 40 *Company Lawyer* 47; Carsten Gerner-Beuerle and Tom Kirschmaier, 'Say on Pay: Do Shareholders Care?' (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2720481.

[73] Jörn Obermann, Patrick Velte, 'Determinants and Consequences of Executive Compensation-Related Shareholder Activism and Say-On-Pay Votes: A Literature Review and Research Agenda' (2018) 40 *Journal of Accounting Literature* 116.

Davies pointed out that the UK's Stewardship Code is more procedural than substantive in nature,[74] as *what* is written in the policies for engagement and voting, and how these are implemented, are up to institutions to determine. Unless the law is unambiguous about what engagement or stewardship should seek to achieve, especially in measurable terms, institutions must default to a stewardship purpose that is consistent with their objectives defined by (a) the legal framing of investment management conduct, and (b) the contractual framing of their investment management mandates. In this manner, it can be argued that the Code's as well as the Directive's provision for institutions *having* policies, but not prescribing further, would mean that there is no other top-down purpose for stewardship that changes the objectives for investment management conduct. Institutions' engagement and stewardship roles therefore do not depart from the purpose of serving ultimate savers' needs within the framework for investment management conduct in fiduciary and contractual law.

We need to query why policy-makers and regulators strongly encourage issuer-specific shareholder engagement as an optimal manner of investment management conduct.[75] Whether shareholder engagement is optimal for carrying out institutions' investment mandates would surely have to be evaluated on a case-by-case basis taking into account the nature and purpose of the mandate and agreed strategies of investment.[76] This is also linked to the critique made against 'untailored' forms of stewardship[77] as opposed to issuer-specific engagement, as there seems to be an assumption made by policy-makers and commentators that the latter is superior.[78]

The fiduciary framing of investment management conduct provides for its legal parameters, chiefly in relation to duties focused on securing financial returns for beneficiaries, in a manner that is loyal and with diligence and care.[79] The fiduciary framing in the US is more expansive than in the UK[80] and commentators argue that investment objectives can be

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[74] Paul Davies, 'The UK Stewardship Code 2020: From Saving the Company to Saving the Planet?' (2020), https://ssrn.com/abstract=3553493.

[75] Variety of investment management objectives and strategies is discussed in Terry McNulty and Donald Nordberg, 'Ownership, Activism and Engagement: Institutional Investors as Active Owners' (2016) 24 *Corporate Governance* 346; John C Coates IV, 'Thirty Years of Evolution in the Roles of Institutional Investors in Corporate Governance' in Jennifer G Hill and Randall S Thomas (eds), *Research Handbook on Shareholder Power* (Cheltenham: Edward Elgar 2015), ch4.

[76] ibid.

[77] Discussed shortly below.

[78] Eg Jan Fichtner & Eelke M. Heemskerk, 'The New Permanent Universal Owners: Index Funds, Patient Capital, and the Distinction Between Feeble and Forceful Stewardship' (2020) 49 *Economy and Society* 493.

[79] Benjamin Richardson, 'Governing Fiduciary Finance' in Tessa Hebb, James P. Hawley, Andreas G. F. Hoepner, Agnes L. Neher, David Wood (eds), *The Routledge Handbook of Responsible Investment* (Oxford: Routledge, 2015), ch50; Chiu (2013). Empirical research on institutions reflects dominant adherence to financial primacy, Anna Tilba and Arad Reisberg, 'Fiduciary Duty under the Microscope: Stewardship and the Spectrum of Pension Fund Engagement' (2019) 82 *Modern Law Review* 456.

[80] The US notion of fiduciary investment management is an umbrella concept comprising both loyalty and care, Tamar Frankel, *Fiduciary Law* at 169ff (Oxford; OUP 2011) while the UK sees fiduciary duty in its proscriptive sense ie loyalty only. The duty of care is separately regarded. The duty of care in investment management is now governed by regulation, in terms of suitability for portfolio management, Art 25, Markets in Financial Instruments Directive 2014/65/EU, and precise duties regarding diversification and delegation by pension funds, sections 1-6 Trustee Act 2000; s36, Pensions Act 2005.

subject to more organic development.[81] Nevertheless, the upshot is that investment purpose or objectives are privately determined. Although US law provides much clearer articulation of the connection between institutions' corporate governance roles and their fiduciary governance, as pension fund institutions are required to vote the shares they hold in portfolio companies,[82] this regulatory fiat deals with a mandatory *means* of investment management and not its ends. It would also be clear that voting as a prescribed means says nothing about *how to vote*, as that would be in the freedom of institutions to designate. In the eyes of the regulator, adhering to these means reflects meaningful management of the portfolio and of diligence. The regulatory mandate to vote can be seen as supportive of institutions' investment management conduct and their accountability to their beneficiaries. Such an underlying narrative is one that focuses on stewardship as serving the private purposes of the investment management mandate.

For the UK and EU, it is questioned to what extent an alternative purpose for engagement implicitly lurks in its underlying narrative. As argued above, the purpose of 'long-termism' is part of a comply-or-explain regime in the Directive, and not all institutions are managing funds according to a long investment horizon. The objectification of 'long-termism' can therefore only mean the long-term well-being and performance of investee companies. In the UK and EU, the underlying narrative arguably frames institutions into a gatekeeping role to safeguard the long-term well-being of the corporate sector as a social good. This is a much more public interest-oriented objective external to and not derived from the private paradigm of fiduciary investment management. Such an objective can only transform investment management conduct if it is legalised unambiguously, therefore allowing the clear framing of engagement as a norm that is part of institutions' corporate governance roles, as *owed to portfolio companies.*[83] Such a development is not discerned in UK or EU company law developments. It is however arguable that both the UK and EU have now taken steps now to address the clearer articulation of investment management objectives, therefore shaping the regulatory governance of institutions' conduct of investment management according to more public interest expectations. These are canvassed in Sections B and C.

Criticism Against Institutions in relation to Lack of Issuer-specific Stewardship

An oft-raised critique against the manner of shareholder stewardship or engagement is that some institutions do not engage in issuer-specific monitoring and hence do not fulfil intelligent gatekeeping roles for each of their portfolio companies.[84] These institutions in particular offer passive investment management strategies based on curating portfolios that match an established index. Passive investment managers tend to show interest, particularly in voting, in 'across the board' issues such as best practice in corporate governance or ESG

[81] James P. Hawley, Keith Johnson, Ed Waitzer, 'Reclaiming Pension Fund Fiduciary Duty Fundamentals' in Hebb et al (eds), The Routledge Handbook of Responsible Investment (2015), ch49; Arthur R Laby, 'The Fiduciary Structure of Investment Management Regulation' in William A Birdthistle and John Morley (eds), *Research Handbook on the Regulation of Mutual Funds* (Cheltenham: Edward Elgar 2018), ch4.
[82] Employee Retirement Income Security Act of 1974, 29 US Code Article 18, Sections 1101-1114.
[83] Iris H-Y Chiu and Dionysia Katelouzou, 'Making a Case for Regulating Institutional Shareholders' Corporate Governance Roles' (2018) *Journal of Business Law* 67.
[84] Bebchuk and Hirst (2019); Jill E. Fisch et al., 'The New Titans of Wall Street: A Theoretical Framework for Passive Investors' (2019) 168 University of Pennsylvania Law Review 17.

issues for portfolio companies without much discrimination.[85] This is regarded as sub-optimal compared to issuer-specific engagement such as conducted by activist hedge funds,[86] as well as certain socially responsible themed funds. The latter have the mandate to engage with ESG issues, such as by filing shareholder proposals or engaging in informal dialogue with companies.[87]

However, why should passive investment strategies such as exclusion or untailored stewardship be regarded as sub-optimal *from the point of view* of fiduciary investment management? Or divestment in the case of actively managed funds?

Despite Bebchuk and Hirst's[88] pessimistic account of passive investment managers' disengagement from their corporate governance roles, there is evidence to the usefulness of passive investment managers' techniques.[89] This should be considered carefully by policy-makers as the shift of assets under management from active to passive is marked,[90] and the Big Three, Blackrock, Vanguard and State Street, would come to assume importance in corporate governance discussions. In particular, commentators argue that passive investment funds vote intelligently in face of hedge fund activism, showing that they provide a moderating gatekeeping influence even if they do not initiate actions.[91] It is also to be noted that active managers who stock-pick are not likelier to adopt issuer-specific shareholder engagement as part of their optimal investment management strategy.[92]

A number of commentators find that passive investment managers exert considerable influence in relation to *issue-specific matters*, not necessarily *issuer-specific concerns*. These matters relate generally to corporate governance practices, shareholder power and rights and increasingly, ESG issues.[93] Such influence is usually exercised by voting,[94] which on the

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[85] Suren Gomstian, 'Voting Engagement by Large Institutional Shareholders' (2020) 45 *Journal of Corporation Law* 659.
[86] Pacces (2019); Reddy (2020).
[87] Leslie King and Elisabeth Gish, 'Marketizing Social Change: Social Shareholder Activism and Responsible Investing' (2015) 58 *Sociological Perspectives* 711; Natalia Semenova and Lars H Hassel, 'Private Engagement by Nordic Institutional Investors on Environmental, Social, and Governance Risks in Global Companies' (2019) 27 *Corporate Governance* 144; Nur Uysal, Aimei Yang & Maureen Taylor, 'Shareholder Communication and Issue Salience: Corporate Responses to 'Social' Shareholder Activism' (2018) 46 *Journal of Applied Communication Research* 179; Erwin Eding and Bert Scholtens, 'Corporate Social Responsibility and Shareholder Proposals' (2017) 24 *Corporate Social Responsibility and Environmental Management* 648. These papers document shareholder social activism/engagement (SSE) through filing shareholder proposals, voting and informal discourse.
[88] (2019).
[89] Marcel Kahan and Edward B Rock, 'Index Funds and Corporate Governance: Let Shareholders Be Shareholders' (2020) 100 *Boston University Law Review* 1771; Assaf Hamdani and Sharon Hannes, 'The Future of Shareholder Activism' (2019) 99 *Boston University Law Review* 971.
[90] Kenechukwu Anadu, Mathias Kruttli, Patrick McCabe, Emilio Osambela, and Chae Hee Shin, 'The Shift from Active to Passive Investing: Potential Risks to Financial Stability?' (Federal Reserve Bank of Boston Working Paper, 2018), https://ssrn.com/abstract=3321604.
[91] Kahan and Rock, (2020); Hamdani and Hannes (2019).
[92] Kahan and Rock (2020).
[93] Gomstian (2020); Virginia Harper Ho, 'From Public Policy to Materiality: Non-Financial Reporting, Shareholder Engagement, and Rule 14a-8's Ordinary Business Exception' (2019) 76 *Washington and Lee Law Review* 1231.
[94] Ibid.

one hand may be regarded as visible and low cost, but on the other hand is still a definitive exercise of shareholder power. The Big Three are also not susceptible to merely voting according to proxy advisers' recommendations.[95] In this sense, Gordon[96] has forcefully argued that passive investment managers can be positioned as optimal gatekeepers for portfolio systematic risk, relating to issues that affect the corporate economy as a whole, such as ESG issues, rather than idiosyncratic risk associated with individual portfolio companies. Griffith also argues similarly that mutual funds' corporate governance roles lie in voting for proposals of common interest for the saver constituency.[97] In this manner, the corporate governance roles of passive investment managers can be looked at differently in terms of what they achieve within their investment management strategies and mandates, and not be judged by a narrow yardstick focused on the expression of issuer-specific engagement.

Further, divestment actions by actively-managed funds would seem contrary to issuer-specific engagement aimed at changing corporate behaviour. However, such actions directed at certain types of portfolio companies, such as those engaged in traditional energy activities like fossil fuels, is often expected and perceived as supporting the public interest, and actually called upon by the public.[98] Although divestment is not in the vein of issuer-specific engagement seeking to change corporate behaviour, it may achieve beneficiaries' objectives as well as resonate with public interest. Given that much of the socially responsible investment universe adopts exclusion strategies,[99] why should exclusion or exit be regarded as less important than issuer-specific engagement?

It is arguable that the preference for issuer-specific engagement being *the norm* for shareholder engagement must be based on an underlying narrative that seeks to enhance institutions' corporate governance roles in the belief that their monitoring benefits portfolio companies in the long-term.[100] Such a preference cannot be based on a narrative that is focused only on the investment management dimension, i.e. premised on institutions performing optimally for their ultimate savers. The narrative supporting institutions' private roles to deliver for their savers would accommodate greater freedom in designing the various means in investment management conduct for meeting beneficiaries' objectives,[101] and would unlikely be fixated upon issuer-specific engagement. In this manner, the

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[95] Gomstian (2020) and Bebchuk and Hirst (2019) differ on this observation.
[96] Jeffrey N Gordon, 'Systematic Stewardship' (ECGI Working Paper 2020), https://ecgi.global/sites/default/files/gordon_systematic_stewardship_draft_1.0._101820.pdf.
[97] Sean J Griffith, 'Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority' (2020) 98 *Texas Law Review* 983.
[98] Gary J Cundill, Palie Smart and Hugh N Wilson, 'Non-financial Shareholder Activism: A Process Model for Influencing Corporate Environmental and Social Performance' (2018) 20 *International Journal of Management Reviews* 606. Public appetite for divestment perceived as in line with social expectations, Friends of the Earth, 'Divestment and Climate', https://friendsoftheearth.uk/climate-change/divestment; 'Cambridge University to divest from fossil fuels by 2030' (The Guardian, 1 Oct 2020), https://www.theguardian.com/education/2020/oct/01/cambridge-university-divest-fossil-fuels-2030-climate#:~:text=Cambridge%20University%20is%20to%20divest,by%20students%2C%20academics%20and%20politicians, as a result of a 5-year long campaign by students, staff and politicians.
[99] Eurosif, 'SRI Study 2018', http://www.eurosif.org/sri-study-2018/.
[100] John Kay, *Other People's Money* (London: Profile Books, 2015), ch7.
[101] McNulty and Nordberg (2016); Coates IV (2015).

encouragement towards issuer-specific engagement is arguably beyond the fiduciary and contractual framing of institutions' obligations.

Indeed this may explain why policy-makers do not regard the 'normification' of issuer-specific shareholder engagement as legitimising hedge fund activism, as there is inconclusive evidence regarding the long-term performance effects upon target companies. Empirical research has found continuing benign performance effects in a sample of companies targeted by hedge funds in the UK for up to 5 years.[102] However, corporate performance has also been adversely affected by hedge fund activism.[103] Issuer-specific engagement by hedge funds does not sit easily with the policy preference for corporate 'long-termism' although such a form of engagement is possibly the most intense and well-informed type in the market for corporate influence.[104] This author has also earlier discussed a type of shareholder engagement undertaken by some mainstream investment managers as part of their focused investment management strategy.[105] This strategy targets under-performing companies in a focused manner in order to improve performance and shareholder value in due course. Such a strategy is likely less aggressive than hedge fund activism and has been lauded to be constructive for companies in the long term.[106] It is however a *type* of investment strategy and it can be questioned whether all equity strategies should be in the same mould.

Criticism Against Institutions in relation to Incentive-based Limitations to Stewardship

Next, institutions may be criticised for ineffective engagement or stewardship because they lack incentives to do so, not because their investment strategies are carefully considered and incompatible with issuer-specific engagement. A number of commentators[107] argue that institutions' incentives to engage in stewardship is determined by private factors within the chain of investment management relationships, such as how pension consultants influence pension funds as asset owners, and how such influence plays out in the delegation to asset managers, and other service providers in the investment chain.[108] Hence, institutional shareholders are incentivised to behave as 'agency capitalists'[109] rather than Hawley & Williams' 'fiduciary capitalists'.[110] In particular, short-term (such as quarterly) evaluations of asset managers by asset owners,[111] intense competition in the asset

[102] Marco Becht, Julian Franks, Jeremy Grant and Hannes Wagner, 'The Returns to Hedge Fund Activism: An International Study' (2017) 30 *The Review of Financial Studies* 2933.
[103] John C Coffee and Darius Palia, 'The Impact of Hedge Fund Activism: Evidence and Implications' (2016) 1 *Annals of Corporate Governance* 1-94.
[104] Pacces (2019).
[105] Iris H-Y Chiu, *The Foundations and Anatomy of Shareholder Activism* (Oxford: Hart 2010), ch4.
[106] Marco Becht, Julian Franks, Colin Mayer and Stefano Rossi, 'Returns to Shareholder Activism: Evidence from A Clinical Study of the Hermes UK Focus Fund' (2009) 22 *Review of Financial Studies* 3093.
[107] See below.
[108] Mila R Ivanova, 'Institutional Investors as Stewards of the Corporation: Exploring the Challenges to the Monitoring Hypothesis' (2017) 26 *Business Ethics: A European Review* 175.
[109] Ronald J Gilson and Jeffrey N Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights' (2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2206391.
[110] Hawley and Williams (2000).
[111] Simon CY Wong, 'Why Stewardship Is Proving Elusive for Institutional Investors' (2010) 7 Journal of International Banking and Financial Law 406; 'Is Institutional Investor Stewardship Still Elusive?' (2015) Butterworths Journal of Banking and Financial Law 508.

management market,[112] and chain intermediaries who tend to maximise their own interests by rent extraction,[113] are all phenomena that affect investment management behaviour. The non-assumption of effective shareholder engagement can thus be perceived to be a market failure. In this manner, it can be argued that the reason for institutions falling short of issuer-specific shareholder engagement is not due to the ambiguities and inappropriateness surrounding such normification, but rather, due to institutions' structural weaknesses.

In order to overcome institutions' lack of incentives to engage in shareholder stewardship, the Kay Review has opined that facilitating collective engagement, so that the cost of stewardship can be reduced and shared, would be important.[114] This has empirically been observed to be beneficial for institutions in a few jurisdictions who would otherwise be put off engagement due to perceived cost.[115] However, the UK Investors' Forum does not seem to be well-used. It records only 40 engagements with listed company boards to date.[116]

One of us in another work[117] critically questioned whether perceived structural weaknesses, such as investor short-termism and disincentives for long-term shareholder engagement, are due to other legitimate drivers and rationale, such as the regulatory framework for investment funds. The regulatory framework for investment funds revolves around regular and periodic reporting of performance, in order to mitigate the perceived principal-agent problems inherent in the design of pooled and collective investing. Hence pension funds, albeit being long-term in horizon, are subject to regular reporting,[118] and defined benefit funds subject to yearly actuarial review.[119] Mutual funds that are open-ended are regulated to protect investors by way of strong redemption rights,[120] hence regular valuation[121] and reporting[122] are required to support these regulatory objectives.

Regular accountability and reporting entail certain consequences. The insistence of regulatory frameworks on regular evaluation and accountability exacerbates the short-termist preferences in investment management because such evaluation and accountability,

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[112] Diane Del Guercio and Paula A Tkac, 'Star Power: The Effect of Morningstar Ratings on Mutual Fund Flow' (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=286157.

[113] *Kay Review* (2012), paras 3.9, 3.10, 4.10, 4.12; BIS, Exploring the Intermediated Shareholding Model (January 2016), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/489357/bis-16-20-intermediated-shareholding-model.pdf; Kathryn Judge, 'Intermediary Influence' (2015) 82 *University of Chicago Law Review* 573.

[114] *Kay Review* (2012), paras 7.2-7.7, p50-51.

[115] Semenova and Hassel (2019) in relation to Nordic institutions' collective engagement, Camila Yamahaki, 'Responsible Investment and the Institutional Works of Investor Associations' (2019) 9 *Journal of Sustainable Finance & Investment* 162 on collective shareholder engagement for socially responsible causes; Craig Doidge, Alexander Dyck, Hamed Mahmudi, and Aazam Virani, 'Collective Action and Governance Activism' (2019) *Review of Finance* 893 on collective engagement by Canadian institutions.

[116] https://www.investorforum.org.uk/activities/collective-engagement/case-studies/; also Davies (2020).

[117] Barker and Chiu (2017), ch2.

[118] Section 244, Pensions Act 2004.

[119] Section 224, ibid.

[120] Right to request redemption for UCITs investors, Art 84, UCITs Directive 2009/65/EU; FCA Handbook COLL 6.2.

[121] FCA Handbook COLL 6.3.

[122] FCA Handbook, COLL 4.5 for annual and half-yearly reporting.

pursuant to the need of being standardised and objective, is necessarily based on market price, therefore reinforcing a narrow-minded attention to marketised values.[123] Regular reporting also forces funds to regularly evaluate their performance, and funds may be under pressure to boost such performance from one reporting interval to the next. For open-ended investment schemes, past performance may also be crucial to attracting new inflows. The regulatory regime for regular reporting has played no small part in encouraging funds and their asset managers to pursue short-termist investment performance.[124] Guyatt argues that investor myopia is entrenched as it is seen as a defensible practice in light of regulatory requirements. Funds and asset managers are reluctant to move away from the norm and adopt 'outlier' modes of investment thinking that do not strictly conform to the dominant practice of short-termist evaluation.[125]

In this manner, institutions may be disincentivised from issuer-specific shareholder engagement because of competing legal imperatives that pull in different directions. The matter may not be simply framed as a market failure on institutions' part. It can be argued that resolving the 'normification' of issuer-specific shareholder engagement requires a wider institutional apparatus, addressing the competing regulatory demands placed on institutional investors and the contest between the private and public expectations of what shareholder engagement is for.

Fixation upon issuer-specific engagement has resulted in an unproductive cycle of criticisms against institutions that are narrowly focused. It is however arguable that policy-makers are finally 'out of the woods' as steps have been taken to articulate more clearly the desired purposes of investment management in law and soft law. These developments would enrich the private investment management dimension by adding public interest impetus for governing investment managers. In this light a more comprehensive rubric of policy measures is being developed, away from the singular fixation on issuer-specific shareholder engagement.

The UK Stewardship Code 2020, adopting an apply-and-explain modus for voluntary signatories, contains goal-based articulations in relation to long-termism, market-wide stability and ESG objectives. It is poised to reset the governance of investment management conduct with purpose-based steering.[126] A clearer imperative is also found in the EU's

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[123] Maria Maher and Thomas Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' (OECD Working Paper 1999).

[124] Empirical research on short-termism in investment management, Brian J Bushee, 'Do Institutional Investors Prefer Near-Term Earnings Over Long-Run Value?' (2001) 18 *Contemporary Accounting Research* 207–246; A Manconi, M Massa and A Yasuda, ' The Role of Institutional Investors in Propagating The Crisis of 2007–2008' (2012) 104 *Journal of Financial Economics* 491–518; X Yan and Z Zhang, ' Institutional Investors and Equity Returns: Are Short-Term Institutions Better Informed?' (2009) 22 *Review of Financial Studies* 893–924. Opposite view: Jeffrey L Callen and Xiaohua Fang, 'Institutional Investor Stability and Crash Risk: Monitoring Versus Short-Termism?' (2013) 37 *Journal of Banking and Finance* 3047; Mark J Roe, 'Corporate Short-Termism—In the Boardroom and in the Courtroom' (2013) 68 *Business Lawyer* 977.

[125] Danyelle Guyatt, 'Meeting Objectives and Resisting Conventions: A Focus on Institutional Investors and Long-Term Responsible Investing' (2005) 5 *Corporate Governance: The International Journal of Business in Society* 139.

[126] Section B.

sustainable finance regulations, as sustainability disclosure and stewardship obligations are now introduced.[127]

The next Section proceeds to discuss the UK Stewardship Code 2020, in order to analyse the beginnings of purpose-based articulation for investment management conduct, as well as to offer suggestions as to how institutions should respond to the initiative.

B. Stewardship Code 2020

The UK Stewardship Code was revised in 2020 from its 2012 version, in light of the Kingman Review's critique[128] against the lack of demonstration of 'outcomes' by signatories adopting the Code. The Stewardship Code 2012[129] contained seven principles which all revolved around issuer-specific shareholder engagement and forms of engagement that were encouraged, ie having an engagement policy (Principle 1), informal dialogue with portfolio companies (Principle 3), escalation of engagement (Principle 4), collective engagement (Principle 5), and voting (Principle 6). Principles 2 and 7 dealt with institutions having a conflict of interest management policy and accountability to their beneficiaries respectively.

The 2012 Code was for voluntary adoption and signatories needed to 'comply or explain'. Where signatories deviated from any of the Principles, an explanation for such decision had to be provided. Many asset managers signed up to the Code as being a signatory could be attractive to asset owners looking to delegate portfolio management. However, over the years, the FRC found that signatories made boilerplate disclosures of policies and explanations,[130] and the 'stewardship' label could be eroded in terms of quality for market confidence. In 2016, the FRC introduced a tiering regime in order to rank the quality of signatories' disclosure.[131] Nevertheless, the quality signals sent by the FRC were entirely based on what signatories *said* about their stewardship activities. These were not further mapped against what they *did,* as stewardship reporting was not required to be assured. Hence both the FCA and the market could not tell for certain what has been *achieved* in terms of improvement or transformation of corporate behaviour.

The 2020 Stewardship Code is an attempt to address the limitations of the previous Code by introducing a set of 12 new principles for asset owners and managers, and a set of 6 new principles for service providers. The Code also adopts a new 'apply and explain' regime for signatories. An 'apply and explain' regime may transcend the limitations of disclosure under a 'comply or explain' regime.[132] In the latter regime, 'explain' is regarded as the antithesis to 'comply'. Hence, institutions who regard themselves as broadly 'compliant' would likely say little as the narrative in 'explain' is treated as an alternative mode of action. 'Comply or explain' based disclosure requirements therefore do not encourage knowledge-building

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[127] Section C.
[128] Kingman Review (2019), p10.
[129] Iris H-Y Chiu, 'Institutional shareholders as Stewards: Towards a New Conception of Corporate Governance?' (2012) 6 *Brooklyn Journal of Financial, Corporate and Commercial Law* 387; Chiu (2013).
[130] FRC, 'Tiering of 2012 UK Stewardship Code Signatories', https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements.
[131] Ibid.
[132] Parmi Natesan, 'The Evolution and Significance of the "Apply and Explain" Regime in King IV' (2020) 11 *Journal of Global Responsibility* 135.

about what institutions *do* as a whole. In contrast, 'apply and explain' is premised on the basis that application of the Code's principles is mandatory for signatories, and 'explain' is meant to flesh out how the application takes place. 'Explain' is therefore no longer optional or is regarded as 'fringe' action, but is expected and purposed towards knowledge-building of what institutions do. In this manner, the FRC's adoption of 'apply and explain' is a direct response to the Kingman Review's critique that outcomes of stewardship remained shrouded in mystery.

Asplund[133] also argues that the 'apply and explain' approach, which was first adopted for the South African Corporate Governance Code (King Code IV), is rooted in wider stakeholder and social interest in the governance of listed companies in South Africa. The Code in particular adopts the goal of long-term sustainability for the South African corporate economy, and in this manner, 'apply and explain' is meant as a form of information accountability more broadly to stakeholders and wider civil society, so that all can scrutinise how listed companies are governed and managed. It is arguable that this foundation for the 'apply and explain' nature of the King IV Code can apply to the UK Stewardship Code 2020. This is because the Code has now, as argued below, articulated more clearly goals and purposes for institutions that are wider-facing in nature, beyond the private universe of their investment management chains and accountability. Hence, the 'explain' aspect of adherence to the Code can be regarded as knowledge-building for the benefit of policy-makers, regulators, interested stakeholders and civil society who may scrutinise the modus and arrangements of investment management in order to interrogate their social effects. Broad-based interest in global asset management is likely to take off as civil society increasingly recognises the phenomenal amounts of sovereign, household and investment assets that are managed by global asset managers.[134]

The FRC, in its first survey[135] of asset owner and manager signatories' reports under the 'apply and explain' approach, finds encouraging signs of disclosure by signatories who understand that the 'explain' approach requires them to shed light on what they do. The survey also extracts good explanatory practices as examples to encourage other signatories.

This paper argues that there are four key aspects to transformative behaviour for institutions provided in the Code. These aspects reflect the trend of increased governance endeavour on the part of policy-makers *vis a vis* institutions' investment management conduct, usually thought to be a discretionary universe subject to private contractual design and governed only by the private law of investment management. Even if the Code is regarded as soft law and not in the same manner as legislative rules, the Code signals an emerging governance initiative. This initiative should also be understood against a broader context of developments in increased *regulatory* governance of investment management conduct introduced in the EU and UK. These regulatory initiatives have resulted from the

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[133] Aino Asplund, 'Lost in Accountability. 'Comply or Explain', 'Apply or Explain' and 'Apply and Explain' in a Test: The Barriers to Company Benefit?' (2019) 13 *International and Comparative Corporate Law Journal* 111.
[134] PwC, 'Global Assets under Management set to rise to $145.4 trillion by 2025' (2020), https://www.pwc.com/ng/en/press-room/global-assets-under-management-set-to-rise.html.
[135] FRC, *The UK Stewardship Code Review of Early Reporting* (Sep 2020), https://www.frc.org.uk/getattachment/975354b4-6056-43e7-aa1f-c76693e1c686/The-UK-Stewardship-Cod-Review-of-Early-Reporting.pdf.

Financial Conduct Authority's Asset Management Market Study[136] and the recent developments in the EU's sustainable finance regulations.[137]

The four key aspects are:

(a) Articulation of wider public interest purposes of stewardship (Principles 1, 2, 4, 6 and 7) in the Code;
(b) Moving away from exclusively normifying shareholder engagement as equivalent to stewardship but adopting a wider understanding of investment management conduct and strategies in achieving the purposes in (a) (Principles 2, 3, 5 and 12);
(c) Continuing support for shareholder engagement but requiring disclosure of what such engagement seeks to achieve and its efficacy (Principles 9, 10, 11, 12, also 5 more broadly); and
(d) Cognisance and reporting of investment chain monitoring and activities, possibly for knowledge-building in relation to agency problems (Principle 8, Principles 1-6 for service providers).

(a) *Articulation of wider public interest purposes of stewardship (Principles 1, 2, 4, 6 and 7)*

The Code now articulates a number of purpose-based goals for stewardship more clearly than under the previous Code. This goes an extent towards addressing the previous critiques levied against stewardship. Stewardship processes or activities can now be evaluated against particular goals, which have been debatable and implicit surrounding the previous Codes. The move to articulating purposes and goals for investment management may be regarded as a radical 'governance' measure. The regulation of investment management has primarily been focused on the intermediary-client relationship, in order to mitigate principal-agent problems,[138] in the regimes in the US[139] and UK/EU.[140] Regulation is focused on the pre-sale context, in terms of advice[141] and product disclosure[142] but the universe of post-sale investment management conduct and outcomes is largely left to the working of private market forces[143] subject to certain investor protection rights which relate

[136] See note 15.
[137] See note 17.
[138] Alessio M Pacces, "Financial Intermediation in the Securities Markets Law and Economics of the Conduct of Business Regulation" (2000) 20 *International Rev of Law and Economics* 479.
[139] Deborah DeMott, 'Fiduciary Contours: Perspectives on Mutual Funds and Private Funds' in Birdthistle and Morley (eds), *Research Handbook* (2019), ch3.
[140] private law of fiduciary and contractual management, Lodewjik van Setten, *The Law of Institutional Investment Management* (Oxford: Oxford University Press 2009), para 1.21, 3.15-3.69, 4.92 and regulations in UCITs Directive 2009/65/EU and Markets in Financial Instruments Directive 2014/65/EU (MiFID 2014).
[141] Art 25, MiFID 2014, on the suitability of advice, UK FCA Handbook COBS 9 and 9A. See Paolo Giudici, 'Independent Financial Advice' in Danny Busch and Guido Ferranini (eds), *Regulation of the EU Financial Markets: MiFID II and MiFIR* (Oxford: OUP 2017), ch6.
[142] Pre-sale disclosure of prospectuses and short-form key information sheets for mutual funds, UCITs Directive Art 68, 69 and Commission Regulation 583/2010.
[143] The universe of investment management strategies, like active, passive, hybrid forms, alternative strategies etc. However, specific EU funds are regulated more specifically for portfolio composition, prudential and investor protection, i.e. long-term investment funds, venture capital funds or social entrepreneurship funds marketed across the Single Market, Regulation (EU) No 346/2013; Regulation (EU) 2015/760; Regulation (EU) No 345/2013.

more to exit than voice.[144] In this manner, articulating 'for what' investment management is for can be regarded as radical and potentially transformative.

The Code's purpose-based articulations complement recent regulatory reforms. In the FCA's recent reforms for pension funds, whether defined benefit or contribution schemes, funds need to set out investment objectives with their asset managers.[145] This may be regarded partly as a response to principal-agent problems, as expert asset managers and pension consultants can be seen to wield significant influence over less expert pension scheme trustees and governance boards.[146] However, the regulatory mandate to specify and clarify purpose also engages with social accountability more widely for the benefit of beneficiaries, and allows regulators and policy-makers to scrutinise how funds conceive of their purposes and what these are. This is especially relevant in light of policy-makers' interest in mobilising the private sector, particularly private assets under management, towards purposes that are aligned with public interest, such as sustainability goals, [147] and social development, for example in impact investing.[148]

Principle 1 now defines stewardship as delivering long-term value for clients and beneficiaries and also sustainable benefits for the economy, society and environment. This is inherited from the previous Code that articulates long-termism as a preferred goal, but being nested in a 'comply or explain' regime, it is arguable that long-termism could be regarded as a strong but not binding steer. With the 'apply and explain' regime, the goal of long-termism is not optional. But as asset owners and managers can elect to be signatories, those who do not identify with long-termism as such could choose not to be signatories. Mainstream institutions, especially with pension and mutual fund portfolios, may be faced with demand-side pressure to opt in, which means subscribing to the investment purpose of long-termism.

In an 'apply and explain' regime, mainstream institutions opting into the Code would have to explain how they manage investments for long-term value creation, as opposed to short-term performance. In this sense, it is queried if active management strategies would be reshaped by the long-termism goal and perhaps their churning tendencies may be

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[144] John Morley, 'The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation' (2013-14) 123 *Yale Law Journal* 1228.

[145] The Statement of Investment Principles for Occupational Pensions, s2, The Occupational Pension Schemes (Investment) Regulations 2005, also the FCA's Policy Statement for other non trust-based occupational schemes, FCA Independent Governance Committees: Extension of Remit (Sep 2019), https://www.fca.org.uk/publication/policy/ps19-30.pdf, ch2.

[146] FCA, *Asset Management Market Study Final Report* (2017), https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf, para 4.23.

[147] Nicholas Dorn, 'Capital Cohabitation: EU Capital Markets Union as Public and Private Co-regulation' (2019) 11 *Capital Markets Law Journal* 84 on the EU's endeavour to marry private finance with public interest goals. Section C discusses sustainable finance reforms.

[148] Alma Pekmezovic, 'The New Framework for Financing the 2030 Agenda for Sustainable Development and the SDGs' in Julia Walker, Alma Pekmezovic, and Gordon Walker (eds), *Sustainable Development Goals: Harnessing Business to Achieve the SDGs through Finance, Technology, and Law Reform* (Chicester: John Wiley & Sons 2019), ch5; Martin Blessing and Tom Naratil, 'The Contribution of the International Private Sector to a More Sustainable Future' in Walker et al (eds, 2019), above, ch6; David Wood , Ben Thornley & Katie Grace, 'Institutional Impact Investing: Practice and Policy' (2013) 3 *Journal of Sustainable Finance & Investment* 75.

moderated. The long-termism purpose articulated here is arguably inherently biased against trading strategies, but these are neither necessarily inefficient or mispriced. Securities mispricing is due to behavioural sub-optimalities,[149] information inefficiencies and structural conditions of markets that promote these. For example, allowing high frequency traders' servers to be co-located with stock exchange servers[150] brings about a structural advantage for traders in exploiting a short window of information inefficiency. Trading itself is merely an information signal to the market that allows price to be adjusted. At the macro level, one needs to ask whether it is trading frequencies and efficiencies that have contributed more to price bubbles[151] or whether other drivers such as central bank liquidity tools are more significant for such phenomena.[152] It remains uncertain if investment intermediaries explaining their long-termist strategies need to show moderation of trading behaviour, or otherwise. Nevertheless, the opportunity to 'explain' can afford investment intermediaries the space to account for broader structural factors affecting trading behaviour. Signatory reporting is however not assured and continues to be susceptible of self-selectivity, so it remains highly uncertain how stewardship reports would shed precise light on investment managers' interpretation of 'long-termism' and the proxy indicators for adhering to this goal.

Principle 1 can also be regarded as encouraging investment value creation to be holistic and aligned with sustainable benefits for the economy and society, and the environment as well. The outward-facing purposes for investment management are not only found in this Principle but continues through Principles 4 and 7 where these purposes are more clearly defined. Principle 4 relates to institutions' roles in promoting a well-functioning financial system and not contributing to market-wide systemic risk. Principle 7 relates to integrating material ESG issues and climate change targets.

Systemic risk in the financial system is defined in relation to the preservation of the functioning of the financial system in a manner that does not result in domino-type failures of connected institutions or disruption to key services that may be unsubstitutable.[153] Does

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[149] Robert Shiller, *Irrational Exuberance* (3rd ed, Princeton University Press, 2016), chs 7-9.

[150] Michael Aitken, Douglas Cumming and Feng Zhan, 'Trade Size, High Frequency Trading, and Co-Location Around the World' (2014), https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.1026.159&rep=rep1&type=pdf; Alex Frino, Vito Mollica and Robert I Webb, 'The Impact of Co-Location of Securities Exchanges' and Traders' Computer Servers on Market Liquidity' (2014) 34 *Journal of Futures Markets* 20 on impact on market liquidity and efficiency.

[151] There is some evidence, Joseph Chen, Harrison Hong and Jeremy C. Stein, 'Forecasting Crashes: Trading Volume, Past Returns and Conditional Skewness in Stock Prices' (NBER Working Paper 2000), https://www.nber.org/system/files/working_papers/w7687/w7687.pdf but only amongst other explanations; Oliver Blanchard and Mark Watson, 'Bubbles, Rational Expectations and Financial Markets' (NBER Working Paper 1982), https://www.researchgate.net/publication/5184534_Bubbles_Rational_Expectations_and_Financial_Markets; Charles Noussair, Stephane Robin and Bernard Ruffieux, 'Price Bubbles in Laboratory Asset Markets with Constant Fundamental Values' (2001) 4 *Experimental Economics* 87.

[152] John H Huston and Roger W Spencer, 'Quantitative Easing and Asset Bubbles' (2018) 25 *Applied Economics Letters* 369.

[153] Miquel Dijkman, 'A Framework for Assessing Systemic Risk' (2010) *World Bank Policy Research Working Paper*, http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-5282; Franklin Allen, Ana Babus and Elena Carletti, 'Financial Connections and Systemic Risk' (2010) NBER Working Paper,

Principle 4 mean that institutions should identify and manage these risks, ensuring that they do not contribute to these? In this manner, institutions should institute systems that mitigate trading disruptions for clients and markets,[154] or counterparty risk.[155] There is an existing regulatory requirement to mitigate the possibility of systemic risk creation by investment intermediaries engaged in high frequency algorithmic trading.[156] This MiFID requirement ensures that where algorithmic high frequency traders become key suppliers of market liquidity in particular financial instruments, they continue to carry out that role under all market conditions and do not unexpectedly withdraw market liquidity which may destabilise market prices. Is the application of Principle 4 envisaged more widely to all investment intermediaries to be aware of and mitigate systemic risks?

The FRC seems to be unclear what Principle 4 imports. It has raised an example of good practice in its survey, focusing on thematic risk in the corporate economy.[157] The FRC's example relates to issue-specific or systematic risk, which is addressed by Principles 9-11 as discussed below. This is arguably not the same as 'market-wide' systemic risk provided in Principle 4. The disconnect between the FRC and 'market stability' goals may be understandable as such a goal can be seen as strictly within the remit of the market and prudential regulators.[158] Nevertheless, more clarity is required in relation to the implementation of Principle 4, arguably in relation to institutions' risks in trading strategies, leverage employment if any, settlement risk, market abuse risk etc. Institutions should shed light on how they fulfil their responsibilities as citizens of the financial system and contribute to its healthy functioning.

Principle 7 relates to investment management conduct that integrates material ESG matters and climate change. There is a tendency on the FRC's part to see such integration as primarily demonstrated by shareholder engagement. This may be because ESG engagement is arguably consistent with the Shareholders' Rights Directive provisions. Indeed, signatory reporting of engagement with these concerns is regarded well in the FRC survey, relating to purpose-based stewardship in Principle 1, or engagement activities in Principles 9-11 (discussed further below). One point that may be made is that Principle 7 refers to material ESG matters, and therefore does not break new ground in terms of institutions' perception of the needs for fiduciary investment management. The call to integrate 'material ESG' does not compel institutions to demand ESG performance beyond that connected to financial value creation (albeit in the long term). However, it is arguable that the EU sustainable finance regulations, discussed in Section C, demand more of institutions in their investment management conduct.

Finally, Principle 6 articulates the need for signatories to take into account the needs of clients and beneficiaries as a whole, and make appropriate communication with them as to

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http://www.nber.org/papers/w16177; Matthew Beville, 'Financial Pollution: Systemic Risk and Market Stability' (2010) 36 *Florida State University Law Review* 245.

[154] Such as limit or stop-loss orders offered by brokerages to protect investors from unexpected financial losses, https://www.hl.co.uk/shares/share-dealing/limits.

[155] Mitigating defaults where leverage is used, eg by collateral management.

[156] Art 17, MiFID 2014.

[157] FRC, *The UK Stewardship Code Review of Early Reporting* (2020), p21.

[158] Remit of the Financial Conduct Authority, see objectives in sections 1B to 1E, Financial Services and Markets Act 2000.

how stewardship meets their needs. This Principle is an extension from the previous Code which requires accountability to beneficiaries on stewardship activities. However the Principle is different as it goes beyond *ex post* accountability, to require that asset managers take *ex ante* steps to ascertain the wishes of asset owners and beneficiaries and to consider how these may be translated into investment management conduct. We regard it as a purpose-based articulation for investment management conduct to be carried out with the consciousness of investment managers' representative capacity. In this manner, institutions need to explain how this representative capacity is implemented. The FRC has reported generally weak reporting by signatories, as signatories are not comprehensive or consistent in terms of reporting their investor base or what is communicated to investors. Signatories' reporting also tends to focus on processes carried out, such as surveys of client wishes, but the FRC seems to express expectations for explanation as to how institutions use this information and conceive of their representative capacity.

Arguably, Principle 6 goes further than the legal framing of rights within the investment chain. Beneficiaries are usually unable to exercise their economic interest rights due to the no-look through rule that accords the legal registered holder of shares,[159] usually a custodian, with corporate governance rights. It is possible for asset owners to instruct and steer asset managers, who should ensure that such communications are conveyed to the custodian, to exercise corporate governance rights. However structural impediments and incentive weaknesses exist in the investment chain.[160] Critique has been made against the dilutive effects of the investment chain upon institutions' engagement with their corporate governance rights, prompting research into potential reform to English law on intermediated securities.[161] If beneficiaries were empowered to feed their voice into the corporate governance processes, the corporate economy could be more effectively subject to social voice and pressure.[162] In this manner, Principle 6 does not merely deal with mitigation of principal-agent problems in the investment chain, although that is an immediate consequence. Principle 6 seems more purpose-based, incorporating a stronger social basis for investment management conduct, and potentially having a radical impact on the principal-agent problems affecting voiceless beneficiaries in particular. In this manner, the FRC should require institutions to report more clearly on how they ascertain beneficiaries' and asset owners' wishes and perceptions, in order to map out a balanced representative strategy.

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[159] Eva Micheler, "Intermediated Securities from the Perspective of Investors: Problems, Quick Fixes and Long-term Solutions" in Louise Gullifer and Jennifer Payne (eds), *Intermediation and Beyond* (Oxford,: Hart Publishing, 2019), ch12, 237–258; Law Commission, *Intermediated Securities: Who Owns Your Shares? A Scoping Paper* (Nov 2020), https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2020/11/Law-Commission-Intermediated-Securities-Scoping-Paper-1.pdf; para 2.18-2.34 on challenges for asset owners in pooled funds to instruct their wishes. For benefits of the intermediated shareholder system, para 2.91, ibid.

[160] Ewan McGaughey, 'Does Corporate Governance Exclude the Ultimate Investor?' (2016) 16(1) *Journal of Corporate Law Studies* 221. See para 1.33, 3.17-3.54, 3.58, Law Commission (2020).

[161] Law Commission (2020), ibid. The Law Commission does not recommend structurally changing intermediated structures to facilitate direct beneficiary voting, para 1.30. Commentators arguing for legal facilitation of beneficiaries to vote, Christoph van der Elst and Anne LaFarre, 'Blockchain and Smart Contracting for the Shareholder Community' (2019) 20 *European Business Organisations and Law Review* 111.

[162] Law Commission (2020), paras 3.6, 3.7; 3.83-3.90.

(b) *Moving away from exclusively normifying shareholder engagement as equivalent to stewardship but adopting a wider understanding of investment management conduct and strategies in achieving the purposes in (a) (Principles 2, 3, 5 and 12)*

The Code may be interpreted as moving away from exclusively 'normifying' issuer-specific shareholder engagement. Engagement activities is now articulated in Principles 9-11, while the rest of the Code adopts a wider understanding of stewardship conduct. Principle 2, which requires institutions to ensure that their governance, resources and incentives support stewardship, can broadly be interpreted to mean that institutions should disclose how their strategies meet beneficiary needs and how such strategies are resourced and capabilised within institutions' governance and incentive structures.

In this manner, asset owners can discuss asset allocation and outsourcing strategies as meeting stewardship demands, and asset managers can discuss their choice of strategies and how these meet asset owners' and beneficiaries' needs. A wider range of investment management conduct and strategies can therefore be acceptable forms of 'stewardship' beyond the hitherto 'normification' of issuer-specific shareholder engagement.[163] Indeed the FRC's survey even highlights institutions' disclosures of their own governance initiatives, such as improving diversity in their own outfits, as being connected with stewardship. This acceptance of a wide range of 'stewardship' activities is reinforced in Principle 12 which requires signatories to exercise their rights and responsibilities effectively. These rights and responsibilities are recognised as different across different asset classes, including fixed income, equities and possibly other asset classes.

Following this new broad perception of what constitutes stewardship, Principle 5 requires institutions to regularly review their policies, assure their processes and assess the effectiveness of their activities. This is buttressed by the more specific Principle 3 that deals with effective management of conflicts of interest in order not to compromise beneficiaries' interests (inherited from the previous Code). The breadth of Principle 5 is not presumptive as to what manners of conduct count as stewardship, as long as adequate explanation is made of them in Principle 2. The FRC noted in its survey that signatories tended to discuss engagement process reviews. This is possibly a path dependent response carried over from adherence to the previous Code. Signatories have not reported satisfactorily against Principle 5 as yet, and it may take time for signatories to realise the import of the broader approach in order to report a wider range of review, assurance and evaluation measures for a broader spectrum of investment strategies and conduct accommodated under Principle 2.

(c) *Continuing support for shareholder engagement but requiring disclosure of what such engagement seeks to achieve and its efficacy (Principles 9, 10, 11, 12, also 5 more broadly)*

Principles 9, 10 and 11 arguably inherit the previous Code's provisions on the forms of shareholder engagement regarded as desirable practice. It may be argued that in light of the discussion in (b), Principle 9 has adopted a wider conception of engagement that need not be issuer-specific. Principle 9 envisages institutions may be issues-focused rather than issuer-specific, and that engagement can be delegated. This is also reflected in Principle 11

[163] Davies (2020).

that deals with escalation of engagement activities. Principle 10 also accommodates this wider conception of engagement by articulating that collaborative engagement, where necessary, could be issuer-specific or could be thematic in nature.

In this manner, it is arguable that Principles 9-11 would likely negate many previous critiques focused on non issuer-specific engagement. However, what has changed with Principles 9-11 from the previous Code is that disclosure is now required not only of policies, but of implementation, processes and outcomes achieved. Effective reporting in this area can contribute to knowledge-building as to whether and to what extent shareholder engagement should itself be normified.

(d) *Cognisance and reporting of investment chain monitoring and activities, possibly for knowledge-building in relation to agency problems (Principle 3, 8, Principles 1-6 for service providers)*

Agency problems exist between the different links in the investment chain. It has been posited that conflicts of interest exist between asset managers and their investors. The former may maintain business relationships with portfolio companies, and this could affect asset managers' exercise of corporate governance rights.[164] Hence the previous Code and the 2020 Code require the effective management of conflicts of interest.[165] This remains a weak area of 'explanation' for institutions as noted in the FRC's survey.[166] Agency problems in investment management conduct can be seen as market failures, and the FCA has intervened into market failures in order to mitigate these problems. For example, the FCA's Asset Management Market Study found that asset owners were not sufficiently critical of the performance delivered by asset managers and their fees and charges.[167] This has now resulted in the imposition of a regulatory duty for asset owners to assess whether their delegation produces 'value for money'[168] for the ultimate beneficiaries, therefore addressing the agency problem between asset owners and managers.

The introduction of precise regulatory duties to correct market failures and agency problems is the backdrop to the soft law in the Code. Provisions in the Stewardship Code 2020 now address more generally the monitoring of service providers (Principle 8) and how service providers should ensure that they effectively support their clients' stewardship (Principles 1, 2, 5 and 6 for service providers). Disclosure can be treated as part of knowledge-building as to the extent of agency problems that may exist in the investment chain. Asset owners and managers should also scrutinise how service providers manage conflicts of interest (Principle 3) in order not to compromise their support of effective stewardship by institutions.

It is noted that although a key service provider, the proxy adviser industry, came under the spotlight for regulatory consideration in light of the potential power they wield in

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[164] Bebchuk and Hirst (2019); earlier evidence: Jennifer S Taub, 'Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights' (2009) 34 *Journal of Corporation Law* 102.
[165] Principle 3, Stewardship Code 2020.
[166] FRC, *The UK Stewardship Code Review of Early Reporting* (2020), p17.
[167] FCA (2017), paras 1.10-1.16, 6.8.
[168] FCA Handbook COLL 4.5.7, 6.6.20-22; 8.3.5A, 8.5.16-19.

influencing institutions in their corporate governance roles,[169] it was ultimately agreed in the EU/UK that they should be subject to self-regulation.[170] The Shareholders' Rights Directive 2017 introduced mandatory disclosure obligations for proxy advisers in order to secure market and public scrutiny of their roles and influence,[171] but arguably the standards of conduct remain self-regulatory.[172]

The FRC's survey surprisingly did not include service providers, which seems to indicate that focus is placed much more on asset owners and managers. Further, it may be perceived that the Asset Management Market Study has yielded comprehensive findings, so regulatory responses are targeted at precise agency problems and market failures.

It is arguable that the UK Stewardship Code 2020, despite being soft law, has made significant strides in articulating purpose for stewardship and clarifying a broader range of investment management strategies and activities that can be scrutinised for stewardship purposes. Being a measure in soft law and relying on a meta-governance framework, the Code guides investment firms towards internalisation of its purpose-based articulations, but implementation is a private matter for contractual mandates. This remains necessary as investment allocation is a market-based matter and not under the command of regulatory fiat. Bilateral monitoring by contracting parties would be the 'supervisory' framework and it remains uncertain if the performance of signatories would be carefully scrutinised by regulators. The FRC relies on unassured reporting[173] by signatories and it is uncertain to what extent the FRC would be able to tell if signatories 'walk the talk'. The FRC's surveys, if regularly carried out, may send signals of moral suasion for best practice, but the channels for change in practice or behaviour remain private and their effectiveness indetermined.

However, it may also be argued that soft law can often be experimental and transitory,[174] providing further information and empirical bases for governance and regulatory development. A new regulator, the Accounting and Governance Reporting Authority,[175] is to replace the FRC and poised to be a fully-fledged regulatory body with significant enforcement powers. Hence, a new 'supervisory' approach may come about for monitoring Code signatories. Further, the FRC has been coordinating with the investment firm regulator in the UK, the FCA, and it cannot be ruled out that regulatory governance may be introduced to address issues of public interest if market discipline continues to leave gaps. The coordination between the FRC and FCA[176] in relation to investment management

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[169] Michael C Schouten, 'Do Institutional Investors Follow Proxy Advice Blindly?' (2012), http://ssrn.com/abstract=1978343; Stephen J Choi, Jill E Fisch and Marcel Kahan, 'The Power of Proxy Advisors: Myth or Reality?' (2010) 59 *Emory Law Journal* 869.

[170] ESMA, *Final Report on The Proxy Advisor Industry* (19 Feb 2013); ESMA, *Report: Follow-up on the Development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis* (2015).

[171] Art 3j, Shareholders' Rights Directive 2017.

[172] UK Proxy Advisers (Shareholders' Rights Directive) Regulations 2019. Although the FCA is empowered to enforce against non-disclosure, the exact standards of conduct are for industry best practice.

[173] Reddy (2020).

[174] Gralf-Peter Calliess & Moritz Renner, 'From Soft Law to Hard Code: The Juridification of Global Governance' (2009) 22 Ratio Juris 260.

[175] BEIS, *Restoring Trust In Audit and Corporate Governance* (March 2021), ch10.

[176] Work coordinated between the FRC and FCA, *Building a Regulatory Framework for Effective Stewardship* (Discussion Paper Jan 2019), https://www.fca.org.uk/publication/discussion/dp19-01.pdf and *Feedback*

regulation and the implementation of the Stewardship Code 2020 may signal trends towards regulatory governance of investment management conduct where it matters- not only to resolve agency problems but also to serve public interest goals. The next Section turns to examine if firmer legalisation has been achieved by the EU sustainable finance regulations and its purpose-based articulation for investment management entities to heed sustainability.

C. The Implications of the Sustainable Finance Reforms in the EU and UK

The push for sustainable finance regulatory reforms in the EU and UK has been pronounced in recent years. Former Bank of England Governor Mark Carney played a significant role as chair of the Financial Stability Board during his term to highlight the importance of counting climate risk in financial institutions' assets.[177] There has hitherto been a neglected practice of counting risks such as the obsolescence of physical assets affected by net zero carbon policies, transition risks and costs, as well as stranded assets.[178] With the launch of the Financial Stability Board's Taskforce for Climate-related Financial Disclosures in 2017,[179] and the adoption of the UN Sustainable Development Goals in 2015,[180] policy-makers in the EU and UK have begun to address regulatory risk management by financial institutions of climate and sustainability risks, as well as the role of private finance in addressing sustainability goals and objectives. The EU has commissioned a sustainable finance strategy[181] since 2018 in order to inquire into the mobilisation of private sector finance for sustainable goals and purposes, as the investment sector wields significant influence, with global assets under management estimated to be at USD$145 trillion by 2025.[182] Besides policy-makers' initiatives, market appetite and industry initiatives have also blossomed. The United Nations Environment Programme Finance Institute has for example led the way in facilitating legal clarity and discourse in order to encourage the private sector to engage in sustainable investments.[183]

In relation to investment managers, it is arguable that the EU's reform strategy is ambitious and has the potential to re-orient practices in investment management. The EU's sustainable finance strategy has brought about reforms in capital markets regulation, particularly in mainstream investment management. These provide an early indication of regulatory 'normification' for the conduct of investment management, arguably aligned

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Statement (Oct 2019), https://www.fca.org.uk/publications/feedback-statements/fs19-7-building-regulatory-framework-effective-stewardship.

[177] Mark Carney, 'TCFD: strengthening the foundations of sustainable finance' (8 Oct 2019), https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/tcfd-strengthening-the-foundations-of-sustainable-finance-speech-by-mark-carney.pdf?la=en&hash=DAF.

[178] Jakob Thomä & Hugues Chenet, 'Transition Risks and Market Failure: A Theoretical Discourse on Why Financial Models And Economic Agents May Misprice Risk Related to the Transition to a Low-Carbon Economy' (2017) 7 Journal of Sustainable Finance & Investment 82.

[179] https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf.

[180] See EU's and UK's commitments to the UN SDGs, note 18.

[181] HLEG, *Financing a Sustainable European Economy* (2018), https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf.

[182] PwC, *Asset & Wealth Management Revolution: Embracing Exponential Change* (2017), https://www.pwc.com/ng/en/press-room/global-assets-under-management-set-to-rise.html.

[183] UNEPFI, PRI and the Generation Foundation, *A Legal Framework for Impact* (2021), https://www.unepfi.org/legal-framework-for-impact/.

with public interest concerns in sustainability. Such regulatory normification takes a step further than merely clarifying in general law the freedoms for the investment management industry to engage in sustainable objectives and investments. However, such regulatory 'normification' cannot go too far in micro-managing how investment management is conducted, and the accountability of investment managers continues to be framed within a private framework of legal duties and obligations. Regulatory 'normification' in the EU for investment management and its relationship with sustainable goals is therefore framed in a complex matrix of mandatory and market-based governance. On the other hand, the UK's approach is more firmly based on market-based governance, relying on market forces and choices to be aligned with sustainability goals. This approach at first glance may seem not to be too disruptive for investment management practices. However, coupled with the purpose-based steers in the Stewardship Code 2020, investment managers who are Code signatories may be nudged towards incrementally changing their practices in due course.

EU Sustainable Finance Reforms

The EU Sustainable Disclosure Regulation 2019 now compels all financial markets participants who engage in portfolio or fund management (whether as mainstream pension or collective investment schemes, or alternative investments funds)[184] to integrate sustainability risks in their investment decision-making.[185] This also includes financial services providers who provide investment-based products as part of an insurance product. Such 'integration' relates to both conventional and sustainable portfolios or funds.

Further, if funds wish to market sustainably-labelled financial products,[186] they have to ascertain and report on sustainable achievements as meeting doubly material criteria. This means that sustainably-labelled funds should achieve sustainable performance as such, apart from such achievement being related to financial performance. The EU has begun to provide outcomes standards for environmentally sustainable financial products[187] and this will in time extend to socially sustainable products.[188] The sustainable label for investment products is an attempt to mobilise a market for investment products that exceed conventional 'socially responsible investing' or 'ESG-based' investing, which relate non-financial criteria primarily to their materiality for financial performance.[189] The latter market has grown due to investors' pro-social preferences, on the parts of many institutions and

[184] Sustainability Disclosures Regulation 2019, Art 2.
[185] Ibid, Art 3.
[186] Ibid, Arts 8-11.
[187] Arts 9-17, Taxonomy Regulation 2020.
[188] the forthcoming Social Taxonomy envisaged by the Commission, https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/finance-events-210226-presentation-social-taxonomy_en.pdf.
[189] MacNeil and Esser (2021).

individuals,[190] but is often criticised to offer opaque and uncertain quality in terms of sustainable achievement.[191]

Under the Sustainability Disclosure Regulation 2019, investment fund intermediaries are under a universal obligation to make mandatory disclosure of how they 'integrate sustainability risks.' 'Sustainability risk' is defined as 'environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment'.[192] Such a definition adopts a 'single materiality' approach of treating sustainability risk as salient only if it materially affects investment performance. At a baseline, this is not novel and consistent with the interpretation of fiduciary duty in private investment management.[193] It may even be argued that this baseline duty pertains only to disclosure and does not change the nature of the financially-focused duty of fiduciary investment management. Policy-makers in the EU have responded by clarifying that the baseline duty is not merely a duty of disclosure but also a duty to integrate sustainability risks as such in the governance and risk management of investment intermediaries.[194] In this way, the achievement in this legalisation is that all mainstream investment intermediaries are at least bound to consider material sustainability issues in their investment management, this is not limited to funds that opt to be labelled as SRI or ESG. This regulative steer is arguably novel as public policy objectives for sustainability are now enmeshed with investment management conduct by regulatory fiat. On the other hand, it may be argued that the baseline duty is not terribly potent, as enforcement is likely to come from market discipline, relying on the mandatory disclosure by investment intermediaries. It is also challenging for regulators to undertake clear enforcement actions regarding how firms integrate sustainability risks into their governance and risk management processes. This aspect is meta-regulatory in nature[195] and allows firms a certain scope of open-endedness for implementation within its systems, processes and culture.

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[190] George Apostolakis, Gert Van Dijk, Robert J Blomme, Frido Kraanen & Athanasios P. Papadopoulos, 'Predicting Pension Beneficiaries' Behaviour When Offered a Socially Responsible and Impact Investment Portfolio' (2018) 8 *Journal of Sustainable Finance & Investment* 213; Anett Wins and Bernhard Zwergel, 'Comparing Those Who Do, Might and Will Not Invest in Sustainable Funds: A Survey Among German Retail Fund Investors' (2016) 9 *Business Research* 51; Lei Delsen & Alex Lehr, 'Value Matters or Values Matter? An Analysis of Heterogeneity in Preferences for Sustainable Investments' (2019) 9 *Journal of Sustainable Finance & Investment* 240.

[191] 'Unregulated 'greenwashing'? ESG investing is under the microscope as the money rolls in' (CNBC News, 14 Oct 2020), https://www.cnbc.com/2020/10/14/esg-investing-meaning-is-under-the-microscope-as-the-money-rolls-in.html.

[192] Art 2(22).

[193] Freshfields Bruckhaus Deringer (2005), UNEPFI (2019); Benjamin Richardson, 'From Fiduciary Duties to Fiduciary Relationships for Socially Responsible Investing: Responding to The Will of Beneficiaries' (2011) 1 *Journal of Sustainable Finance and Investment* 5.

[194] Commission Delegated Regulation to amend the Alternative Investment Fund Managers Directive, https://ec.europa.eu/finance/docs/level-2-measures/aifmd-delegated-act-2021-2615_en.pdf (21 April 2021); Commission Delegated Directive to amend the UCITs Directive, https://ec.europa.eu/finance/docs/level-2-measures/ucits-directive-delegated-act-2021-2617_en.pdf (21 April 2021); Commission Delegated Directive to amend the Markets in Financial Instruments Directive, https://ec.europa.eu/finance/docs/level-2-measures/mifid-2-delegated-act-2021-2612_en.pdf (21 April 2021).

[195] Christine Parker, *The Open Corporation* (Cambridge: CUP 2000). Critics discuss the opaque and unsupervised nature of meta-regulation, Julia Black, 'Paradoxes and Failures:'New Governance' Techniques and the Financial Crisis' (2012) 75 *Modern Law Review* 1037.

Next, investment intermediaries of a certain scale, defined as having 500 employees or above, or being a parent company of such an undertaking,[196] are mandated to account for principal adverse sustainability impacts (applying from 30 June 2021). This applies whether or not such intermediaries engage with sustainably-labelled products. They must account for any adverse impact of their investment decision-making processes on sustainability objectives, how adverse impacts are discovered and what due diligence policies are deployed.[197] Smaller entities are able to declare that they do not consider adverse sustainability impacts in their investment decision-making process but must clearly explain why and whether this practice cuts across all their products.[198] This means that smaller entities are subject to the broad duty to integrate sustainability risks, but not specifically to measurement of adverse sustainability impact. In this manner, larger investment intermediaries are imposed with an obligation that is more socially-facing in nature, ie to account for sustainability cost *as such.* The type and nature of principal adverse impact that will be disclosed is based on double materiality ie these are measured not only in terms of their impact upon investment performance but for their impact upon sustainability performance.[199] Further, by 30 December 2022, financial services providers mandated to integrate and disclose sustainability risks in relation to adverse impacts must also make that transparency available at the level of each financial product.[200] These disclosures are also regarded as pre-contractual in nature, therefore attracting market and legal discipline from investors.[201]

The need to integrate and account for adverse sustainability impact compels large investment fund intermediaries to internalise such impact as part of their investment management purpose. This means that for all investment intermediaries, counting sustainability cost in their investment footprint is no longer an option, which would have been mostly pursued by 'socially responsible' funds.[202] However, the counting of sustainability cost would only change behaviour if asset owners and beneficiaries care about adverse sustainability impact, producing a market response to discourage such harms and therefore influencing allocational steer. There is increasing evidence that asset owners such as pension funds[203] and pro-social individuals value the avoidance of adverse sustainable impact in their investment allocations.[204] However, this is not necessarily the case with

[196] Arts 4(3), (4), Regulation 2019/2088.
[197] Art 4(1)(a), ibid.
[198] Art 4(1)(b), ibid.
[199] European Securities and Markets Authority's draft technical standards, 23 April 2020, https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules.
[200] Art 7, Sustainability Disclosure Regulation 2019.
[201] Art 6, ibid.
[202] Such as strategies excluding investments that perpetuate harm to sustainability goals.
[203] note 189.
[204] Manuel Ammann, Christopher Bauer, Sebastian Fischer, Philipp Müller, 'The Impact of the Morningstar Sustainability Rating on Mutual Fund Flows' (2018), https://ssrn.com/abstract=3068724.

many conventional institutions[205] and investment beneficiaries have highly heterogenous preferences.[206]

Many large investment firms or funds targeted under the Regulation are likely to be the largest global asset managers, a number of whom are passive managers, such as Vanguard and the world's largest exchange-traded fund provider, Blackrock. These have been observed to be involved in engagement with corporate issuers on common issues across portfolios, such as sustainability or ESG issues.[207] Hence, the EU reforms may be regarded as facilitating this process which is already underway. Nevertheless, these reforms may compel large fund intermediaries' to assume a 'representative capacity' in bringing to light and challenging their investee companies' sustainability cost.

Although we perceive large investment intermediaries to come under more radical obligations that may shape the market's perceptions and preferences for double materiality, many smaller investment intermediaries can elect to be principally 'private-facing' and potentially 'exempt', subject to their explanation, from a scope of socially-facing accountability imposed on larger firms. There is a large sector of investment firms that are medium sized and employ under 500 employees. In this manner, there could still be a sizeable market focusing only on single materiality. It is questioned if the market would dramatically pivot towards double materiality. Nevertheless, it may be argued that the reforms recognise the potential systemic impact of large investment firms' stewardship actions, and that it is not disproportionate to require their greater demonstration of social accountability in investment management.

Next, the Sustainable Disclosure Regulation clarifies that sustainably-labelled finance goes beyond 'harm-based analysis'. As 'harm-based analysis' now forms part of a universal obligation to integrate sustainability risks in investment management, this provides a starting point for sustainably-labelled financial products to be based on a higher departure point, i.e. the achievement of positive sustainability outcomes and not merely the avoidance of negative ones. Indeed 'sustainable investment' is defined as 'investment products [that] should positively achieve specified sustainable outcomes and at least do 'no significant harm' to environmental and social objectives as a whole'.[208] The definition of 'sustainably-labeled' relates to: 'an economic activity that contributes to an environmental objective, …[such as], by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, … [such as] tackling inequality or

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[205] Magnus Jans Jansson and Anders Biel, 'Investment Institutions' Beliefs About and Attitudes Toward Socially Responsible Investment (SRI): A Comparison Between SRI and Non-SRI Management' (2014) 22 *Sustainable Development* 33; Federica Ielasi and Monica Rossolini, 'Responsible or Thematic? The True Nature of Sustainability-Themed Mutual Funds' (2019) 11 *Sustainability Journal* 3304.

[206] George Apostolakis, Frido Kraanen and Gert van Dijk, 'Pension Beneficiaries' and Fund Managers' Perceptions of Responsible Investment: A Focus Group Study' (2016) 16 *Corporate Governance* 1; prosocial individual investors remain a minority, Charlotte Christiansen, Thomas Jansson, Malene Kallestrup-Lamb and Vicke Noren, 'Who are the Socially Responsible Mutual Fund Investors?' (2019), http://ssrn.com/abstract=3128432.

[207] Harper Ho (2019); Gomstian (2020).

[208] Art 2 (17), Sustainability Disclosure Regulation 2019.

that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.'

Investment intermediaries who provide explicitly sustainably-labelled products must explain how the environmental or social characteristics promoted by each product meets its characterisation, whether in active or passive management. In an actively managed product, disclosure is to be made of the strategies designed to meet the relevant characteristics, including how the intermediary defines the sustainability objective and measures its attainment or otherwise.[209] The European Securities and Markets Authority (ESMA) will prescribe a template[210] for such disclosure so that such disclosure attains certain standards and comparability.

In relation to passively managed products, investment intermediaries must disclose if the environmental or social characterisation is derived by benchmarking against indices for sustainable finance.[211] It is not sufficient to refer to a designated index to be satisfied of a product's environmental or social characteristics. They must disclose how the index is aligned or consistent with those characteristics and how alignment with it differs from a broad market index.[212] Although investment intermediaries are in substance relying on an index provider's diligence and evaluation, there needs to be some level of intelligent engagement with indexers' methodologies[213] in order to demonstrate why the index has been selected and the difference to sustainable performance made by adhering to the index.

The Regulation provides new standards for the design and offering of sustainable financial products. Although the Taxonomy Regulation does not outlaw 'lower' labels such as 'ESG' or 'socially responsible' products,[214] the regulatory governance of the 'sustainable' label is intended to set standards as well as galvanise market choice. These are regulatory steers for the market building of investment products that would meet the purposes of double materiality. However, the effectiveness of such regulatory policy again depends on the alignment between market choice and regulatory steering. If sustainably-labelled products are more costly due to the more demanding compliance obligations, this could affect market choice and the demand side may be incentivised to settle for 'lower' labels.

In sum, can it be argued that sustainability has been legalised as a new purposed-based norm for investment management conduct in the EU? The EU Regulation's framing seems non-optional and can be understood to have introduced a regulative modification to the

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[209] Art 8, 10, ibid.
[210] https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules.
[211] Art 8, 9, Sustainability Disclosure Regulation 2019.
[212] Art 9(1)(b), ibid.
[213] Robert J Bianchi & Michael E Drew, 'Sustainable Stock Indices and Long-Term Portfolio Decisions' (2012) 2 *Journal of Sustainable Finance & Investment* 303 on the differences between Indices.
[214] Art 7, Taxonomy Regulation 2020.

understanding of fiduciary investment management in private law. However, the regulatory provisions work with meta-regulatory firm implementation (where 'integrating sustainability risks' are concerned), market-based discipline for the disclosure dimensions and uncertainty in relation to market appetite for the orientation of investment products. It is arguable that despite the mandatory nature of new obligations for investment intermediaries to integrate sustainability risks, and for larger fund intermediaries to report on specific matters of adverse sustainability impact, the substantive nature of such obligations is that of a nudge,[215] as the purpose is ultimately to provide information and framing to guide asset owners' and beneficiaries' choices. Whether such market-based regulation ultimately changes allocative steer and influences behaviour at the level of the corporate economy, can only be observed in time.[216]

However, it can be argued that with prescriptive templates for disclosure of adverse sustainability risks imposed on larger intermediaries, sustainability risks would be evaluated as a matter of double materiality, not merely single materiality. In this manner, some of the largest and most well-known investment intermediaries would be compelled to engage with granular items of sustainability cost that would appeal to the public interest, in order to adhere to mandatory disclosure. In turn, these investment intermediaries may weigh in more pronouncedly against their portfolio companies, or in an issue-specific manner across the board, in order to demand information of a nature that meets double materiality needs. The Taxonomy Regulation contains amendments to the EU Non-financial Disclosure Directive 2013 in order to further support the mandatory disclosure of environmental, social, human rights and anti-corruption matters by listed corporations.[217] Reforms are also afoot to revamp the EU Non-financial Disclosure provisions into comprehensive disclosure obligations for corporations so that they can provide standardised and comprehensive disclosures on sustainability matters.[218] The European Securities Markets Authority welcomes and is collaborating with bodies such as the International Financial Reporting Standards body to develop meaningful metrics of sustainability performance.[219] The legalisation carried out in the EU reforms is poised to being about a new landscape of transparency that galvanises public alongside market pressure. It may be too early to

[215] Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions About Health, Wealth and Happiness* (Penguin, 2009).
[216] 'Fifty Shades of Green: How Prevalent is ESG Window Dressing?' (Citywire), https://citywire.co.uk/wealth-manager/news/investor-faith-risks-drowning-in-a-rising-tide-of-greenwash/a1363868.
[217] Art 8, Taxonomy Regulation 2020 supplementing the Non-financial Disclosure Directive 2013/34/EU.
[218] ongoing reform see European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal* (21 April 2021), https://ec.europa.eu/finance/docs/law/210421-sustainable-finance-communication_en.pdf; European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (April 2021), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189.
[219] 'ESMA Supports IFRS Foundation's Efforts on International Standardisation in Sustainability Reporting' (16 Dec 2020), https://www.esma.europa.eu/press-news/esma-news/esma-supports-ifrs-foundation%E2%80%99s-efforts-international-standardisation-in.

dismiss these reforms as merely market-based regulation that would be subservient to market behaviour.[220]

UK's Sustainable Finance Reforms

The UK made early indications[221] that it did not necessarily wish to adopt the EU's sustainable finance regulations for the investment sector, having now the freedom to debate policy independent of the EU after Brexit.[222]

In June 2021, the UK FCA unveiled its consultation for sustainable finance reforms for the investment management sector. These reforms focus only on climate risks as the FCA proposes to introduce a baseline duty for all investment asset management entities, including life insurers, to make mandatory reporting based on the TCFD.[223] This is also seen as a reasonable introduction of a mandatory duty, as the TCFD is already imposed on all premium-listed entities on the London Stock Exchange.[224] Mandatory TCFD reporting is to be made by investment managers at an 'entity-level' and at a 'product or portfolio- level'. In relation to 'entity-level' reporting, investment managers subject to this duty would need to disclose how they as a whole manage climate risks according to the four components of TCFD reporting, i.e. how their ***business strategy*** and ***governance*** take into account of climate risk, how their ***risk management policies and framework*** take into account of climate risk, how firms employ ***scenario analysis*** to map and evaluate climate risks, and what ***metrics and targets*** are used for measuring financial risks and opportunities from climate risks (guided by examples provided in the TCFD framework).

On product or portfolio-level disclosure, investment management entities should include for each product or portfolio managed, a list of standardised metrics on their climate footprint. This should be provided to clients of investment managers as continuing disclosure reporting in annual and periodic reports, or on an on-demand basis by clients. There is however no clarity on whether such information would be mandated in pre-sale communications as is mandated in the EU. The climate metrics to be disclosed include the greenhouse gas, GHG and carbon emission levels implicated by the product or portfolio, as well as the carbon footprint measurement and the Weighted Average Carbon Intensity (WACI) developed by the Partnership for Carbon Accounting Financials. Other metrics can also be included. Product and portfolio-level disclosure also includes disclosure regarding the investment manager's business strategy, governance, risk management and policies, and approaches to scenario analyses that are relevant to the product or portfolio.

The UK's regulatory approach is arguably different from the EU as it is focused on single materiality, therefore more clearly refraining from importing public interest goals as such

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[220] Florian Möslein and Karsten Engsig Sørensen, 'The Commission's Action Plan for Financing Sustainable Growth and its Corporate Governance Implications' (2018), https://ssrn.com/abstract=3251731.
[221] See note 20.
[222] Finalised on 31 Dec 2020.
[223] FCA (2021), note 20.
[224] FCA, *Proposals to Enhance Climate-Related Disclosures by Listed Issuers and Clarification of Existing Disclosure Obligations: Policy Statement* (21 Dec 2020), https://www.fca.org.uk/publications/policy-statements/ps20-17-proposals-enhance-climate-related-disclosures-listed-issuers-and-clarification-existing.

into regulating investment management. The TCFD focuses on the financial risks from climate-related risks and opportunities, and is therefore complimentary to mainstream financial institutions' focus on financial performance. This is narrower than the EU's embrace of double materiality for large investment firms' mandatory reporting of adverse sustainability impact which is to be evaluated in non-financial as well as financial terms. Further, the range of sustainability goals and metrics for double materiality is broader than the UK's focus only on climate risks. It may be queried whether the UK's approach is sounder as carbon footprint and greenhouse gas emission measurements are established metrics and lend themselves to be perceived with greater scientific accuracy, than say, social development measurements. Nevertheless, metrics are developing for various areas of sustainability such as SDG-compliance.[225] The EU's approach of adopting a mixed public and private approach to developing and governing metrics for sustainability indicators[226] may also provide longer-lasting influence of public interest infusion into metrics development, which has hitherto been dominated by the private sector.[227] This furthers a broader agenda of steering sustainable finance reforms according to public interest and preventing disengagement of the sustainable finance market from public interest goals. In contrast, by mandating investment institutions to focus on single materiality, UK policy-makers need to ask the question whether incentive-based calculations and internalisation of climate risk is always aligned with public interest goals and to what extent these goals are really served. For example, a focus on single materiality may lead investment institutions to price solar energy investments favourably, but these are not uncontroversial in relation to community rights, such as in relation to farming and food security.[228] Would such holistic 'social risks' be priced into investment allocations and valuations, and what would the social impact be of a narrow approach? However, it may be argued that regulators could overstretch their mandates by extending into public interest goals that are not primarily related to financial regulatory goals such as investor protection.[229]

It may nevertheless be argued that the EU's reforms do not achieve markedly different effects from the UK, as its introduction of a mandatory duty to 'integrate sustainability risks' for all investment management entities is also based on single materiality. The connection with public interest goals and double materiality are imposed on a small set of large investment management entities only. Further, the UK's narrower approach focusing on climate risks also makes firm compliance easier to achieve given the relative clarity of the TCFD's template. As discussed above, the meta-level governance articulated in the

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[225] Gianni Betti, Costanza Consolandi and Robert G. Eccles, 'The Relationship Between Investor Materiality and the Sustainable Development Goals' (2018) at https://ssrn.com/abstract=3163044.

[226] Iris H-Y Chiu, 'The EU Sustainable Finance Agenda- Developing Governance for Double Materiality in Sustainability Metrics' (2021) European Business Organisations Law Review, forthcoming.

[227] Such as by bodies for social reporting and accounting like the GRI and SASB, and by indices and ratings providers for sustainable or 'ESG' related investment products.

[228] For example, 'Campaigners fight plans for one of the world's biggest solar farms on Suffolk-Cambridgeshire border' (ITV News, 4 Dec 2020), https://www.itv.com/news/anglia/2020-12-04/campaigners-fight-plans-for-one-of-the-worlds-biggest-solar-farms-on-suffolk-cambridgeshire-border.

[229] David A. Katz and Laura A. McIntosh,, 'SEC Regulation of ESG Disclosures' (Harvard Law School Forum on Corporate Governance, 28 May 2021), https://corpgov.law.harvard.edu/2021/05/28/sec-regulation-of-esg-disclosures/; Paul G Mahoney and Julia D Mahoney, 'The New Separation of Ownership and Control: Institutional Investors and ESG' (2021), Columbia Business Law Review, forthcoming, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3809914.

expectations to 'integrate sustainability risks' can be vague in terms of what processes and frameworks are needed for investment firms.

On the marketing of sustainable investment products, both the UK's and EU's approaches are market-based but the EU relies on a greater extent on legalising new mandatory transparency in order to inform market choice. The UK FCA has issued guidance to investment firms to warn that 'ESG' or 'sustainably' labelled products should show substantive connections to investment objectives and strategies and should not be meaningless in case of mis-selling.[230] Existing periodic disclosure obligations for investment funds should also include ESG or sustainability specific performance information for such labelled products. It is queried why the UK has not chosen mandatory legalisation of proper selling and disclosure duties for investment firms marketing 'ESG' or sustainably-labelled funds since the EU has adopted that route. The EU's definition of sustainably-labelled products and its Taxonomy of environmentally-sustainable products provide standards for investment objectives and performance that can shore up investor confidence, as well as double materiality baselines for the public interest goals sought to be concurrently achieved. This therefore more robustly appeals to pro-social investors looking to be able to verify double materiality outcomes. The UK's approach may not do enough to prevent greenwashing, although much depends on the FCA's *ex post* enforcement. Further, the UK's bifurcated approach between climate prioritisation and other ESG objectives may send ambiguous messages regarding different levels of public regulatory interest in socially desirable goals.

The more pronounced coupling of public interest goals with sustainable finance regulation in the EU provides an interesting hybrid approach to nudging financial allocation as well as governing investment management conduct. The FCA's apparently narrower reforms could however be understood in the context of the Stewardship Code 2020. In consolidating with the purpose-based steers in the UK Stewardship Code 2020, code signatories can no longer ignore the wider context for investment fund allocation and management, and meta-level policy scrutiny. Although the framework seems to comprise of soft law, meta-level governance and market-based discipline, the visibility of policy steer is still remarkable, and strikes a balance between leaving to contractual implementation and painting the boundaries of public interest. Such designs of modern governance are not in the vein of central planning or allocation, but do not subscribe to laissez-faire either.[231] The UNEPFI reports of 2019 and 2021 have also done much to pave the way for the integration of a traditionally private law-based paradigm with modern concerns of a broader nature.[232]

Modern investment management contributes to and is part and parcel of global capital allocation. Policy-makers are increasingly scrutinising the purposes to which such capital is put. It may be argued that as many countries struggle with economic recovery in the wake

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[230] FCA, 'Guiding Principles on Design, Delivery and Disclosure of ESG and Sustainable Investment Funds' (19 July 2021), https://www.fca.org.uk/news/news-stories/guiding-principles-on-design-delivery-disclosure-esg-sustainable-investment-funds.

[231] P95, Ian Goldin, *Rescue: From Global Crisis to Better World* (Sceptre, 2021), where the author admonishes going beyond stale central planning and capitalist divides in political economy and modernising the hybrid roles of public and private sector.

[232] https://www.unepfi.org/investment/fiduciary-duty/.

of the Covid pandemic, the needs for financial allocation at a macro level would more than ever become questions of public interest, in addition to the long-running issues of climate change, environmental sustainability and social development that have been on policy-makers' agendas for a long time. The governance of investment fund management is transcending the paradigm revolving around the micro needs of private entrustment and allocation, moving towards the macro needs of global capital allocation.

D. Conclusion

From the introduction of shareholder engagement as a 'norm' for stewardship, the regulatory governance of investment management conduct has been ramping up, not to mention areas not covered in this paper such as policy-makers' scrutiny for systemic risks.[233] As investment funds and asset managers assume control of increasing global assets under management and enjoy significant allocative power, public interest in the exercise of such power increases correspondingly. It is inevitable that societal and public expectations would be augmented and the governance needs for the industry would rise. This article argues that the UK Stewardship Code 2020 is a 'graduation' from an earlier experimental period which focused on the narrower and process-based 'norm' of shareholder engagement. The Code has broken new ground by articulating purpose-based steers for investment management, providing the starting point for a type of governance that may come to define the regulation of investment management in the future. Indeed, sustainable finance reforms such as in the EU and UK may provide the crucial kickstart to introducing non-optional integration of sustainability risks and goals into mainstream investment management in due course. Purpose-based governance, albeit in its soft law beginnings, is arguably a new trajectory for calibrating the relationship between private investment management and regulation, reflecting the public interest and expectations for the future of the industry.

[233] Financial Stability Board, 'Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities' (Jan 2017), https://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

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