

**SHAREHOLDER ENGAGEMENT IN EU
AND IRISH CORPORATE GOVERNANCE
LAW: THE IMPACT OF THE REVISED
SHAREHOLDER RIGHTS DIRECTIVE**

**Submitted for the degree of Doctor of Philosophy:
Law**

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SUMMARY

This thesis is concerned with the operation of shareholder democracy across the European Union and especially in relation to Irish public listed companies and Irish institutional investors and asset managers. More specifically, the thesis is concerned with how shareholder engagement operates and how this important practice interacts with the law of the European Union and Ireland. Public listed companies will be impacted by the obligations that the revised Shareholder Rights Directive imposes upon them and institutional investors will be impacted by the actions of their own shareholders that are subject to the Directive. The thesis analyses the Directive, using a descriptive approach, supplemented by an empirical analysis in the form of a survey of both Irish and international asset managers, who are invested in Irish public listed companies. The thesis identifies the theoretical background with regard to shareholder democracy and the importance of shareholder engagement in paradigms of shareholder democracy. In particular, a description is given of agency theory, how it is related to shareholder democracy and the role that shareholder engagement is expected to play in these theoretical frameworks.

In analysing the Directive, the thesis finds that there are formidable obstacles and impediments to shareholder engagement. A major theme of the thesis involves the understanding of the meaning of engagement, how it is understood by legislators and regulators and how this may differ from the understanding of market participants themselves. This thesis identifies where differences in understanding may arise and how introducing a legal instrument, such as the Directive, into the practice of shareholder engagement may distort the understanding and the practice itself. The thesis identifies the potential impacts of formalising the practice of shareholder engagement in law. These impacts include the potential for excessively rigid approaches to engagement that do not reflect the ideal of shareholder engagement, the potential for confusion surrounding disclosures under the Directive and the potential for increased compliance costs that make investment less efficient for individuals and institutions alike. Finally, the thesis focuses on passive investors and finds that this subset of institutional investor will be impacted

particularly and may produce a particular impact upon companies that have a large shareholder base of passive investors.

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1. Introduction

A. Shareholder engagement and democracy

“Democracy” is a word that is charged with immense emotional power. For decades, it has been considered the ideal form of government in which the power is vested in the people and democratic institutions have been fiercely protected from perceived threats. Corporate governance is concerned with how companies are directed and organised and involves balancing power between different corporate constituencies, including the board of directors, shareholders and other company stakeholders.¹ Historically and for reasons that will be explored, shareholders are the sole constituency that possess voting rights in companies in most countries. “Shareholder democracy”, however, is a concept that describes more than the exclusive voting right of shareholders. Voting can be exclusively vested with the body of shareholders but be limited in various ways that undermine their ultimate control.² Companies can be thought of as representative democracies in which those elected to control the day to day affairs of the company can be expected to serve the interests of their electorate.³ Where those in control are insulated from the reproach or admonishment of their electorate, this can be regarded as less “democratic” than a situation where controllers must face and be accountable to such an electorate on a regular basis. Just as a society can be “more” or “less” democratic, companies can be more or less of a shareholder democracy. A “direct democracy” involves the electorate deciding directly, usually in a referendum, on matters to be undertaken in a society, rather than simply choosing representatives to make these decisions.⁴ Companies, too, can move beyond representative democracy and can contain direct intervention rights for shareholders.⁵

¹ See “Report of the Committee on the Financial Aspects of Corporate Governance” 1 December 1992, chaired by Sir Adrian Cadbury [hereafter “Cadbury report”] in which “corporate governance is defined as “the system by which companies are directed and controlled.”

² These limitations can include “control enhancing mechanisms” which are discussed further in Chapter 3: Market Impediments to Shareholder Engagement below at pp 103-114. Other ways ultimate control can be limited include limiting the areas over which shareholders can vote. For example, directors can maintain a higher degree of control by staggering board elections, such that the entire board cannot be replaced from year to year.

³ See Lucian A Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 Harvard Law Review 833 at 837.

⁴ Usha Rodrigues, 'The Seductive Comparison of Shareholder and Civic Democracy' (2006) 63 Washington and Lee Law Review 1389 (for a description of direct and representative democracy in both a civic and shareholder context).

⁵ For a discussion of the difference between direct and representative democracies in companies, see Bernard Black and Reinier Kraakman, 'A Self Enforcing Model of Corporate Law' (1996) 109 Harvard Law Review 1911 at 1943-1944.

Mechanisms for maintaining and furthering shareholder democracy in the form of voting and other access rights describe, in various forms, shareholder engagement. In the context of legal systems that seek to support shareholder democracy in company law, the question of shareholder engagement becomes all important. Engagement, as will be described in greater detail below, is the manifestation of shareholder empowerment and the means by which shareholder democracy becomes effective. Without engagement, those in control of companies, its directors, managers and executives, can conduct the business of the company without oversight by and accountability to shareholders, giving them greater discretion to disregard the interests or views of shareholders when making strategic company decisions. A legal system that bestows legal rights upon shareholders of access to company decision making does not effectively inculcate shareholder democracy without corresponding engagement by those shareholders. As will be described, this is the difference between the original 2007 Shareholder Rights Directive⁶ (“SRD”) and its 2017 revision⁷ (“SRD2”), the former grants shareholders the rights of access in corporate governance, the latter seeks to encourage the effective use of those rights.

Corporate governance debates have long centred on the whether the objective of the company is to increase the wealth of shareholders or to enhance the welfare of company stakeholders more broadly.⁸ Since this thesis is concerned with shareholder democracy, an examination of so-called stakeholder theories of corporate governance is beyond its scope. However, it is important at the outset to distinguish shareholder democracy from other theories of corporate governance that promote the position of shareholders. Shareholder primacy is frequently identified as the leading theory of how to organise companies in law.⁹ It is perhaps lamentable that so many terms have arisen describing similar but subtly different concepts. Shareholder democracy is not identical to shareholder primacy, and neither are identical to shareholder wealth maximisation. Other terms used which might be considered identical to “shareholder primacy” are “shareholder value” and “shareholder

⁶ Directive 2007/36/EC.

⁷ Directive 2017/828 (EU) [hereafter “SRD2”].

⁸ See generally, Andrew Keay, *The Corporate Objective*, (Edward Elgar, 2011); Adolph A Berle, 'Corporate Powers as Powers in Trust' (1931) 44 Harvard Law Review 1049; E Merrick Dodd Jr, 'For Whom Are Corporate Managers Trustees?' (1932) 45 Harvard Law Review 1145.

⁹ Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 The Georgetown Law Journal 439; Andrew Keay, 'Shareholder Primacy in Corporate Law: Can it Survive? Should it Survive?' (2010) 7 European Company and Financial Law Review 369; Robert J Rhee, 'A Legal Theory of Shareholder Primacy' (2017) 102 Minnesota Law Review (forthcoming).

supremacy.” “Shareholder primacy” describes a legal context whereby shareholder interests are given priority when company decisions are made.¹⁰ This can be done in two different but often overlapping ways. First, those in control of the company can be bound by law to place the interests of shareholder ahead of all other interests. It is not always clear what the term “shareholder interests” may comprise, since different shareholders may have different (and conflicting) interests.¹¹ In theory, what unifies shareholders is their interest in seeing profits being maximised, since they are residual claimants of the company’s profits.¹² For this reason, requiring those in control of the company to prioritise shareholder interests is commonly understood to mean maximising the wealth of shareholders.¹³

It should be noted that “profit maximisation” is not necessarily a unified goal from the perspective of a company’s shareholders. Profits may be maximised in a shorter or longer time span and some shareholders may have a preference for the former, placing them in conflict with those preferring profits to be maximised over the long term. A manifestation of such a conflict could, for example, take the form of a decision regarding the investment in new technologies that address a company’s environmental impact. Some shareholders may wish for the company to not bear the short term costs of such an investment, thereby reducing short term profits but others may prefer the investment on the grounds that it will be profitable for shareholders in the long term. Conflicts may also arise in how profits are to be distributed, with some shareholders preferring dividends or share buybacks and others preferring the profits to take the form of capital appreciation of the shares. This may also implicate a short term versus long term conflict, as shareholders interested in profit maximisation in the short term may prefer dividends or buybacks and longer term shareholders preferring capital appreciation.

Shareholder wealth maximisation is the first means of carrying out shareholder primacy. It can involve aligning the interests of company controllers with shareholders, through compensation packages, or specific legal duties upon controllers of companies to prioritise

¹⁰ Ibid.

¹¹ See Iman Anabtawi, 'Some Skepticism About Increasing Shareholder Power' (2006) 53 UCLA Law Review 561.

¹² George W Dent, 'The Essential Unity of Shareholders and the Myth of Investor Short-Termism' (2010) 35 Delaware Journal of Corporate Law 97

¹³ Bernard S Sharfman, 'Shareholder Wealth Maximization and Its Implementation Under Corporate Law' (2014) 66 Florida Law Review 389 at 389 (“Shareholder wealth maximization is a norm of corporate governance that encourages a firm’s board of directors to implement all major decisions such as compensation policy, new investments, dividend policy, strategic direction, and corporate strategy with only the interests of shareholders in mind.”) (references omitted)

shareholder interests above all others. Shareholder wealth maximisation does not imply control rights of shareholders and certain theories of corporate governance include shareholder wealth maximisation while simultaneously limiting shareholder control rights. The most notable theory in this regard is director primacy, wherein directors are given control rights and discretionary power at the expense of shareholders' control rights but must exercise these powers for the purposes of shareholder wealth maximisation.¹⁴ The second means of carrying out shareholder primacy, then, is the granting of control rights to shareholders. This aspect of shareholder primacy is what is referred to in this thesis as "shareholder democracy".

It is worth noting that there are alternative schools of thought that reject shareholder primacy in all its forms, emphasising the role and control rights of all stakeholders, including employees, creditors and wider society. "Stakeholder theories" of corporate governance can provide for stakeholder participation in company decision making (what might be termed "stakeholder democracy"¹⁵) or place duties on directors to balance and consider the interests of stakeholders when making decisions. "Enlightened shareholder value" in the UK might be considered a movement towards stakeholder theory, as the Companies Act 2006 requires directors to "have regard" to, *inter alia*, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and the impact of the company's operations on the community and the environment.¹⁶ Since this thesis is concerned with the operation of shareholder democracy in the context of the SRD2, a comprehensive discussion of stakeholder theories is beyond its scope.¹⁷

Control rights can imply a wide range of access rights to company decision making processes. These include the right to propose items on the agenda at a company's annual general meeting (AGM), the right to ask questions of incumbent management, the right to replace board members, the right to propose alternative candidates for election to the board

¹⁴ See Stephen M Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 Northwestern University Law Review 547 at 563 ("In its various guises, shareholder primacy contends not only that shareholders are the principals on whose behalf corporate governance is organized, but also that shareholders do (and should) exercise ultimate control of the corporate enterprise. In contrast, director primacy accepts shareholder wealth maximization as the proper corporate decision making norm, but rejects the notion that shareholders are entitled to either direct or indirect decision making control."); Stephen M Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 199 Harvard Law Review 1735.

¹⁵ See Dirk Matten and Andrew Crane, 'What is Stakeholder Democracy? Perspectives and Issues,' (2005) 14 Business Ethics: A European Review 6.

¹⁶ Companies Act 2006, section 172(1)(b), (c) and (d).

¹⁷ For further consideration of stakeholders, see Chapter 7 at pp 240-246.

of directors and the right to vote on management's compensation packages.¹⁸ What these rights have in common is that they afford an opportunity for shareholders to discipline management in some manner. Where shareholders are unhappy with the performance of the company or its strategic direction, they can use these rights to express dissatisfaction, put pressure on management to alter company strategy or even replace directors. There is a great deal of overlap in theory between shareholder democracy and shareholder wealth maximisation. Where shareholders are given control rights, in theory they ought to use this control to maximise their wealth. Indeed, both shareholder democracy and shareholder wealth maximisation are designed to achieve the same goal: shareholder primacy (that is, the prioritising of shareholders' interests in company decisions). In reality, shareholder democracy presents a far more complex picture than shareholder wealth maximisation norms. It cannot be assumed that shareholders will be unified in how they engage and to what end they engage.

The problem that exists in law is how shareholder democracy is practically carried out. It is not enough to simply enumerate a list of shareholder rights that provide shareholders with access to corporate decision making. As will be seen, this is basically what the initial SRD did and a revision was subsequently required in order to further realise the European Union's ("EU's") vision of shareholder democracy.¹⁹ As noted above, the practical manifestation of shareholder democracy is engagement; how shareholders engage with investee companies is the essence of a functioning shareholder democracy. It is for this reason that this thesis will focus predominantly on shareholder engagement in the law. Impediments to shareholders engagement will be set out in detail and these impediments are formidable. Shareholders must be willing as well as able to use their rights and engage with investee companies in order for shareholder democracy to function properly. The response of the EU has been to revise the SRD in a manner that makes it more likely that shareholders will properly engage in corporate governance. The SRD2 was realised at an EU level in 2017 and was transposed into Irish law in March 2020.²⁰ Increasing engagement is a central aim of the SRD2 and, as will be described, the main tool used to achieve this aim is transparency. Transparency obligations are mandatory in the SRD2 but engagement itself is not, which presents problems in relation to overcoming the existing impediments to engagement. This thesis addresses itself to the problem of carrying out

¹⁸ As will be discussed, many of these rights are found in the first Shareholder Rights Directive in 2007, see Chapter 2: The Shareholder Rights Directive, its Development and its Revision, below.

¹⁹ See *ibid.*

²⁰ SI No. 81/2020 – European Union (Shareholders' Rights) Regulations 2020.

shareholder democracy in practice through the prism of the SRD2 and, more specifically, how to increase the level of shareholder engagement.

B. Research Questions

This thesis is concerned with the effectiveness of the SRD2 and this therefore forms the primary research question. Will the SRD2 be effective in achieving its aims with respect to shareholder engagement? In reality, this question can be split again into two vital questions about the SRD2 and shareholder engagement: (1) Will the SRD2 be effective in achieving its aims in raising the *level* of shareholder engagement and (2) will the SRD2 be effective in achieving its aims in raising the *quality* of shareholder engagement? This is a particularly important distinction when considering any regulation that seeks to affect shareholder engagement and will be returned to throughout the thesis. Secondary research questions arise from each of these primary questions. What factors reduce the level of shareholder engagement? Impediments of shareholder engagement are often dealt with in isolation but when considering a regulation of the nature of the SRD2 that seeks to enhance shareholder engagement, these impediments must be considered together in order to assess how effective the SRD2 can be. As will be seen, dealing with impediments broadly rather than in isolation reveals that certain impediments affect certain forms of engagement for certain shareholders. In some cases, a market practice or regulation can even simultaneously impede engagement and help to encourage and enhance engagement.

Related to this, is the question of what is meant by shareholder engagement. This may seem like a straightforward question but a coherent understanding of what actions constitute engagement must be set out before the effectiveness of the SRD2 can be assessed. Setting out a meaning for shareholder engagement lends clarity to the discussion and also helps to contribute to answers that relate to the second primary question; ie will the SRD2 help to enhance the quality of shareholder engagement? In order to address this question, the actions that may be considered higher “quality” engagement and the reasons why they may be so considered should be set out. In other words, secondary questions of this this thesis are what is the quality of engagement that is sought and, correspondingly, what is the quality of engagement that would be considered undesirable, if any?

Two areas should be discussed at this introductory stage in order to provide clarity for the discussion that follows in later chapters. The first is what exactly is meant by “shareholder” in the context of the SRD and SRD2. There are a variety of different institutions and actors with a range of different investment styles and strategies that will affect how they should be perceived as parties to engagement. Second, the meaning of “engagement” requires attention. It is vitally important to know what actions are expected and how shareholders subject to the SRD2 can comply with its provisions.

C. Taxonomy of Shareholders

Knowing the identity of the “shareholders” who populate the shareholder democracy of companies is a preliminary necessity. As will be seen, the SRD2 is concerned exclusively with different classes of “institutional” shareholder rather than individuals who own shares. Recent data from the OECD shows that institutional investors are the largest category of investors globally, owning 41% of the shares of public listed companies (PLCs) around the world.²¹ With respect to Irish PLCs, the data covers 25 PLCs which reflect 99% of the market capitalisation of the country.²² In this dataset, an average of 40% of shares are owned by institutional investors.²³ This is the largest category of investor with respect to these 25 PLCs. The second largest category of average share ownership in respect of Irish PLCs is “other free float” at 32% but this category includes retail investors who are not obliged to disclose their holdings and institutional investors who have not exceeded the required threshold for public disclosure.²⁴ As is clear from this OECD data, the market for shares of PLCs across the EU consists of institutional investors, public sector investors, strategic individuals and private corporations, as well as the “free float” investors. Since the SRD2 applies only to institutional investors, it is this category that will be focused upon.

It is also worth briefly setting out the structure of the market in Ireland. Euronext Dublin is the only regulated market in Ireland and is the location for the public listing of many Irish PLCs.²⁵ An Irish domiciled company can list its shares publicly on a foreign regulated

²¹ Adriana De La Cruz, Alejandra Medina and Yung Tang, “Owners of the World’s Listed Companies”, (2019) OECD Capital Market Series, Paris, available at <http://www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf>.

²² Ibid at 34.

²³ Ibid at 37.

²⁴ Ibid at 9.

²⁵ Regulated under Directive 2014/65/EU.

market and it is common for Irish PLCs to list on the London Stock Exchange and therefore subject themselves to the listing rules of that market. Most companies listed on the Main Securities Market of Euronext Dublin are also listed on the London Stock Exchange as dual listed companies. Prior to its sale to Euronext in 2018, the Irish Stock Exchange was owned by five Irish stock brokers.²⁶ Euronext was formed between 2000 and 2002 by the merger of several European stock exchanges and Euronext now operates public markets in Dublin, Amsterdam, Brussels, Lisbon, London, Oslo and Paris. It serves an enforcement function by virtue of its Listing Rules, which includes a requirement to apply the principles in the 2016 UK Corporate Governance Code,²⁷ as well as the Irish Corporate Governance Annex, which contains disclosure requirements regarding the composition of the board of directors, how board appointments are undertaken, and how the board is evaluated, as well as regarding the work of the audit and remuneration committees. Courtney has described the Annex as being designed “to enhance the meaningfulness of the explanations given by companies of how they have applied the [UK Corporate Governance] Code.”²⁸

During the course of the research for this thesis, a database was constructed of twenty four PLCs that are listed on the Irish Main Securities Market that did not have a non-Irish controlling parent company and the ownership of these companies was analysed.²⁹ This analysis revealed that these Irish companies had, at that time,³⁰ a shareholder base of predominantly international institutional investors. Depending on the type of institutional investor, each shareholder will have different fee structures, different investment time horizons, different social goals and different political pressures. As suggested above, there has been an ongoing debate regarding whether shareholders have different and conflicting interests or whether they ultimately share the same goal of maximising shareholder value.³¹ Even accepting that all shareholders share the goal of maximising shareholder value, there could be conflicts between shareholders with regard to how shareholder value is to be

²⁶ Arthur Beesley, “Irish Stock Exchange sale offers ‘pivot towards Europe’”, *Financial Times*, 31 January 2018.

²⁷ Euronext Dublin Rulebook, Book II: Listing Rules, 21 July 2019, available at <https://www.ise.ie/Products-Services/Sponsors-and-Advisors/Dublin-Listing-Rules-Book-II.pdf>, rule 6.1.82(6).

²⁸ Thomas B Courtney, *The Law of Companies*, (4th ed, Bloomsbury, 2016), at para. 31.176.

²⁹ These companies were AIB Group PLC, Aminex PLC, Bank of Ireland Group PLC, C&C Group PLC, Cairn Homes PLC, CRH PLC, Dalata Hotel Group PLC, Datalex PLC, FBD Holdings PLC, Glanbia PLC, Glenveagh Properties PLC, Green REIT PLC, Hibernia REIT PLC, IFG Group PLC, Independent News & Media PLC, Irish Continental Group PLC, Irish Residential Properties REIT PLC, Kenmare Resources PLC, Kerry Group PLC, Kingspan Group PLC, Paddy Power Betfair PLC, Permanent TSB Group Holdings PLC, Ryanair Holdings PLC, Smurfit Kappa Group PLC.

³⁰ This analysis was undertaken during the month of December 2018.

³¹ Dent (n 12); Anabtawi (n 11).

maximised or even how shareholders interpret the meaning of “shareholder value”.³² Certainly, as will be described, the SRD2 and the Stewardship Code in the UK (“SC”)³³ differentiate between at least two different groups of shareholders: asset managers and asset owners and place different expectations on each regarding engagement. Indeed, funds are structured in such a way as to guarantee different levels and forms of engagement. It is therefore important to describe these kinds of institutional investor in order to understand the engagement (or lack thereof) that may arise.

i. Asset Owners

The term “asset owner” covers a number of different institutional investors but the SRD2 limits its definition of “institutional investor” to just two: pension funds and life insurance companies.³⁴ While the SRD2 uses the term “institutional investor” in its definition, it is clear that it is identical to how the term “asset owner” is generally understood. Other commentators and analysts that have looked at institutional investors and corporate governance have also preferred the term “asset owner” as a way of distinguishing this group from “asset managers”.³⁵ The 2012 version of the SC defines “asset owners” as “pension funds, insurance companies, investment trusts and other collective investment vehicles.”³⁶ It is submitted that the “institutional investors” of the SRD2 are identical to the “asset owners” of the SC and both intend to use these respective terms to distinguish them from

³² Andrew Keay, *The Corporate Objective*, (Edward Elgar, 2011).

³³ Financial Reporting Council, “The Stewardship Code 2020”, [hereafter “Stewardship Code 2020”] available at https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf

³⁴ See SRD2, Article 1(2)(b) which provides that “institutional investor” means: (i) an undertaking carrying out activities of life assurance within the meaning of points (a), (b) and (c) of Article 2(3) of Directive 2009/138/EC of the European Parliament and of the Council, and of reinsurance as defined in point (7) of Article 13 of that Directive provided that those activities cover life-insurance obligations, and which is not excluded pursuant to that Directive; (ii) an institution for occupational retirement provision falling within the scope of Directive (EU) 2016/2341 of the European Parliament and of the Council in accordance with Article 2 thereof, unless a Member State has chosen not to apply that Directive in whole or in parts to that institution in accordance with Article 5 of that Directive” and “asset manager” means an investment firm as defined in point (1) of Article 4(1) of Directive 2014/65/EU that provides portfolio management services to investors, an AIFM (alternative investment fund manager) as defined in point (b) of Article 4(1) of Directive 2011/61/EU that does not fulfil the conditions for an exemption in accordance with Article 3 of that Directive or a management company as defined in point (b) of Article 2(1) of Directive 2009/65/EC, or an investment company that is authorised in accordance with Directive 2009/65/EC provided that it has not designated a management company authorised under that Directive for its management.”

³⁵ Serdar Çelik and Mats Isaksson, 'Institutional Investors as Owners: Who Are They and What Do They Do?' (2013) 11 OECD Corporate Governance Working Papers.

³⁶ Financial Reporting Council, “The UK Stewardship Code” September 2012, [hereafter “Stewardship Code 2012”], available at [https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf), at 1.

“asset managers”. Asset owners are described as “providers of capital” in the SC and have been identified as tending to have long term liabilities by the European Commission.³⁷ The two major forms of asset owner are those defined in the SRD2, pension funds and life insurance companies.

A pension fund is defined in European and Irish law as “a financial corporation or quasi-corporation that is principally engaged in financial intermediation as the consequence of the pooling of social risks and needs of the insured persons (social insurance).”³⁸ This definition specifically excludes investment funds, financial vehicle corporations engaged in securitisation transactions, monetary financial institutions, insurance companies and social security funds. In Ireland, a pension fund can include the pooled assets from the public pension system, occupational pension schemes organised by employers, Personal Retirement Savings Accounts or Retirement Annuity Contracts.³⁹ Pension funds are usually administered by a board of trustees who typically do not have a particular expertise in investment and so will hire consultants and professional trustees to assemble a list of asset managers with whom the pension assets are invested. Pension funds have long been discussed as having a role in corporate governance. In the US, pension fund activism became a point of debate in the late 1980s and early 1990s after the Californian Public Employees’ Retirement System (CalPERS) began to target certain investee companies in the 1980s to agitate for governance and strategy changes.⁴⁰ Pension fund activism was encouraged in the US by legal reforms. The Securities and Exchange Commission (“SEC”) rules that prevented collective action were removed in 1987 and the Department of Labor clarified their view that private pension funds had a fiduciary duty to vote their shares in the interests of the pension plan as a whole.⁴¹ By the early 1990s pension fund challenges to public companies were not uncommon in the US and shareholder proposals were receiving increasing amounts of support, though victories remained a rarity.⁴² Some commentators regarded pension funds activism as providing a new opportunity to solve the

³⁷ Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 4 April 2014, at 4.

³⁸ Regulation (EU) 2018/231 of the European Central Bank of 26 January 2018 on statistical reporting requirements for pension funds (ECB/2018/2).

³⁹ OECD, “Review of the Irish Pension System: Preliminary version,” 22 April 2013.

⁴⁰ Michael P Smith, 'Shareholder Activism by Institutional Investors: Evidence from CalPERS' (1996) 51 *The Journal of Finance* 227 at 231-232.

⁴¹ John C Carter, 'The New Shareholder Power' (1989) 16 *Pepperdine Law Review* 1045 at 1055. See also Chapter 5: Overcoming Impediments to Shareholder Engagement below at p 173.

⁴² Bernard S Black, 'Shareholder Passivity Reexamined' (1990) 89 *Michigan Law Review* 520 at 571-572.

problem of the separation of ownership and control⁴³ and create a greater accountability of managers to shareholders.⁴⁴ Both conflicts of interest and collective action problems limited the level and impact of this form of activism during the 1990s, such that shareholder advocates were ultimately disappointed.⁴⁵ These conflicts differ depending on whether the pension fund is a public fund administering public assets or a private pension fund administering the assets of an occupational pension scheme of an issuer company. In the case of the latter, the pension fund managers will have an incentive to manage the pension assets of issuer companies and so will be disinclined to engage confrontationally with issuers in cases where the pension fund invests directly and not through an asset manager.⁴⁶ The former can be subject to political pressures with regard to how assets are invested and how activism is conducted.⁴⁷ Pension funds invest directly in equity markets around the world, as well as hiring asset managers to invest on their behalf. Among the sample of twenty-four Irish public listed companies on the Main Market of the Irish Stock Exchange analysed for this research, a US pension fund TIAA-CREF had invested in thirteen.

Insurance companies are a class of asset owner that have received far less scrutiny than pension funds but still have conflicts of interest by virtue of the manner in which they are structured and run. Insurance companies invest funds in capital markets to mitigate losses from policy holder claims. They have long been criticised for their passivity as institutional investors.⁴⁸ One problem is that insurance companies may not want to jeopardise business with corporate clients with whom they have underwriting business by engaging confrontationally with them.⁴⁹ In many jurisdictions, insurance companies are limited in the proportion of capital that can be invested in equities.⁵⁰ Ireland has no such restrictions

⁴³ Adolf A Berle Jr and Gardiner C Means, *The Modern Corporation and Private Property*, (Macmillan, 1933) (1932). For further discussion of the separation of ownership and control, see below at p 22.

⁴⁴ Bernard S Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 *UCLA Law Review* 811.

⁴⁵ Anna L Christie, 'The new hedge fund activism: activist directors and the market for quasi-control' (2019) 19 *Journal of Corporate Law Studies* 1 at 3. See also Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered' (1993) 93 *Columbia Law Review* 795.

⁴⁶ Conflicts of interest as an impediment to engagement are discussed in more detail in Chapter 3 below at pp 99-100.

⁴⁷ Romano (n 45).

⁴⁸ Mark J Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, (Princeton University Press, 1994) at 60-61.

⁴⁹ Stuart L Gillan and Laura T Starks, 'Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective' (2003) Fall/Winter *Journal of Applied Finance* 4 at 8 ("...an insurance company that underwrites for a corporate client may feel pressure to vote with corporate management or face losing the insurance business.") (text in footnote).

⁵⁰ Lori Versteegen Ryan and Marguerite Schneider, 'The Antecedents of Institutional Investor Activism' (2002) 27 *The Academy of Management Review* 554 at 568.

on insurance companies. Of the sample of Irish public listed companies, the insurance company AXA is notable for investing in eleven of twenty-four sample companies.

ii. Asset Managers

“Asset manager” is a category of institutional investor that provides investment services to a third party. The distinction between asset owners and asset managers is sometimes blurred. The term “asset manager” is defined in the SRD2 as an investment firm that provides portfolio management services.⁵¹ Many institutions that would properly be considered asset owners manage their own portfolios or manage part of their portfolio and delegate other parts to outside asset managers.⁵² Çelik and Isaksson note that asset managers tend not to invest in their own name but in the name of their client, whereas an asset owner would normally invest in their own name if they are making portfolio investment decisions.⁵³ Broadly speaking, asset managers are generally understood to be limited to those institutions specialising in portfolio management and asset allocation. Asset owners that seek out these specialists will hire them under a contract called a “mandate”.⁵⁴ The mandate will define the investment policy, strategy and goals of the investment. For example, an asset owner may wish to invest in a small amount of equities relative to debt or other asset groups. They may wish to invest in mostly passive index tracking products or they may wish to invest in a higher risk strategy involving active portfolio selection, with correspondingly higher fees and higher expected return.

Asset managers can be authorised under several different but overlapping regulatory regimes, the primary one being the Markets in Financial Instruments Directive (MiFID) regime.⁵⁵ The MiFID regime contains a range of transparency requirements for investment companies subject to it, especially around the process of trading securities, including

⁵¹ See definition as set out in SRD2, article 1(2)(b), above (n 34).

⁵² Çelik and Isaksson (n 35) at 15 (n 10 in their text), using as examples the Canada Pension Plan Investment Board (CPPIB) and California Public Employees’ Retirement System (CalPERS).

⁵³ Ibid.

⁵⁴ Andrew Bates and Blanaid Clarke Chapter 12 “Ireland” in Danny Busch and Deborah A DeMott (eds), *Liability of Asset Managers* (Oxford University Press, 2012) at para 12.09; UK Department for Business, Innovation and Skills “Exploring the Intermediated Shareholding Model”, BIS Research Paper No 261, January 2016 at 9. The International Corporate Governance Network has created a Model Mandate for asset owners and asset managers, see “ICGN Model Mandate Initiative Model contract terms between asset owners and their fund managers” (2012), available at https://www.icgn.org/sites/default/files/ICGN_Model-Contract-Terms_2015.pdf.

⁵⁵ Directive 2004/39/EC, as amended by Directive 2014/65/EU and Markets in Financial Instruments (MiFIR) - Regulation (EU) No 600/2014.

equities.⁵⁶ Asset management companies can also be authorised under the Undertakings for Collective Investment in Transferrable Securities (UCITS) Directive⁵⁷ or the Alternative Investment Funds (AIFs) Directive.⁵⁸ These latter forms are mutual funds and, depending on the form the fund an asset manager invest through, there will be restrictions on how assets are invested. For example, UCITS funds are prohibited from acquiring “any shares carrying voting rights which would enable it to exercise significant influence over the management over an issuing body.”⁵⁹ This will clearly affect how the manager of a UCITS fund carries out any engagement.

Certain kinds of asset manager have in recent years attracted greater scrutiny of commentators and academics concerned with shareholder engagement and shareholder democracy. Hedge funds, in particular, have ignited a debate about the merits of shareholder activism more generally.⁶⁰ These different types of asset manager will be described in more detail in later chapters. Other kinds of asset manager are also described further in later chapters, such as index funds and exchange traded funds. What these forms of asset manager have in common is that they are collections of assets that are open to investment from the public. What distinguishes them is how the assets are invested by the manager. For example, an index fund will strictly follow some index, such as the S+P 500, whereas a hedge fund manager will have a great deal more freedom with respect to which companies their assets are invested in.

D. The Meaning of “Engagement”

Engagement is, as noted above, a complicated process and describes a range of actions undertaken by shareholders. The concept of shareholder engagement is as old as the public company itself. Perhaps the first instance of shareholder activism was in 1609, when Isaac La Maire, a large shareholder and former director of the first company to issue shares to the public, the Dutch East India Trading Company, launched a petition against the board

⁵⁶ See MiFIR, article 3(1) (pre-trade transparency requirements for shares, depositary receipts, ETFs, certificates and other similar financial instruments), article 6 (post-trade transparency requirements for shares, depositary receipts, ETFs, certificates and other similar financial instruments).

⁵⁷ Directive 2009/65/EC.

⁵⁸ Directive 2011/61/EU

⁵⁹ Directive 2009/65/EC, article 56(1).

⁶⁰ See below at pp 19-21.

of the company.⁶¹ In modern companies, institutional investors have always played a role in seeking to have influence over corporate decision making. As Gillan and Starks describe,

“In the early 1900s, American financial institutions such as insurance companies, mutual funds, and banks were active participants in U.S. corporate governance. In many cases, the representatives of such institutions – among them J.P. Morgan and his associates – served on corporate boards and played major roles in the strategic direction of the firm.”⁶²

As will be seen, the SRD2 aims to enhance the level of shareholder engagement but stops short of imposing a legal obligation on shareholders to engage. However, it does create a norm where engagement is expected and a choice to not engage is an active deviation from this norm.⁶³ Engagement is unquestionably a fundamental aspect of shareholder democracy, which is why it is a central concern of this thesis. Subsequent chapters will analyse the law relating to engagement, the impediments that are presented for engagement and the positive or negative effects of such engagement. Before addressing such issues, it is important to determine a meaning for engagement. Where engagement develops into an expected activity, as it has through the SRD2 and the various stewardship codes around the world,⁶⁴ it is important that shareholders are aware of what particular actions are expected of them. If there is any ambiguity about what actions constitute “engagement” and what actions are merely preparatory for engagement or the effect of engagement, this will undermine the regulatory expectation that shareholders “engage” with investee companies. Where the regulatory expectation centres on a particular kind of “engagement” (for example, “long term” engagement⁶⁵), it is important that this is also made clear and why certain forms of engagement do not qualify. Otherwise, any and all forms of “engagement”, including those forms which are considered damaging or value decreasing by regulators can be relied upon to satisfy the regulatory expectation of “engagement”. Understanding the full continuum of engagement actions helps to identify which actions fall into the desired categories of expectations.

⁶¹ Henry Hansmann and Mariana Pargendler, 'The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption' (2014) 123 Yale Law Journal 948 at 1004.

⁶² Stuart L Gillan and Laura T Starks, 'The Evolution of Shareholder Activism in the United States' (2007) 19 Journal of Applied Corporate Finance 55 at 55.

⁶³ For a greater discussion on this point, see Chapter 2, below at pp 65-66.

⁶⁴ For a greater discussion on Stewardship Codes, see *ibid* below at pp 45-57.

⁶⁵ This category of engagement is especially focused upon in the provisions of the SRD2.

As will be described, engagement is at the forefront of the post-financial crisis regulatory agenda, its inadequacies having been identified by international financial regulators as a contributing factor to the behaviour that caused the crisis.⁶⁶ Engagement itself is a broad concept, and not one that has received the attention that is required if it is to be analysed as a tool to enhance managerial accountability and to reduce agency costs.⁶⁷ “Engagement” is a concept that does not invite a precise definition. In the Oxford English Dictionary, “engage” is given several meanings, the most relevant of which includes the preposition “with”. These definitions are “to participate or become involved in” and “establish a meaningful contact or connection with.”⁶⁸ In the next section a description will be given of “engagement”, what must be achieved to constitute “engagement” and how it is distinguished from other actions that may reduce agency costs.

i. Engagement as dialogue

A very common description of engagement involves the concept of “voice”.⁶⁹ This concept is distinguished from “exit”, which, in this context, involves simply selling one’s shareholding in a company. This classification was first described by Hirschman, who defined “voice” as:

“any attempt at all to change, rather than to escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge, through appeal to a higher authority with the intention of forcing a change in management, or through various types of actions and protests, including those that are meant to mobilize public opinion.”⁷⁰

⁶⁶ See Chapter 2 at pp 48; 58.

⁶⁷ Notable exceptions include Matthew J Mallow and Jasmin Sethi, 'Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate' (2016) 12 NYU Journal of Law and Business 385; Gillan and Starks (n 62).

⁶⁸ Oxford English Dictionary.

⁶⁹ John Kay, “The Kay Review of UK equity markets and long-term decision making” 2012, [hereafter “Kay Review”], at par 1.31; Black (n 44); Alessio M Paces, 'Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance' (2016) ECGI Law Working Paper No 320/2016 1.

⁷⁰ Albert O Hirschman, *Exit, Voice and Loyalty: responses to decline in firms, organizations, and states* (Harvard University Press, 1970) at 30.

Hirschman describes voice as a “messy” option, extending from “faint grumbling to violent protest.”⁷¹ His conception of voice is broader than simply shareholder action in respect of the investee company, encompassing relationships with customers and companies, stakeholders. In this context, “voice” has been described as including actions such as putting forward and voting on shareholder resolutions, behind the scenes dialogue, public confrontations and collection action among shareholders.⁷² “Engagement” as a concept is broader than Hirschman’s concept of voice, however. As can be seen, Hirschman’s concept is expressly oppositional, in the sense that it is specifically used to challenge, alter or bring about a different state of affairs in a company from the status quo. “Voice”, as defined by Hirschman, does not encompass actions that communicate approval or a desire to maintain the existing strategies and direction of the company. Very often, “engagement” will involve attempts to change from an objectionable state of affairs or protest with existing management. However, it is submitted that “engagement” is not restricted in this way.

In order to be coherent, shareholder engagement must include any actions that have the deliberate effect of sending some signal, whether positive or negative, to the decision makers in an investee company. In this sense, the act of engagement provides a communication to management, to which they can respond. “Communication”, much like “voice”, is a common means of characterising engagement.⁷³ An important minimum requirement of an act of engagement is its bilateral quality. It is submitted that an action cannot coherently be called “engagement” if there is no counterparty or if any conceivable counterparty is unaware of the engagement. As noted, the most relevant definition of “engage” for the purposes of defining the actions contemplated by “shareholder engagement” includes the preposition “with”. In other words, an engaging party must engage with someone or something in order to properly be said to be “engaging”. The involvement of the company or its representatives in some form or another is an essential element.

⁷¹ Ibid at 16.

⁷² Jennifer Goodman and others, 'Social Shareholder Engagement: The Dynamics of Voice and Exit' (2014) 125 *Journal of Business Ethics* 193 at 195.

⁷³ Michelle Edkins, “The Significance of ESG Engagement”, in BlackRock and Ceres, 21st Century Engagement: Investor Strategies for Incorporating ESG Considerations into Corporate Interactions, available at <https://www.blackrock.com/corporate/literature/publication/blk-ceres-engagementguide2015.pdf>.

Perhaps the best characterisation of engagement comes from Gillan and Starks, who describe a “continuum” of activities constituting “activism”.⁷⁴ Although the difference, if any, between activism and engagement will be described in a later section, it is submitted that the continuum concept applies in the context of a description of engagement activities. These authors set the upper and lower limits of the continuum, at one end being the purchase and sale of shares, since “[t]hrough their initial purchases and subsequent decisions to hold or sell, shareholders are expressing their views of the corporation’s performance.”⁷⁵ At the other end of the continuum, according to the authors, are attempts to launch a takeover bid for the company, with the intention of implementing changes once successful. It is submitted that, while the purchase or sale of shares of a company may be an expression of views on the performance of a company, very often these actions are entirely unilateral. Simply purchasing shares may have the effect of signalling faith in the company and company management and may have the knock-on effect of raising the share price of the company. Alternatively, purchasing shares of the company may send no signal whatsoever to company management, who may be completely oblivious that the purchase has occurred. Similarly, the sale of shares may or may not be a unilateral action. Shareholders may sell shares automatically, where their liquidity requirements of a portfolio demand it or if a company is taken out of an index that the shareholder is passively tracking. Where selling shares involves the carrying out of a threat to do so in response to unfavourable company actions, the sale of the shares sends a deliberate negative signal, communicated to management and therefore constitutes engagement.⁷⁶ In the same vein, the public commitment to take up an institutional investor’s pre-emption rights sends a positive signal to management and in this case the mere purchase of shares can constitute an engagement action.⁷⁷ It should also be noted that selling and purchasing shares may occur for entirely personal reasons that are unconnected to any sentiment, whether positive or negative, about an investee company. For example, an institutional investor may need to raise capital and so will sell shares entirely for this reason. The example of the sale or purchase of company shares shows that the same action can in some instances involve engagement and in other circumstances not involve engagement.

⁷⁴ Gillan and Starks (n 62).

⁷⁵ Ibid.

⁷⁶ See Anat R Admati and Paul Pfleiderer, 'The 'Wall Street Walk' and Shareholder Activism: Exit as a Form of Voice' (2009) 22 *The Review of Financial Studies* 2645.

⁷⁷ Conversely, of course, the public refusal to take up pre-emption rights can constitute engagement, since it sends a deliberately negative signal to management.

In sum, “engagement” as defined here, involves a continuum of different actions, each of which must have the deliberate effect of sending a signal to management, whether negative or positive, to which they can then respond. The language of “signalling” parallels the language of “communication” or “dialogue”. By doing some act which deliberately sends a signal, the shareholder is communicating something, which the management can respond to, hence creating what might broadly be characterised as “dialogue”. These are the minimum characteristics, it is submitted, of an action taken by a shareholder in order to qualify as “engagement” and be placed on the engagement continuum. Such actions include voting, holding meetings with management, proposing resolutions to be voted on at the general meeting, asking questions and commenting on the company at the general meeting and writing public letters to management. Actions that cannot be characterised as engagement are those which are necessarily unilateral, such as monitoring company information and privately seeking the views of other shareholders in a collective action. These actions can be considered preparatory for engagement but since management will be oblivious to them being carried out, they are themselves “engagement”. A difficult question arises with respect to engagement conducted in a superficial manner. An example of this would be blindly following a voting policy of always voting in favour of company management. This is a particularly low cost form of engagement and it is questionable whether or not it is designed to send a signal to management. Arguably, it is designed to send a positive signal to management. From another perspective, it sends no signal at all since the shareholder need not even be aware of the content of the voting proposal before voting whichever way management recommends.

It is perhaps notable that it is not universally agreed that shareholder voting constitutes “engagement”. Some commentators de-emphasise voting as an element of “engagement”,⁷⁸ while it is not listed by institutional investors in some surveys as an engagement activity.⁷⁹ Kay makes the point that “engagement goes beyond merely voting”, implying that voting is the bare minimum of what is considered engagement, rather than engagement being something different from the act of voting.⁸⁰

⁷⁸ Mallow and Sethi (n 67) at 392 discuss voting as “another” way of influence management, along with engagement, implying voting is somehow a separate activity. See also at 400-401, lamenting the excessive focus on voting in discussions of engagement.

⁷⁹ Marc Goldstein, “Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives – A study conducted by Institutional Shareholder Services for the Investor Responsibility Research Center Institute”, 10 April 2014.

⁸⁰ Kay Review at 53.

ii. Engagement as stewardship and activism

An important parallel concept to that of engagement is “stewardship”. As will be described in the next chapter, both “engagement” and “stewardship” have been identified as tools for greater management accountability. Stewardship codes have proliferated around the world specifically in order to encourage institutional investors to hold management accountable. The 2012 SC specifically defines “stewardship” as a non-exhaustive set of actions including monitoring and “engaging with companies” on particular matters.⁸¹ Engagement is given a definition in this SC that is framed in terms of “purposeful dialogue”.⁸² Recently, the Financial Reporting Council (“FRC”) proposed a broader definition of “stewardship” to be included in a future, reformed Code, which is the following:

“Stewardship is the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society. Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities.”⁸³

This definition is incorporated into the SC and specifically includes investment decision making and investments in asset classes other than equity. This definition focuses on the delivery of value to beneficiaries of investment. Other definitions of “stewardship”, such as in the Japanese Stewardship Code, focus on the enhancement of investment value in the medium to long term.⁸⁴ Although the 2012 SC has been criticised for inadequately defining “stewardship”,⁸⁵ it is submitted that the term refers to a broad concept that eschews a precise definition. In order to be a “steward”, one must take on responsibilities to ensure the care of something into the future. The stewardship of a company therefore involves ensuring that the company is managed properly and that damage is not done to its economic

⁸¹ Stewardship Code 2012 at 1.

⁸² *Ibid* at 6.

⁸³ FRC, “Proposed Revision to the UK Stewardship Code”, January 2019 at 2.

⁸⁴ Principles for Responsible Institutional Investors, “Japan’s Stewardship Code – To promote sustainable of companies through investment and dialogue”, The Council of Experts on the Stewardship Code, 29 May 2017, available at <https://www.fsa.go.jp/en/refer/councils/stewardship/20170529/01.pdf>, at 3; see also Lucian Bebchuk and Scott Hirst, “Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy”, (2018) Law Working Paper N° 433/2018 at 13.

⁸⁵ Arad Reisberg, ‘The UK Stewardship Code: On the Road to Nowhere?’ (2015) 15 *Journal of Corporate Law Studies* 217.

well-being through mismanagement or other avoidable factors. John Kay in his influential review of long termism in UK equity markets in 2012 explained:

“The concept of stewardship originates in the responsibilities of a steward as manager of a household or estate, and the historic analogy is apt. The essential characteristics of the steward are understanding and engagement – understanding the needs and expectations of those with whom the steward deals, and engagement with those who meet these needs and discharge the expectations of the principals.”⁸⁶

The stewardship of a company is commonly equated with the stewardship of the “value” of a company. For instance, Bebchuk and Hirst state that “[i]n the literature on institutional investors, *stewardship* refers to the actions that investment managers can take in order to enhance the value of the companies that they invest in on behalf of their own beneficial investors.”⁸⁷ Stewardship actions usually include both monitoring and engagement.⁸⁸ Chiu observes that “[t]he key notions in ‘stewardship’ seem to be long-termism, and taking a more holistic view of the well-being and performance of the company.”⁸⁹ She also argues that the monitoring expected by a “steward” of a company goes beyond the monitoring undertaken by the principal in the agency relationship.⁹⁰ In other words, the steward monitors the investee company with the wider public good in mind and not just the value of their investment.

The stewardship of a company therefore involves ensuring that the company is managed properly and that damage is not done to its economic well-being through mismanagement or other avoidable factors. Stewardship actions encompass more than engagement actions

⁸⁶ Kay Review at par 6.2.

⁸⁷ Lucian Bebchuk and Scott Hirst, “Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy”, (2018) Law Working Paper N° 433/2018 at 13 (emphasis in original, reference omitted).

⁸⁸ See Iris H-Y Chiu and Dionysia Katelouzou, “From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?” in Hanne S Birkmose (ed), *Shareholders’ Duties* (Kluwer Law International BV, 2017) at 134 (“Shareholder stewardship is a term developed in the UK to refer to constructive shareholder engagement and monitoring of investee companies, in order to overcome the agency problems between institutional shareholders and corporate directors.”) (reference omitted). Engagement and monitoring, along with reporting, are the two actions of stewardship, as defined in the 2012 SC.

⁸⁹ Iris H-Y Chiu, 'International Shareholders as Stewards: Toward a New Conception of Corporate Governance' (2012) 6 Brooklyn Journal of Corporate, Finance and Company Law 387 at 387-388.

⁹⁰ *Ibid* at 396-397.

therefore, since, as noted above, engagement actions require some form of bilateralism or “dialogue”. Monitoring of the information and activities of an investee company in an entirely unilateral way on the part of institutional investors constitutes an act of stewardship.

Engagement actions are themselves acts of stewardship, provided that they are done in order to ensure the long term health of the company. In this sense, stewardship could be an umbrella term that encompasses “engagement”. However, considering that engagement has the potential to be conducted at the expense of, rather than for the benefit of, the company, engagement actions do not always fall under this heading. For example, the position of “shareholder activists” in certain cases might be considered “engagement” but not “stewardship”. Activists are a controversial subsection of shareholders, either being heralded as the heroes of capitalism or advocates for damaging short termism in public markets.⁹¹ Activists have been accused of reducing research and development expenditure,⁹² diverting capital from the company and other stakeholders toward themselves (and other shareholders)⁹³ and increasing the leverage of the company.⁹⁴ Activists have also been identified as the initiators of shareholder engagement,⁹⁵ who have favourable long term effects on underperforming companies.⁹⁶ Assuming that there are individual cases where activists have done harm to target companies in order to profit in the short term, the tactics used in such cases are unquestionably “engagement” with the company but would not qualify as “stewardship”. This also hints at a difference in the “quality” of engagement. Engagement that furthers the short term wealth transfer to

⁹¹ “Capitalism’s unlikely heroes: Why activist investors are good for the public company”, *The Economist*, 5 February 2015; Iman Anabtawi and Lynn Stout, 'Fiduciary Duties for Activist Shareholders' (2008) 60 *Stanford Law Review* 1255 at 1261 (“Activist shareholders can have serious conflicts of interest with other shareholders arising from their other relationships with the firm, from their investments in derivatives or securities issued by other corporations, from their investments in other parts of the firm's capital structure, and from their short-term investment focus.”)

⁹² John C Coffee and Darius Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 41 *Journal of Corporation Law* 545, citing Brian J Bushee, 'The Influence of Institutional Investors on Myopic R&D Investment Behaviour' (1998) 73 *The Accounting Review* 305 in which a significant link was found between “transient investors” and cuts to R&D. Coffee and Palia also cite the example of the attempted takeover by Valeant and Pershing Square (an “activist” hedge fund) of Allergan and the resulting reductions in R&D expenditure.

⁹³ Joseph L Bower and Lynn S Paine, “Managing for the Long Term: The Error at the Heart of Corporate Leadership”, (2017) *Harvard Business Review*.

⁹⁴ Coffee and Palia (n 92).

⁹⁵ 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.

⁹⁶ Lucian A Bebchuk, Alon Brav and Wei Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 *Columbia Law Review* 1085.

shareholders at a long term cost to the welfare of the company is not the quality of engagement that is desirable from the perspective of regulation, the companies and wider society.

Shareholder activism is a practice that has caught the attention of a great number of commentators and has sharply divided opinion on whether it is a force for positive or ill in corporate governance.⁹⁷ For this reason, it is worth pausing and scrutinising “activism” as a concept briefly. Activism is commonly carried out by a sub-group of shareholders, hedge funds. While not all hedge funds are activists and not all activists are hedge funds, “hedge fund activism” has been the most discussed practice of shareholder engagement more generally.⁹⁸ It is clear from the above definition of “engagement” that “activists” are heavily engaged shareholders, targeting companies for some aim that the activists have determined during a prior monitoring process. Activism has been described as involving one of two forms: “offensive” and “defensive” activism.⁹⁹ The distinguishing characteristic of these forms of activism is not the nature of engagement necessarily (though an aggressive approach has characterised offensive activism in the past¹⁰⁰) but the time when a stake in the target company is purchased. Defensive activism involves targeting existing investee companies and engaging in order to protect the investment. Offensive activism involves targeting a company in which the activist does not have a pre-existing stake. This latter form of activism is motivated by generating abnormal returns from the engagement.¹⁰¹ These differing motivations often lead to different forms of engagement, though this need not always be the case. For example, defensive activism usually involves “behind the scenes” engagement in order to rectify some issue identified by the activist.¹⁰² Offensive activism can begin behind the scenes but since activists target a company specifically to make changes that will result in abnormal returns, they often act in a more

⁹⁷ For a small sample, see Dionysia Katelouzou, 'Worldwide Hedge Fund Activism: Dimensions and Legal Determinants' (2015) 17 *University of Pennsylvania Journal of Business Law* 789; Maria Goranova and Lori Verstegen Ryan, 'Shareholder Activism: A Multidisciplinary Review' (2014) 40 *Journal of Management* 1230; Bebchuk, Brav and Jiang (n 96); Coffee and Palia (n 92); Leo E Strine Jr, 'Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System' (2017) 126 *The Yale Law Journal* 1870.

⁹⁸ See *ibid.*

⁹⁹ Andreas Jansson, 'No Exit!: The Logic of Defensive Shareholder Activism' (2014) 10 *Corporate Board: role, duties and composition* 16 at 19-20; Brian R Cheffins and John Armour, 'The Past, Present, and Future of Shareholder Activism by Hedge Funds' (2011) 37 *Journal of Corporation Law* 51 at 56-57; Iris H-Y Chiu, *The Foundations and Anatomy of Shareholder Activism* (2010, Hart Publishing) at 8-13.

¹⁰⁰ Cheffins and Armour (n 99) at 57.

¹⁰¹ Chiu (n 99) at 9.

¹⁰² Cheffins and Armour (n 99) at 56.

confrontational manner and often do so publicly, in order to generate support from other shareholders and put pressure on incumbent management.

While engagement and stewardship are, for the reasons given above, strictly speaking, distinct concepts, there are a great deal of parallels between the two. As will be described in the next section, “stewardship” is often the tool that is promoted by regulators for the end of accountability of management. The lines between stewardship and engagement are often blurred and where regulators promote “engagement” it is clear that it is not simply “engagement” that is being sought, but forms of engagement that are for the long term and designed for specific purposes.¹⁰³ This distinguishes lower “quality” engagement that pursues short term wealth.

Both the provisions of the SRD2 and the UK SC will be explored in the next chapter, along with their development. It will be seen that both are in response to commonly identified corporate governance issues, namely, institutional investor passivity. Without a clear understanding of the concept of “engagement” and what it entails, there can be confusion regarding what exactly is expected from regulation that encourages “engagement”. What exactly is expected will be detailed in the next chapter.

E. Agency theory

Shareholder engagement, as described, is a fundamental aspect of shareholder democracy. The roots of shareholder democracy can be found in agency theory, which is an economic concept that more generally considers shareholders as the “principals” of the company. However, assuming that shareholders are the company’s “principal” does not necessarily imply that they ought to be engaged and centrally involved in company decision-making. Viewing shareholders as “principals” may point to engaged shareholders, but it also may point to the controllers of the company directing themselves to make decisions on behalf of the interests of shareholders, or “shareholder wealth maximisation”.¹⁰⁴ This important distinction is not made in agency theory but, since the movement toward shareholder

¹⁰³ See Chapter 2 at p 63 .

¹⁰⁴ For a greater discussion on this distinction, see above at p 2 .

democracy in company law across Europe and the US plausibly began with the development of the theory, it is worth setting out.

Seeking to place shareholders at the centre of the corporate objective has a number of theoretical origins and justifications. Shareholders have long been considered by many to be the “owners” of the company.¹⁰⁵ While this view has met strong resistance,¹⁰⁶ it was an accepted truth for the vast majority of commentators, at least during the twentieth century. Believing that shareholders own the company justifies placing them centrally in company decision making. Neither shareholder democracy nor shareholder wealth maximisation guarantees that controllers will not use their control to their own benefit and at the expense of shareholders. Shareholder democracy in particular relies on shareholder engagement in order to achieve the aim of management accountability to shareholders. As subsequent chapters will explore in greater depth, there are a multitude of reasons why shareholders do not engage. In 1932, Berle and Means published the seminal work “The Modern Corporation and Private Property” in which they made the broad argument that shareholders of US companies at that time were too dispersed to have any real influence in the management of the company.¹⁰⁷ This argument laid the foundation for discussions of corporate law ever since, with many commentators subsequently seeking to solve the problem of “the separation of ownership from control.”¹⁰⁸ This problem stems from a view of shareholders, the owners of the company, as having little or no ability to control the company in which they are invested because of the dispersed shareholding structure of the company. Control is therefore in the hands of executives, managers and directors. An important contribution to this debate came in 1976, when Jensen and Meckling identified agency costs as an important aspect of the organisational structure of the company.¹⁰⁹ These authors defined “agency costs” as the sum of monitoring costs of the principal, bonding costs of the agent and the residual losses where the decisions of the agent still diverges from those that maximise the welfare of the principal.¹¹⁰ The central agency relationship,

¹⁰⁵ See Cadbury Report at par 6.1 (“the shareholders as owners of the company elect the directors to run the business on their behalf and hold them accountable for its progress.”); Richard A Booth, 'Who Owns a Corporation and Who Cares?' (2001) 77 *Chicago-Kent Law Review* 147.

¹⁰⁶ See Lynn A Stout, 'Bad and Not-so-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189 at 1190-1192; Keay (n 9) at 393-397.

¹⁰⁷ Berle and Means (n 43).

¹⁰⁸ George J Stigler and Claire Friedland, 'The Literature of Economics: The Case of Berle and Means' (1983) 26 *The Journal of Law and Economics* 237.

¹⁰⁹ Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

¹¹⁰ *Ibid* at 308.

as Jensen and Meckling saw it, is the “owner-manager” relationship or that between the shareholder and those making and carrying out decisions on behalf of the company.

Jensen and Meckling also pointed to an earlier article by Alchian and Demsetz that examined the issue of shirking within teams in a firm.¹¹¹ Alchian and Demsetz pointed out that, while a specialised monitor is required to monitor teams in order to prevent shirking, this simply raised the further difficult question of who will monitor the monitor since they will also have an incentive to shirk.¹¹² They argued that it is the residual claimant that ought to perform the function of the ultimate monitor since this party will have a reduced incentive to shirk. The residual claimant will also benefit proportionally as they increase their effective monitoring. As they put it: “The monitor earns his residual through the reduction in shirking that he brings about, not only by the prices that he agrees to pay the owners of the inputs, but also by observing and directing the actions or uses of these inputs.”¹¹³ Therefore, shareholders as residual claimants theoretically have an incentive to monitor effectively.

According to agency theory, shareholders are the principal of the company and must function as ultimate monitors of corporate team members and decision makers. However, as Fama argues, despite the argument of Alchian and Demsetz that shareholders will have an incentive to act as effective monitors, the separation of ownership and control suggests a lack of interest on the part of shareholders to monitor management, especially where their investment is spread across a wide range of companies.¹¹⁴ Shareholders, as residual claimants, will thus be imperfect monitors and the agency problem may persist. As Bainbridge asserts: “In general, shareholders of public corporations have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents.”¹¹⁵ Fama makes the argument that the competition amongst managers and the possibility of responding to agency costs revealed after the fact of shirking through wage revisions can resolve the agency problem.¹¹⁶ However, this argument relies on managerial labour markets being efficient, which

¹¹¹ Armen A Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organization' (1972) 62 *The American Economic Review* 777.

¹¹² *Ibid* at 782.

¹¹³ *Ibid*.

¹¹⁴ Eugene M Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288 at 295.

¹¹⁵ Bainbridge (n 14) at 568.

¹¹⁶ Fama refers to this process as “settling up”, see Fama (n 114).

subsequent commentators found to often not be the case.¹¹⁷ Agency theorists have presented a number of possible solutions to aligning the interests of a firm's decision makers and shareholders in the absence of independent shareholder monitoring. Primarily, equity based remuneration for top executives and managers, which became extremely popular in the early 1990s was thought to properly align the interests of these managers with the shareholders they were supposed to be serving. These changes in compensation structures were largely due to regulatory intervention, by way of tax incentives in the US¹¹⁸ and corporate governance codes in the UK.¹¹⁹ These measures did nothing to spur shareholders to monitor companies more or seek to get involved in company decision making – in other words, engage. These measures were, however, instances of furthering the goal of shareholder wealth maximisation, by aligning the incentives of controllers of companies with this aim. In this way, agency theory seeks to solve the problem of agency costs of shirking managers and the imperfect monitoring of shareholders through the alignment of incentives. At the same time that shareholder wealth maximisation norms were being incorporated into the compensation structures of company controllers, as will be seen, the norms of shareholder democracy were being integrated into the corporate governance frameworks of the UK.¹²⁰

Agency theory, developed in the 1970s and 80s, reached its ascendance some time in the 1990s, at which time influential legal scholars Hansmann and Kraakman declared that “[t]here is no longer any serious competitor to the view that corporate law should principally seek to increase long-term shareholder value.”¹²¹ The idea that corporate law should strive primarily to reduce agency costs that company management impose upon shareholders led to particular corporate governance trends that have had significant economic consequences. The groundwork for developments in shareholder democracy was laid by the Cadbury Committee in the early 1990s. This committee was convened in 1991 by the FRC, London Stock Exchange (LSE) and the accountancy profession following several corporate scandals in the early 1990s, including Polly Peck, the Bank of Credit and

¹¹⁷ Edward A Dyl, 'Corporate Control and Management Compensation: Evidence on the Agency Problem' (1988) 9 *Managerial and Decision Economics* 21.

¹¹⁸ Section 162(m) IRS Code.

¹¹⁹ “Directors' remuneration- report of a study group chaired by Sir Richard Greenbury” 17 July 1995, which was incorporated into the UK Corporate Governance Code. See generally, Nicholas Bourne, 'Corporate Governance in the UK and Overseas' (2007) 28 *Business Law Review* 292.

¹²⁰ See Chapter 2 below at p 47.

¹²¹ Hansmann and Kraakman (n 9). See also Catherine M Daily, Dan R Dalton and Albert A Cannella Jr, 'Corporate Governance: Decades of Dialogue and Data' (2003) 28 *Academy of Management Review* 371 (“The overwhelmingly dominant theoretical perspective applied in corporate governance studies is agency theory”).

Commerce International and the Robert Maxwell litigation.¹²² It was chaired by prominent UK businessman Sir Adrian Cadbury and produced a report that profoundly affected the UK corporate governance environment.¹²³ Its most meaningful contribution was the recommendation that principles of good corporate governance be collected in a code and applied to UK companies on a “comply or explain” basis.¹²⁴ The “Cadbury Code” as it became known was adopted by the LSE in 1994. The Cadbury Code was clearly influenced by the conclusions of agency theory. It states, “...the shareholders as owners of the company elect the directors to run the business on their behalf and hold them accountable for its progress. The issue for corporate governance is how to strengthen the accountability of boards of directors to shareholders.”¹²⁵

Shareholder democracy was broadly endorsed in principle in the Cadbury Code and this endorsement would lead to several regulatory developments, including the central plank of institutional investor engagement in the UK, the SC. In the report, the Cadbury Committee “warmly welcomes” a statement of principles produced by the Institutional Shareholders’ Committee, which can be characterised as an early draft of what would become the SC.¹²⁶ The statement of principles is titled “Responsibilities of Institutional Shareholders in the UK” and included principles (quoted in full and endorsed by the Cadbury Committee in its report) such as “Institutional investors should encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and quality of management.”¹²⁷

The Committee on Corporate Governance in the UK was formed on the initiative of the FRC in order to assess the implementation of both the Cadbury and Greenbury reports¹²⁸ in 1995 and was initially chaired by Ronnie Hampel, another prominent UK businessman.

¹²² For background on the setting up of the Cadbury Committee, see Sridhar R Arcot and Valentina G Bruno, *In Letter but not in Spirit: An Analysis of Corporate Governance in the UK* (LSE Working Paper No. 31 2006).

¹²³ Ian Jones and Michael Pollitt, 'Understanding How Issues in Corporate Governance Develop: Cadbury Report to Higgs Review' (2004) 12 *Corporate Governance: An International Review* 162 at 164 (“The quality of the Cadbury Report’s conclusions and implementations lies in the fact that the report is internationally recognised as having been seminal in the development of corporate governance in the UK and elsewhere.”)

¹²⁴ For a greater discussion of “comply or explain” as an enforcement mechanism, see Chapter 5 below at pp 153-172.

¹²⁵ See Cadbury report at 6.1.

¹²⁶ Cadbury report, par 6.11.

¹²⁷ *Ibid.*

¹²⁸ See above, (n 123).

In 1998 this Committee produced its report, in which it generally endorsed all of the recommendations of both of these previous reports,¹²⁹ emphasising that directors are accountable to shareholders alone.¹³⁰ Shortly after, this Committee published the “Combined Code”, which would develop into the UK Corporate Governance Code in 2010.¹³¹ The UK Corporate Governance Code and its subsequent revisions are among the most important legal documents in corporate governance in both the UK and Ireland in terms of guiding how public listed companies organise themselves.¹³² The influence of the Code (and its revisions) is also felt far beyond the UK and Ireland, as it set the norms of good corporate governance across the world. For present purposes, the Code is an important feature of shareholder democracy as it places director accountability to shareholders as a fundamental tenet of good corporate governance and encourages shareholder engagement in order to achieve this accountability. Many of the provisions that manifest this tenet are given fuller elaboration in the different iterations of the SC, on which more in the next Chapter,¹³³ and much more emphasis has been placed on accountability to stakeholders other than just shareholders in more recent manifestations of the Code.¹³⁴ The Code remains distinctly influenced by agency theory in the sense that shareholders continue to take up an outsized position as compared to other stakeholders.¹³⁵ However, the Code has always operated on a “comply or explain” basis in relation to its various provisions and this mechanism illustrates a certain commitment to shareholder democracy because the “comply or explain” disclosures are designed for the shareholders. For example, in the 2018 UK Corporate Governance Code, it is explained that “It is the responsibility of boards to

¹²⁹ “Committee on Corporate Governance: Final Report,” January 1998 Chaired by Ronnie Hampel, (Hampel Report), at par 1.7.

¹³⁰ Ibid at par 1.17.

¹³¹ The process by which the Combined Code became the UK Corporate Governance Code involved a 2009 report by the FRC in which they proposed renaming the Combined Code to the “UK Corporate Governance Code” in order “to make clearer its status as the UK’s recognised corporate governance standard.” See FRC, “2009 Review of the Combined Code: Final Report” December 2009 at 3. The renamed UK Corporate Governance Code was published subsequently in June 2010.

¹³² Revisions to the Code include that done in 2016, FRC “The UK Corporate Governance Code” April 2016, available at <https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf> and in 2018, see FRC “The Corporate Governance Code” July 2018, available at <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf>.

¹³³ Chapter 2 at pp 46-58.

¹³⁴ See FRC, “The UK Corporate Governance Code” July 2018, Principle 1, Provision 5, (“The board should understand the views of the company’s other key stakeholders and describe in the annual report how their interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and decision-making. The board should keep engagement mechanisms under review so that they remain effective.”)

¹³⁵ The relative power and position of stakeholders is generally a consideration that is beyond the scope of this thesis but some consideration is given in Chapter 7: Conclusion and Final Remarks below at pp 238-244.

use this flexibility wisely and of investors and their advisors to assess differing company approaches thoughtfully”¹³⁶ Shareholders are the primary audience for disclosures regarding the Code and these disclosures are intended to trigger engagement on the part of shareholders, for example, where a Code provision is not complied with or an explanation for non-compliance is insufficiently detailed.¹³⁷

In more recent years, the principles and assumptions of agency theory have been challenged and the stated reasons for viewing shareholders as the “principals” of the company have been rebutted by commentators to varying degrees. For instance, a common argument that shareholders ought to be considered the principal of the company is that shareholders own the company and ownership of the company necessarily implies that shareholders are top of the hierarchy of considerations. Friedman, in a famous 1970 opinion piece in the *New York Times Magazine*, stated that shareholders are the owners of the company and therefore those in control of the company had a social responsibility only to increase its profits, in service of the “owners.”¹³⁸ This has been rebutted by a number of commentators, perhaps most notably, Lynn Stout, who has pointed out that shareholders own only the shares that the company issues and not the company itself.¹³⁹ Certainly, shareholders have no legal right to, or interest in, the assets of the functioning company.¹⁴⁰ Stout also seeks to rebut the argument that shareholders should be considered the principal of the company on the basis that they are the sole residual claimant by pointing out that controllers of the company in law have the freedom to ensure shareholders receive nothing, by not declaring a dividend or buying back shares.¹⁴¹ Directors can choose to invest excess earnings in research and development or other projects that reduce profits.

Regardless of the merits of agency theory and its assumptions on a conceptual and legal basis, as will be described below, the theory has been remarkably impactful in the development of regulation over the past three decades. One example is the aforementioned

¹³⁶ See FRC, “The UK Corporate Governance Code” July 2018, at 1.

¹³⁷ For a greater discussion of comply or explain see Chapter 5 below at pp 153-172.

¹³⁸ Milton Friedman, “The Social Responsibility of Business is to Increase its Profits,” *New York Times Magazine*, 13 September 1970.

¹³⁹ Stout (n 106) at 1191-1192.

¹⁴⁰ Generally, see *Salomon v Salomon & Co* [1897] AC 22; *Short v Treasury Commissioners* [1948] 1 KB 116. In Irish law, see *Attorney General for Ireland v Jameson* [1904] 2 IR 644 at 671 per Kenny J, “No shareholder has a right to any specific portion of the company’s property, and save by, and to the extent of, his voting power at a general meeting of the company, cannot curtail the free and proper disposition of it.”

¹⁴¹ Stout (n 106) at 1193.

UK Corporate Governance Code and its reliance on shareholders is its primary enforcers. This is thought to be a better alternative to mandatory hard law intervention to enforce the governance standards of the Code.¹⁴² With regard to shareholder engagement, the SRD2 takes a similar approach to the Code, in the sense that it is based on a “comply or explain” form of enforcement. This aspect of the SRD2 will be considered in more detail in a future chapter.

F. Methodology

i. Critical Analysis

This thesis will primarily involve an analysis of the SRD2, a recent legal development that relates to the operation of shareholder democracy and, in particular, shareholder engagement in European companies. The analysis will be doctrinal and based on critical analysis of the SRD2, as well as descriptive, outlining the development of both the SRD in 2007 and its 2017 revision. Describing the various factors that influenced the development of the Directive is necessary to understand its aims and effectively assess its likelihood of achieving these aims. Critical analysis is used, addressing two primary research questions: how effective will the SRD2 be in achieving its aims and what will be the effect of successfully engaging shareholders in the manner that the SRD2 hopes? These questions are addressed in the context of the development of shareholder democracy more generally, especially with respect to Irish law and Irish companies and shareholders.

ii. Empirical Research

Some empirical work was undertaken as part of the research for this thesis, although it is not claimed to constitute substantial empirical evidence. An original survey, found in the Appendix to this thesis, was created and distributed to representatives of different institutional investors. This survey contained 15 questions that related to the engagement practices of the recipients. It was distributed in order to discover whether Irish institutional investors and institutional investors in Irish companies had an engagement policy, what they viewed “engagement” as meaning and how they had conducted recent engagements.

¹⁴² FRC, “What constitutes an explanation under ‘comply or explain’? Report of discussions between companies and investors”, February 2012 at 8 (“Used properly, the Code-based ‘comply or explain’ approach can deliver greater transparency and confidence than formal regulation which is purely a matter of compliance.”)

Getting the views of institutional investors was considered to be important because they will be the ones subject to the provisions of the SRD2 and they will be tasked with carrying out the engagement that the SRD2 seeks. The success of the SRD2 depends in part on how prepared the institutional investors are to undertake the engagement for which the SRD2 hopes. This is especially so where the law in question is not mandatory, which the provisions of the SRD2 strictly are not, giving institutional investors the choice as to whether or not to comply. Where the aims of the SRD2 could be defeated by the widespread election not to comply, it is worthwhile knowing and understanding how prepared institutional investors are, as well as their general views with regard to engagement.

The survey was sent to potential respondents during 2019. This required ethical approval from the Research Ethics Committee of the School of Law, Trinity College Dublin. In order to capture Irish asset managers, members of the Irish Association of Investment Managers (IAIM) were sent the survey. Out of eleven members, there were two responses. The ethics approval was granted on 18 September 2018, subject to several conditions, including that it is noted on the invitation to participate in the Survey that participation will constitute consent to use the responses in this thesis and that the material be destroyed within 5 years. Subsequent to this, an analysis was conducted of ownership of Irish public listed companies on the Main Market of the Irish Stock Exchange. Surveys were then sent to nineteen international institutional investors who were invested in at least ten of these Irish companies. This required further ethical approval, which was granted on 4 February 2019 subject to the conditions that a data protection impact assessment form was completed and sent to the Data Protection Officer of Trinity College Dublin. Of these recipients, there was one survey response. Due to the low numbers of respondents, it is not claimed that the survey results amount to reliable empirical evidence. However, there is anecdotal value in these responses and they reveal an isolated understanding of certain institutional investors and asset managers of engagement and how they carry it out. The Surveys were conducted on an anonymous basis on the SurveyMonkey platform. There were no identifying features of responses upon entry onto the platform. In particular, the views on the meaning of engagement are of interest. It is submitted that these three responses bolster perspectives on engagement that are better grounded in evidence and provide an interesting and often original context for a discussion on engagement. Aspects of these responses will be mentioned in relevant areas throughout the thesis.

G. Scope

The scope of this thesis is confined to the operation of the SRD2 and the emphasis will be on its transposition and effect in Irish law. The wider philosophical discussion of the place of shareholders in corporate governance will only be detailed in relation to how it has had an impact on the development of the SRD and SRD2. For this reason, the voice of non-shareholder stakeholders will only be discussed as a “final remark” in the concluding chapter of the thesis. Enhancing the voice of shareholders in corporate governance, as both the SRD and SRD2 seek to do raises the legitimate question of whether it can be expected to stifle or dilute the voices of other stakeholders in decision making and corporate governance but this question is not directly relevant to the operation of the SRD2. A stakeholder theory of corporate governance is often placed in opposition to “shareholder primacy” models¹⁴³ and this thesis is not directly concerned with the former.

Since the scope of the thesis concerns shareholder democracy in the context of the SRD2, the question of the jurisdiction of the SRD2 should be considered. The thesis is not only concerned with the actions of institutional investors but also with the actions of investee companies. The SRD2 has an extraordinarily wide jurisdiction, applying to all companies listed on a regulated market in the European Union.¹⁴⁴ This means that institutional investors that are not themselves domiciled in an EU Member State but simply own shares in a company that is listed on a regulated market in the EU will also be subject to the duties imposed by the SRD2. While enforcement of the SRD2 will of course remain an issue,¹⁴⁵ this captures many third country institutional investors and asset managers. This means that consideration of the behaviour and practices of institutional investors in other jurisdictions, most notably the US, are relevant and will be discussed.

H. Originality

Although, as will be noted during the course of the thesis, recent articles and book chapters have reviewed and critiqued the SRD2, this thesis involves a deeper look at how provisions designed to enhance shareholder engagement and further shareholder democracy can be expected to overcome the formidable barriers and impediments to the exercise of

¹⁴³ See for example, Andrew Keay, *The Corporate Objective*, (Edward Elgar, 2011).

¹⁴⁴ SRD2, Article 1.

¹⁴⁵ For a greater discussion of enforcement of SRD2 provisions see Chapter 2, below at pp 71-73.

shareholder voice. The SRD2 is the first piece of legislation that seeks to compel shareholder democracy rather than facilitate it. While the word “compel” may be quibbled with, since no provisions of the SRD2 actually involve mandatory engagement, it is arguable that the SRD2 represents a step towards creating a normative environment where engagement is expected and asset managers can fear being punished by the market if they ignore engagement altogether.¹⁴⁶ As will be described, the engagement provisions of the SRD2 are ambiguous in the sense that it is not clear to what extent outcomes of engagement are expected. It is certainly unclear how much discretion shareholders subject to the SRD2 will retain regarding their own compliance with the engagement provisions of the SRD2. Can shareholder judge themselves to be in full compliance in circumstances where they have made no direct communication with any investee company representatives? These ambiguities inherent in the SRD2 ‘s engagement provisions require exploration in order prior to any analysis of how effective the SRD2 is likely to be. The effects that the SRD2 could have upon the operation of corporate governance across the world could be enormous and involve a complex range of different activities and responses from both companies and institutional investors. This thesis makes a number of original contributions to the literature on the law of shareholder engagement.

First, setting out the meaning of the concept of engagement provides clarity to the discussions of engagement that follow. Understanding what distinguishes engagement from activism and from stewardship helps to understand the merits of the SRD2 provisions and other regulation that seeks to improve and maintain shareholder democracy. Establishing a meaning and understanding of the concept of engagement helps place the SRD2 in its proper context. It also illuminates issues that relate in particular to the SRD2, which will be described, including a possible divergence in how regulators and commentators view engagement and its value and how those subject to the SRD2 view engagement and its value. Furthermore, establishing the meaning of engagement contributes to a more informed and precise discussion and analysis of the impediments to engagement. For example, understanding the complexities of the continuum of engagement, as described by Gillan and Starks,¹⁴⁷ as applied to a discussion about engaging in the context of the SRD2 will contribute to an understanding of the sense in which a particular market phenomenon or regulation impedes such engagement.

¹⁴⁶ For a greater discussion on these points see Chapter 5, below at pp 168-170.

¹⁴⁷ Gillan and Starks (n 62).

Second, the argument is made that creating a duty of engagement can be expected to lead to a more rigid approach to engagement that can be described as “one size fits all”. Criticisms of one size fits all corporate governance have been pointed to in other contexts, most notably with regard to the application of the UK Corporate Governance Code. Shareholders have long been criticised for adopting an inflexible approach to compliance under the Code by commentators¹⁴⁸ and Government sponsored reports.¹⁴⁹ However, this thesis will make the argument that the SRD2 will place pressure upon asset managers to “engage” but that this engagement will occur in a manner that is least costly for the shareholder. This will involve reliance on voting rules and guidelines, proxy advisors and short term indicators. Again, proxy advisors themselves have been accused of adopting a generic, one size fits all approach,¹⁵⁰ which this thesis links back to the possible engagement outcomes of the SRD2. Thirdly, and relatedly, it will be argued that the existing literature on shareholder engagement law does not sufficiently take into account the costs of not engaging, or at least the costs of not appearing to engage. As set out, the literature relating to “rational apathy” does not account for reputational costs which are less immediately calculable than the financial costs of engaging. It is these costs that will place the pressure on asset managers to comply with the engagement provisions in the SRD2.

Finally, an original contribution is made by focusing on shareholder engagement in the context of Ireland, Irish institutional investors and Irish public listed companies as they are

¹⁴⁸ Marc Moore, "'Whispering sweet nothings': The limitations of informal conformance in UK corporate governance' (2009) 9 *Journal of Corporate Law Studies* 95 at 117-125; Sridhar Arcot, Valentina Bruno and Antoine Faure-Grimaud, 'Corporate governance in the UK: Is the comply or explain approach working?' (2010) 30 *International Review of Law and Economics* 193 at 194; Andrew Keay, 'Comply or explain in corporate governance codes: in need of greater regulatory oversight?' (2014) 34 *Legal Studies* 279 at 289.

¹⁴⁹ “Committee on Corporate Governance: Final Report,” January 1998 Chaired by Ronnie Hampel, (Hampel Report) at par 1.12 (“Too often [shareholders] believe that the codes have been treated as sets of prescriptive rules.”)

¹⁵⁰ Latham & Watkins LLP, “Corporate Governance Commentary: Proxy Advisory Business: Apotheosis or Apogee?” March 2011, available at <https://www.lw.com/thoughtLeadership/corporate-governance-commentary-march-2011> (There are, however, a number of countervailing factors that might make apogee a more accurate description of the proxy advisory industry’s role and influence on corporate governance. These include... Growing discontent on the part of companies and company advisers with the one-size-fits-all analytics used by proxy advisory firms...); Albert H Choi, Andrew Lund, and Robert J Schonlau, “Golden Parachutes and the Limits of Shareholder Voting,” (August 23, 2019), *Vanderbilt Law Review* (Forthcoming), available at SSRN: <https://ssrn.com/abstract=3229962> at 22 (“Proxy advisors might economize by using simple, one-size-fits-all criteria when making their recommendations if their clients were expected to care less about the vote.”); Jeffrey N Gordon, “Say on Pay”: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In’ (2009) 46 *Harvard Journal on Legislation* 323 at 353 (“...the very effort to avoid criticism over its multiple roles may lead a multi-service proxy advisor towards ‘one size fits all’ rather than firm-specific compensation tailoring.”)

affected by the various provisions of the SRD2. As will be described, Irish institutional investors and companies exist in a particular legislative and regulatory environment that will be added to by the SRD2 and so can be expected to feel the effects of its provisions in particular ways. As well as the above contributions more generally are made to the study of engagement by passive investors and how they may be incentivised or not to engage with investee companies, which is of particular concern due to the increasing popularity of passive funds.

The remainder of the thesis will be set out as follows:

Chapter 2 will describe the legislative history of both the SRD and SRD2, how and why they developed as they did and describe the content of the provisions. This will include a consideration of a similar effort to engage shareholders which has been influential, the UK SC. This Chapter will also set out the legislative context in Ireland in relation to shareholder empowerment, into which the SRD and SRD2 will fit.

Chapter 3 will set out the market impediments that presently exist to shareholder engagement. These include rational apathy and the free rider problem and related issues, such as intermediation in the investment chain and control enhancing mechanisms.

Chapter 4 will set out regulatory impediments to shareholder engagement, including the mandatory bid rule, shareholder identification and ownership disclosure, the Market Abuse Regulation and the legal formalities of the Annual General Meeting.

Chapter 5 will address how these impediments may be overcome, with reference to many provisions of the SRD2, including the “comply or explain” enforcement mechanism and the outsourcing of engagement to entities such as proxy advisors or representative groups. Blockchain technology as a means of overcoming impediments to engagement is also set out.

Chapter 6 deals with passive investors and shareholder engagement, describing the incentives that affect passive investors in particular, as well as what can be expected of passive investors that engage.

Chapter 7 concludes the thesis, setting out some final remarks and issues that require further research, such as how the engagement of shareholders affects non-shareholder stakeholders of the company.

2. The Shareholder Rights Directive, its Development and its Revision

A. Introduction

Chapter 1 described how agency theory views shareholders as the principals of the company and how agency theory gradually became embedded in important corporate governance texts, such as the UK Corporate Governance Code. Agency theory does not imply a shareholder democracy system, since shareholder maximisation norms that do not include control rights can be utilised to address agency costs in isolation. Regardless of this, shareholder democracy norms such as shareholder engagement have been included in regulatory provisions such as the Shareholder Rights Directive (“SRD”) on the basis of agency theory, culminating in the shareholder engagement provisions of the revised Shareholder Rights Directive (“SRD2”) which will be described in detail in this chapter. The SRD2 imposes legal duties on certain shareholders, which as noted below marks a significant departure from agency theory.¹ For this reason it is worthwhile examining the reason for this change and examining the development of the first Shareholder Rights Directive (SRD), which is more clearly aligned with agency theory.

B. Corporate governance scandals and the attempt at reform

The turn of the century provided agency theory with a number of challenges. As national legislators and regulators (led by the US and UK) were seeking to embed the principles of agency within corporate governance frameworks,² a series of corporate scandals in the US posed serious concerns regarding the adequacy of these frameworks. The collapse of Enron in late 2001, which was perhaps the most prominent of these scandals, involved the largest

¹ For a discussion on how shareholder duties are inconsistent with agency theory see below at p 67.

² Specifically, in the US Internal Revenue Code, executive compensation above \$1million dollars is not tax deductible unless it is “performance based,” incentivising companies in the US to structure compensation in a manner that is aligned with the performance of the share price of the company. See US Internal Revenue Code, s 162(m). Similar compensation-based alignment measures were incorporated into the “Combined Code” after the publication of the Greenbury Report. See Chapter 1: Introduction at p 26.

bankruptcy in US history at that time³ (a record now held by Lehman Brothers) and directly resulted in the collapse of the accountancy firm Arthur Andersen. The large telecommunications firm Worldcom filed for bankruptcy a year later and, like Enron, led to senior executives being imprisoned for fraud related offences. Other US large scale corporate scandals in the early 2000s included Adelphia Communications Corporation, Computer Associates, Healthsouth, Global Crossing and Tyco international, which variously involved bankruptcies, accounting violations and fraud.⁴ These scandals resulted in a legislative response in the US in the form of the Sarbanes-Oxley Act 2002.⁵ This Act required, *inter alia*, independent audit committees,⁶ certain prohibitions on corporate loans to company directors and executives⁷ and a requirement that the Chief Executive Officer and Chief Financial Officer certify that the company's financial reports fairly present the financial condition of the company.⁸

In the EU, a "High Level Group of Company Law Experts" (the Group) was set up in September 2001 by the European Commission, chaired by Jaap Winter, in order to assess company law within the EU. Following the collapse of Enron, the mandate of the Group was extended to cover corporate governance and auditing issues. The Group produced its final report in November 2002 and it contained a number of recommendations and analysis that bore the fingerprint of agency theory.⁹ In their assessment of EU corporate governance, the Group commented that:

“...shareholders are the residual claimholders (they only receive payment once all creditors have been satisfied) and they are entitled to reap the benefits if the

³ Gerald Vinten, 'The corporate governance lessons of Enron' (2002) 2 *Corporate Governance: The international journal of business in society* 4.

⁴ See generally, E Norman Veasey, 'Corporate Governance and Ethics in the Post-Enron Worldcom Environment' (2003) 38 *Wake Forest Law Review* 839; Thomas Clarke, 'Cycles of Crisis and Regulation: the enduring agency and stewardship problems of corporate governance' (2004) 12 *Corporate Governance: An International Review* 153.

⁵ For some commentary on the development of Sarbanes-Oxley as a response to corporate governance scandals in the US, see Kathleen F Brickey, 'From Enron to Worldcom and Beyond: Life and Crime After Sarbanes-Oxley' (2003) 81 *Washington University Law Quarterly* 357; Roberta Romano, 'Quack Corporate Governance' (2005) 28 *Regulation* 36 at 36 (“[Sarbanes-Oxley] was enacted in a flurry of congressional activity in the run-up to the midterm 2002 congressional elections after the spectacular failures of the once highly regarded firms Enron and WorldCom.”)

⁶ Sarbanes-Oxley Act of 2002 (Pub L No.107-204, 116 Stat 745 (2002)), [hereafter “SOX”], s 301.

⁷ SOX, s 402(a).

⁸ SOX, s302.

⁹ High Level Group of Company Law Experts, “A modern regulatory framework for company law in Europe: Final Report,” 4 November 2002 [hereafter “Winter Report”].

company prospers and are the first to suffer if it does not. Shareholders need to be able to ensure that management pursues - and remains accountable to - their interests. Shareholders focus on wealth creation and are therefore, in the Group's view, very suited to act as 'watchdog' not only on their own behalf, but also, in normal circumstances, on behalf of other stakeholders."¹⁰

The Group made a number of recommendations for corporate governance reform. It emphasised the need for shareholders to exercise influence and it made many recommendations for the facilitation of this influence in law. Such recommendations included requiring companies to provide information to shareholders prior to general meetings, shareholders being given a right to ask questions and submit proposals for resolutions at the general meeting, permitting electronic participation at the general meeting and the ability to vote in abstentia by electronic means. Other recommendations foreshadowed the current regulatory push to engage institutional investors and asset managers, including requiring institutional investor disclosure of their investment policies and any policy with respect to the exercise of voting rights.

The European Commission ("EC") responded to the Report in a communication to the European Council and Parliament in 2003.¹¹ Without mentioning any particular company and, in a manner that also reflected a commitment to agency theory, the EC made the following points:

"Recent financial scandals have prompted a new, active debate on corporate governance, and the necessary restoration of confidence is one more reason for new initiatives at EU level. Investors, large and small, are demanding more transparency and better information on companies, and are seeking to gain more influence on the way the public companies they own operate. Shareholders own companies, not management - yet far too frequently their rights have been trampled on by shoddy, greedy and occasionally fraudulent corporate behaviour. A new sense of proportion and fairness is necessary... Ensuring effective and

¹⁰ Ibid at 47.

¹¹ European Commission, Communication from the Commission to the Council and the European Parliament, "Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward," 21 May 2003.

proportionate protection of shareholders and third parties must be at the core of any company law policy.”¹²

The EC stated that it was generally in agreement with the Group’s findings and recommendations and that it specifically endorsed the introduction of greater disclosure obligations for institutional investors with respect to the exercise of their voting rights and the enhancing of particular shareholders’ rights. It considered that there was a “strong medium to long term case for aiming to establish a real shareholder democracy in the EU”, though it noted that further study was needed with regard to initiating a legislative move in this direction.¹³ It is clear that the EC considered “shareholder democracy” to be equivalent to “one share one vote” in law.¹⁴ It is submitted that this is an unduly narrow conception of “shareholder democracy” and that it is better characterised more broadly, as varying levels of shareholder control.¹⁵ This is because there are mechanisms that deviate from “one share one vote” that represent a different vision of shareholder democracy, rather than negate or under shareholder democracy. For example “loyalty shares”, which are discussed in more detail below,¹⁶ are designed to enhance the influence of “long term” shareholders at the expense of the remaining shareholders. For the proponents of loyalty shares, these are tools for the improvement of shareholder democracy. Enhancing shareholder rights of access to company decision making, it is submitted, undoubtedly constitutes a strengthening of shareholder democracy. The enhancement of shareholders’ rights that the EC had in mind closely resembles the recommendations of the Group insofar as it includes the right to access information in advance of a general meeting, the right to ask questions, to table resolutions, to vote in abstentia and to participate in general meetings by electronic means. The EC considered that a Directive would be the most appropriate means of delivering these aims across the EU. It also announced a consultation process in which it would seek the views of experts and the public. This manifested itself in a consultation document of the Internal Market Directorate General of the EC in September 2004.¹⁷ This document began with the assumption that shareholders must have an effective means to exercise

¹² Ibid at 7-8.

¹³ Ibid at 14.

¹⁴ This is also clear from reading the 2004 consultation paper, see below (n 16) in which the EC argue that the subsequent Directive which would become the SRD. As they say: “This intended Directive... would not address issues pertaining to the strengthening of shareholder democracy.”

¹⁵ See Chapter 1: Introduction at pp 1-5.

¹⁶ See Chapter 3 at pp 107; 110-111.

¹⁷ European Commission, Internal Market Directorate General, “Fostering an appropriate Regime for Shareholder Rights in the EU: Consultation document of the Services of the Internal Market Directorate General,” 16 September 2004, available at http://ec.europa.eu/internal_market/company/docs/shareholders/consultation_en.pdf.

active influence over investee companies and that the problem to be solved thus was how to properly realise this.¹⁸ Issues considered in this document included: shareholder identification; the authentication of the “ultimate investor”¹⁹ and the possibility of such an investor controlling the voting rights; disclosure of information relating to general meetings by the company; the practice of “share blocking”²⁰ prior to a general meeting; electronic voting in general meetings; the right to ask questions and add proposals; voting in absentia; proxy voting; post general meeting dissemination of information; and the confirmation of post voting execution.

The EC published a second consultation document in May 2005, in which the focus was on agreeing minimum standards for shareholders’ rights in EU law that it proposed for the future directive.²¹ Specifically, the EC was focused on scope of the future directive, notice periods for general meetings and information to be provided in advance of general meetings. The EC took the view that there was no urgent need to confer any legal entitlement on “ultimate investors” with regard to the control of voting rights. This was because the EC perceived difficulties in devising a definition for the “ultimate investor” and the possibility that empowering such investors might prove “cumbersome,” especially in a cross border context.²² As well as this, it argued that granting legal rights to the “ultimate investor” was not a necessary prerequisite for the exercise of cross border shareholder rights.²³ The EC proposed prohibiting share blocking entirely, giving shareholders the right to ask questions and receive responses, the right to add to the agenda for the general meeting and the removal of all barriers to electronic voting.²⁴

¹⁸ Ibid at 6.

¹⁹ This term would seem to refer in this document to the investor at the end of the chain of investment intermediaries.

²⁰ The practice of share blocking involves a company preventing its shareholders from selling their shares in the company for several days prior to a general meeting. This restriction may deter participation in the general meeting as shareholders will often want to remain free to dispose of their shares in the company in the blocking period.

²¹ European Commission, “Fostering an appropriate Regime for Shareholder Rights in the EU: Second consultation document of the Services of the Internal Market Directorate General” 13 May 2005, available at http://ec.europa.eu/internal_market/company/docs/shareholders/consultation2_en.pdf.

²² Ibid at 6-7.

²³ Ibid.

²⁴ Ibid at 12-14.

In January 2006 a proposal for a directive was issued,²⁵ which would eventually become the SRD.²⁶ In this proposal, the EC reiterated its commitment to the promotion of shareholder participation on the basis that such participation was regarded as “an essential precondition for effective corporate governance.”²⁷ Furthermore, this proposal stated the primary aim of the directive as facilitating the exercise of voting rights in a cross-border context.²⁸ Most of the rights specified in this proposal would become enshrined in the SRD which promoted this primary aim.²⁹ For instance, in the SRD, Article 5 creates an obligation on companies to give at least 21 days’ notice of general meetings to shareholders, stating the location and time of the meetings. Article 6 provides a right for shareholders to add items to the agenda of general meetings and to table resolutions. Article 7 prohibits share blocking. Article 8 mandates that obstacles to electronic voting in Member States be removed. Article 9 provides a right for shareholders to ask questions in general meetings, and to be provided with answers by the company. Article 10 provides a right to appoint any proxy holder to vote the shares on behalf of the shareholder. Article 12 gives a right to vote in absentia.

The SRD was formally adopted in July 2007 and Member States were required to implement it in some form by 3 August 2009. However, in this period of implementation another corporate governance crisis occurred, spurring another regulatory soul-searching exercise. The global financial crisis of 2007-08 resulted in widespread economic damage and the related banking collapse in Ireland required an economic bailout from the “troika” of the International Monetary Fund (“IMF”), European Central Bank and the EC.³⁰ Similar to the events following the collapse of Enron, the financial crisis set off another wave of

²⁵ European Commission, “Proposal for a directive of the European Parliament and of the Council on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC” 5 January 2006 [hereafter “EC 2006 proposal”], available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52005PC0685&from=EN>.

²⁶ 2007/36/EC.

²⁷ EC 2006 proposal at 2.

²⁸ *Ibid* at 3.

²⁹ There are slight changes from the 2006 proposal in the SRD in Articles 13 and 15: Article 13 in the 2006 proposal deals with voting instructions in omnibus accounts, and in the SRD limits requirements of institutional investors that may prove an impediment to the exercise of voting rights. Article 15 in the 2006 proposal allows certain post meeting information for shareholders and this is not provided for in the SRD, where Art 15 contains details of transposition.

³⁰ For an *ex post* overview, see International Monetary Fund, ‘Ireland: Ex Post Evaluation of Exceptional Access under the 2010 Extended Arrangement’ IMF Country Report No 15/20 (2015); European Commission, ‘Ex Post Evaluation of the Economic Adjustment Programme - Ireland, 2010-2013’ Institutional Paper 4 (2015).

reforms. As will be described in the next section, the tenets of agency theory were retained by regulators worldwide in their response to the financial crisis.

C. The Financial Crisis and the response to it

Shortly after the finalisation of the reforms in the SRD, the global financial crisis (GFC) swept across the global economy. As will be described, this event placed financial regulators in a defensive crouch similar to that seen during the early 2000s. Corporate governance reform has long proved itself to be responsive rather than proactive and the response to the GFC is consistent to the reforms of the 2000s. Before discussing these reforms, the GFC itself will first be described.

i. The Global Financial Crisis

There is some disagreement about the role of corporate governance frameworks in the GFC. The GFC was caused by the subprime market in the US, wherein financial institutions in the US made increasingly risky mortgage loans which were securitised and resold as mortgage backed securities, in the form of “collateralised debt obligations” (CDOs).³¹ CDOs are structured financial products in which bundles of assets are pooled together and sold to investors. CDOs were often themselves pooled together and resold as “CDO squared”.³² This led to opacity and uncertainty with regard to how to properly value these products.³³ Ratings agencies gave many of them a “AAA” rating, as low risk mortgages were pooled together with higher risk mortgages and these ratings agencies earned their revenue from the financial institutions selling the CDOs.³⁴ This allowed for rapid growth in the market for subprime mortgages.³⁵ When the housing market in the US experienced widespread defaults from these subprime borrowers, the value of the CDOs collapsed.³⁶ In turn, the insurance on these products, which was managed through “credit default swaps”, became more expensive and led to pay-outs from firms such as AIG.³⁷ Underwriting banks holding large quantities of CDOs on their balance sheets experienced a serious liquidity

³¹ Lynne L Dallas, 'Short-Termism, the Financial Crisis, and Corporate Governance' (2011) 37 *The Journal of Corporation Law* 264 at 285.

³² James Crotty, 'Structural causes of the global financial crisis: a critical assessment of the 'new financial architecture'' (2009) 33 *Cambridge Journal of Economics* 563 at 566-567.

³³ Gary B Gorton, 'The Panic of 2007' (September 2008) No 14358 NBER Working Paper at 76.

³⁴ Crotty (n 32) at 56.

³⁵ Arthur E Wilmarth Jr, 'The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis' (2009) 41 *Connecticut Law Review* 963 at 1024-1027.

³⁶ Crotty (n 32) at 567.

³⁷ Dallas (n 31) at 291-292.

squeeze, as they could not sell the products to investors.³⁸ Many financial institutions, as a result, required the US Government to intervene to provide credit or sought outside buyers to purchase the institution.³⁹ Other financial institutions received neither Government support nor an outside purchaser and ultimately failed and declared Chapter 11 bankruptcy.

The most notable of these failed institutions was Lehman Brothers. At the time of its collapse, Lehman was the fifth largest investment bank in the world.⁴⁰ By certain accounts, the cause of Lehman's fall in particular was to do with its strategy as the subprime crisis began.⁴¹ Although Lehman was amongst the largest producers of securitised subprime products, when the value of these products began to decline in 2007, Lehman moved aggressively forward, investing in the property market further, believing that the lowering prices represented an opportunity. However, the losses that the bank was bearing in an illiquid market forced those running Lehman to cease the strategy. When Bear Stearns, another investment bank with a large exposure to the subprime housing market, failed, Lehman's share price fell dramatically. Unlike Bear Stearns, which was purchased by JP Morgan Chase, Lehman was not purchased and did not receive a credit extension from the US Government. When Lehman declared bankruptcy, it was the largest in US history, a record it still holds.⁴² More importantly, the bankruptcy of Lehman resulted in a crisis of confidence in capital markets generally. Swedberg quotes economist Robert Lucas, who claimed: "Until the Lehman failure the recession was pretty typical of the modest downturns of the post-war period... After Lehman collapsed and the potential for crisis had become a reality, the situation was completely altered."⁴³

The failure of Lehman Brothers sparked a panic not just in US markets. The EC noted in 2009 that the bankruptcy of Lehman Brothers triggered a panic in markets that "snowballed

³⁸ Crotty (n 32) at 568.

³⁹ See Wilmarth (n 35) at 1044-1045.

⁴⁰ Chitru S Fernando, Anthony D May and William D Megginson, 'The Value of Investment Banking Relationships: Evidence from the Collapse of Lehman Brothers' (2012) 67 *The Journal of Finance* 235 at 235.

⁴¹ See Richard Swedberg, "The Structure of Confidence and the Collapse of Lehman Brothers" in Michael Lounsbury and Paul M Hirsch (eds), *Markets on Trial: The Economic Sociology of the U.S. Financial Crisis: Part A*, (Emerald Publishing, 2010) at 84. Much of the following information with regard to Lehman and its failure is taken from this source.

⁴² Caitlin Bozman, 'Holding the Line or Changing Tides? The Future of 'Too Big to Fail' Regulation' (2019) 107 *The Georgetown Law Journal* 1105 at 1112; Kimberly Summe, 'Misconceptions About Lehman Brothers' Bankruptcy and the Role Derivatives Played' (2011) *Stanford Law Review Online* 16 at 16, 19.

⁴³ *Ibid* at 72.

rapidly across the world.”⁴⁴ Several prominent financial institutions in Europe were exposed to the US subprime markets and, when Lehman filed for bankruptcy, their liquidity was squeezed as investors reduced their investments and share prices fell.⁴⁵ This resulted in European banks, like US banks, restricting the credit they lent out into the economy, deepening the recession that was developing. For certain banks, their difficulties were directly related to the subprime market in the US, an example being BNP Paribas, which announced in 2007 that it was shutting down three investment vehicles that had invested heavily in this market.⁴⁶ For others, like Northern Rock in the UK, the exposure was not direct but a dependency on interbank short term funding meant that, even though they had little subprime debt on their balance sheet, they still collapsed and required the Bank of England to provide emergency liquidity.⁴⁷

Indirect exposure to the subprime markets in the US through direct reliance on short term interbank funding certainly played a role in the banking collapse in Ireland in 2008. However, as detailed by Patrick Honohan in his Report to the Minister for Finance, which was commissioned by the then Minister for Finance to investigate the banking collapse, the problems in Irish banks went deeper than simple exposure to illiquid international markets. As Honohan noted:

“The initial expectation of officials at the time of the guarantee was that none of the institutions involved was insolvent, and that their problems stemmed mainly from a freezing of short-term liquidity in the wake of the bankruptcy of Lehman Brothers. However, subsequent developments have revealed a more serious and costly situation.”⁴⁸

⁴⁴ European Commission, “Economic Crisis in Europe: Causes, Consequences and Responses” 2009, available at http://ec.europa.eu/economy_finance/publications/pages/publication15887_en.pdf, at 8.

⁴⁵ Ibid at 9.

⁴⁶ Sudip Kar-Gupta, Yann Le Guernigou, “BNP freezes \$2.2 bln of funds over subprime” Reuters, 9 August 2007.

⁴⁷ Hyun Song Shin, 'Reflections on Northern Rock: The Bank Run That Heralded the Global Financial Crisis' (2009) 23 *The Journal of Economic Perspectives* 101 at 102. Northern Rock experienced these problems prior to the collapse of Lehman Brothers but it was the problems stemming from defaults in the subprime market and resulting liquidity squeeze that caused its problems.

⁴⁸ Patrick Honohan, “The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008: A Report to the Minister for Finance by the Governor of the Central Bank” 31 May 2010 [hereafter “Honohan Report”]

Honohan argued that property prices in Ireland would have fallen regardless of the collapse of Lehman and that this would have revealed the weaknesses in Irish banks. In other words, Irish banks would have suffered serious losses even if the subprime market had not collapsed as it did in the US. However, the collapse of Lehman Brothers and the resulting liquidity squeeze and market panic triggered a more severe fall for Irish banks.⁴⁹ The true problem in Irish banks was the relaxation of lending standards and risk assessment, such that more and more credit was extended to individuals and property developers who would later default when property prices fell.⁵⁰ This was exacerbated by a concentration of bank assets in the Irish property market. As Regling and Watson put it in their report on the causes of the banking collapse in Ireland that had been commissioned by the Minister for Finance, “a critical weakness in bank risk management was the concentration of bank assets in activities related primarily to property, and more specifically commercial property.”⁵¹

Important common elements of the GFC as manifested in the US, Europe and Ireland were risk levels in financial institutions and short termism in capital markets. Subprime lending necessarily entails enhanced risk as subprime mortgage borrowers are defined as carrying a high default risk.⁵² Certainly, where banks are reliant on short term funding from other banks, they are vulnerable to a risk of credit tightening. Dallas argues that short termism runs to the core of what occurred during the lead up to the GFC, that financial institutions systematically preferred short term profits to considerations of long term value creation.⁵³ A widespread market myopia could have contributed to the widespread investment in CDOs that were underpinned by very risky mortgages that produced high profits. With regard to the banking collapse in Ireland, risk management was identified in particular as a primary cause.⁵⁴ Certain banks, most notably Anglo Irish Bank, took greater risks in how they lent money and reaped short term rewards and other banks consequently felt pressure

⁴⁹ Ibid at 32.

⁵⁰ Report of the Commission of Investigation into the Banking Sector in Ireland, chaired by Peter Nyberg, “Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland”, March 2011, [hereafter “Nyberg Report”] at 44-47 (“Bank management and boards seem to have been totally unprepared for both of their key risks (property loan impairment and funding problems) occurring simultaneously.”)

⁵¹ Klaus Regling and Max Watson, “A Preliminary Report on the Sources of Ireland’s Banking Crisis” 31 May 2010, at 35.

⁵² Yuliya Demyanyk and Otto Van Hemert, 'Understanding the Subprime Mortgage Crisis' (2011) 24 *The Review of Financial Studies* 1848 at 1853.

⁵³ Dallas (n 31) at 266 (“The financial crisis of 2007–2009 was preceded by a period of financial firms seeking short-term profit regardless of long-term consequences. Numerous market participants engaged in myopic behavior, including mortgage originators, securitizers, credit default-swap sellers, rating agencies, and investors.”) (references omitted)

⁵⁴ See Nyberg Report.

to follow suit.⁵⁵ It can be concluded then that the main problem that created the banking collapse in Ireland and the GFC more generally was the accumulation and level of risk in financial institutions and this seems to have occurred due to widespread short term thinking.

ii. The Role of Corporate Governance Frameworks

There is some disagreement in respect of the contribution of corporate governance frameworks to the GFC. Brian Cheffins, for instance, argued that “a stock market crisis likely would have been in the cards even if model corporate governance arrangements had been in place.”⁵⁶ He concluded this on the basis of an empirical analysis of the 37 companies that had fallen out of the S+P 500 list in 2008. Among these 37 companies, according to Cheffins, corporate governance functioned “tolerably well” and he even noted “various encouraging corporate governance trends.”⁵⁷ This was because, among these companies, there was an absence of fraud (distinguishing these companies from those involved in the corporate governance scandals of the early 2000s, described above), a general lack of public criticism of boards (implying their performance was “at least tolerable”) and some “offensive” shareholder activism as hedge funds agitated for change in underperforming firms.⁵⁸ Cheffins offered a mixed verdict on executive remuneration noting “while crucial elements of executive pay policies that major financial firms adopted proved to be ill-judged, the approach taken to managerial remuneration otherwise seemed largely acceptable.”⁵⁹

Importantly, Cheffins was in the minority with regard to the adequacy of corporate governance frameworks. The Organisation for Economic Cooperation and Development (OECD) produced a report in 2009 in which it stated that “the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements.”⁶⁰ More specifically, it was critical of risk management systems in financial

⁵⁵ Nyberg Report at 23 (Anglo’s increased risk) and 7-9 (on herding amongst Irish financial institutions); Honohan Report at 8 “...in their anxiety to protect market share against the competitive inroads of Anglo Irish Bank and UK-based retail lenders, their management tolerated a gradual lowering of lending standards, including decisions to authorise a numerous exceptions to stated policies.”)

⁵⁶ Brian R Cheffins, 'Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500' (2009) *The Business Lawyer* 1 at 4.

⁵⁷ *ibid* at 50.

⁵⁸ *ibid* at 50-51.

⁵⁹ *ibid*.

⁶⁰ Grant Kirkpatrick, “The Corporate Governance Lessons from the Financial Crisis”, *Financial Market Trends*, July 2009, at 2.

institutions, noting in certain firms inadequate attention to stress testing and transmission of information through different channels in the company.⁶¹ As well as this, it argued that executive remuneration gave rise in many firms to strong incentives to take risks and make decisions on the basis of short term interests.⁶²

Jacques de Larosière, former Managing Director of the IMF and Governor of the Banque de France, chaired the High Level Group on Financial Supervision in the EU, which produced a report in 2009 dealing with the GFC and its aftermath.⁶³ This report singled out corporate governance failures, also pointing to risk management systems and executive remuneration schemes and the failure of both directors and shareholders to adequately monitor managers of firms. As well as this, Larosière pointed out that shareholder pressure to deliver higher share prices and dividends “meant that exceeding expected quarterly earnings became the benchmark for many companies’ performance.”⁶⁴ In other words, according to Larosière, shareholders’ failure was both to properly monitor the managers of businesses in which they were invested and to pressure these same managers to maximise earnings on a short term basis.

Following this report, the EC published a Green Paper in 2010 focusing entirely on corporate governance in financial institutions, noting that “[a]lthough corporate governance did not directly cause the crisis, the lack of effective control mechanisms contributed significantly to excessive risk-taking on the part of financial institutions.”⁶⁵ In this report, the EC pointed to: conflicts of interest of managers in financial institutions; the lack of effective implementation of corporate governance principles; the failure of boards of directors to identify, understand and control risk; the passivity of shareholders; and the failures of supervisory authorities and auditors.

In the UK, then Chancellor of the Exchequer Alistair Darling commissioned Adair Turner to write a report reviewing the causes of the GFC and recommend changes to the regulatory

⁶¹ Ibid at 10-11.

⁶² Ibid at 12-13.

⁶³ Report of the High Level Group on Financial Supervision in the EU, 25 February 2009 [hereafter the “Larosière Report”].

⁶⁴ Ibid at 10.

⁶⁵ European Commission, Green Paper, “Corporate governance in financial institutions and remuneration policies” 2 June 2010 [hereafter “EC 2010 Green Paper”] at 2.

and supervisory architecture in the UK as a response to it.⁶⁶ Turner argued that “improvements in the effectiveness of internal risk management and firm governance are ... essential.”⁶⁷ Before the publication of the Turner Report, then Prime Minister Gordon Brown commissioned Sir David Walker to review corporate governance in the UK banking sector and the latter’s report was published after the Turner Report.⁶⁸ Walker was a controversial choice at the time as he had connections to various banks and the financial industry which was at the centre of the crisis.⁶⁹ Walker pointed to risk management, board quality and practice, remuneration practices and the functioning of institutional investors as monitors as areas of inadequacy in the UK corporate governance framework. He made several recommendations for reforms including some which eventually would result in the development of the Stewardship Code in the UK.⁷⁰

Clearly, the predominance of opinion, at least at a Governmental and regulatory level, was that corporate governance frameworks required reform and strengthening as a result of the GFC. In its aftermath, the commentary quickly turned from what aspects of the corporate governance landscape had contributed to the GFC to the reforms that would be put into place. These are considered in the next section.

D. Corporate Governance Reform after the GFC

i. The UK Stewardship Code

One of the first corporate governance reforms that occurred after the GFC in Europe was the formulation of the UK Stewardship Code (“SC”) in 2010. The SC formed the basis of

⁶⁶ Lord Turner, “The Turner Review: A regulatory response to the global banking crisis” March 2009 [hereafter “Turner Review”].

⁶⁷ *Ibid* at 92.

⁶⁸ Sir David Walker, “A review of corporate governance in UK banks and other financial industry entities: Final recommendations” 26 November 2009 [hereafter “Walker Review”].

⁶⁹ Alan Dignam, ‘The Future of Shareholder Democracy in the Shadow of the Financial Crisis’ (2013) 36 *Seattle University Law Review* 639 (“Sir David’s connection with Morgan Stanley created significant concern that his report would not provide the governance shake-up that the banking industry needed.”); Jill Treanor and Julia Finch, “Sir David Walker: I’m a man of the people, not a City grandee” *The Guardian*, 26 November 2009.

⁷⁰ See Walker Review, Recommendations 16-20.

many other similar codes around the world including Italy,⁷¹ Japan,⁷² Brazil,⁷³ Taiwan,⁷⁴ Denmark⁷⁵ and Kenya.⁷⁶ In the US, the “Investor Stewardship Group” developed a stewardship code similar to the SC which came into effect on 1 January 2018.⁷⁷ Jennifer Hill notes that certain international stewardship codes are led by national regulators, others are developed by private industry participants and others, such as in the US, are led by investors themselves.⁷⁸ Originally, what would become the SC was developed by institutional investors but the mantle was eventually taken by the Financial Reporting Council (“FRC”) and now the SC firmly sits in the first category of stewardship codes, those led by national regulators.⁷⁹

As noted above, the Cadbury Committee welcomed the statement of principles promulgated by the Institutional Shareholders’ Committee (ISC) in 1991. The ISC was a collection of groups that represented institutional investors, including the Association of British Insurers, Association of Investment Trust Companies, National Association of Pension Funds and Investment Management Association.⁸⁰ Subsequent to the Cadbury Code, several UK reports discussed institutional investor engagement and the ISC’s statement of principles. First, Paul Myners was commissioned by then Chancellor of the Exchequer Gordon Brown in 2001 to review institutional investment in the UK.⁸¹ Although

⁷¹ Italian Stewardship Principles 2016, available at

<http://www.assogestioni.it/ass/library/32/principiitastewardship16.pdf>.

⁷² Principles for Responsible Institutional Investors (Japan’s Stewardship Code) 26 February 2014.

⁷³ AMEC Stewardship Code, public consultation commenced July 2016, see

<https://www.amecbrasil.org.br/en/association-starts-the-public-consultation-about-amec-stewardship-code/>.

⁷⁴ Taiwan Stock Exchange, “Stewardship Principles for Institutional Investors”

⁷⁵ The Committee on Corporate Governance, “Stewardship Code”, November 2016 (Denmark), available at

https://corporategovernance.dk/sites/default/files/erst_247_opsaetning_af_anbefalinger_for_aktivt_ejerskab_uk_2k8.pdf

⁷⁶ See the Kenya Gazette, Vol. CXIX, No. 81, 23rd June 2017 at 2892. See also “Press Release: Stewardship Code for Institutional Investors gazetted,” available at

<http://www.cma.or.ke/index.php/news-and-publications/press-center/354-press-release-stewardship-code-for-institutional-investors-gazetted>.

⁷⁷ This Group was founded by 16 institutional investors from both the US and internationally who in aggregate manage over \$17 trillion in US equity markets. See Investor Stewardship Group, “Corporate Governance and Stewardship Principles,” Harvard Law School Forum on Corporate Governance and Financial Regulation, 7 February 2017.

⁷⁸ Jennifer G Hill, ‘Good Activist/Bad Activist: The Rise of International Stewardship Codes’ (2018) 41 Seattle University Law Review at 507-509.

⁷⁹ See below at p 48.

⁸⁰ See ISC “The Responsibilities of Institutional Shareholders and Agents – Statement of Principles” (2002).

⁸¹ Paul Myners, “Institutional Investment in the United Kingdom: A Review,” 6 March 2001.

More specifically, the UK Treasury wished to know whether institutional investors were systematically avoiding certain equity asset classes and whether other decision making distortions existed amongst institutional investors.

Myners focused most of his criticisms on the pensions system, he reserved specific criticisms for the reluctance of asset managers to take on an activist role in their investment strategy.⁸² Myners strongly asserted the benefits of active intervention on the part of asset managers in particular on behalf of their investors, where they identify some problem in the investee companies. He recommended that active engagement be codified as a fiduciary duty in UK law.⁸³

In 2003, Derek Higgs was commissioned by the UK Government in the aftermath of the aforementioned corporate governance scandals of the early 2000s to examine the role of non-executive directors in the UK. The Higgs Review noted that regular channels of communication between shareholders and senior executive such as CEOs and Chairmen is “widely accepted as being both desirable and useful.”⁸⁴ Higgs lamented that non-executive directors rarely communicated with shareholders and made the following statement:

“I endorse the Government’s approach to more active engagement by shareholders and hope that the financial community will make the ISC’s code of activism work in practice. For completeness, I therefore propose that the ISC code of activism be endorsed through reference in section 2 of the Code.”⁸⁵

In the wake of the GFC, these calls became louder and more focused. As noted above, the Walker Review contained recommendations that would lead to the development of the SC. Walker argued that “the board and director shortcomings... would have been tackled more effectively had there been more vigorous scrutiny and engagement by major investors acting as owners.”⁸⁶ He noted the assumptions of agency theory, that misalignments of interest between owners (shareholders) and board members create the potential for underperformance. Walker voiced reservations to an increased institutional investor engagement initiative which included the costs and barriers to investors engaging, as well as possible adverse publicity where a “stand off” situation emerges between a board and an engaging investor. Ultimately Walker recommended that the ISC’s Code on the

⁸² Ibid at 89.

⁸³ Ibid at 93.

⁸⁴ Derek Higgs, “Review of the role and effectiveness of non-executive directors Higgs Review,” January 2003, [hereafter “Higgs Review”] at 67.

⁸⁵ Ibid at 70. “The Code” referred to is the Combined Code, which is now the UK Corporate Governance Code.

⁸⁶ Walker Review at par 5.11.

Responsibilities for Institutional Investors be ratified by the FRC, which he recommended should have its remit extended for the purpose of developing a stewardship code.⁸⁷ He also made a number of recommendations that would become features of the SC including the “comply or explain” approach, the regular FRC review, the public disclosure by asset managers in relation to the extent of their commitment to the SC and an explanation from those asset managers not willing to commit to it.

In July 2010, the SC was put into effect by the FRC. In line with the recommendations of the Walker Review, the 2010 SC was voluntary in nature, with institutional investors free to sign up to the various principles comprising the Code on a “comply or explain” basis.⁸⁸ The wording of the 2010 SC suggests a certain flexibility with regard to compliance with certain principles, rather than an “all or nothing” compliance. The preface of the 2010 SC notes that the “comply or explain” approach should be “complementary” to the UK Corporate Governance Code.⁸⁹ The latter contains Main Principles which must be applied according to the Listing Rules of the UK (and the Listing Rules of the Irish Stock Exchange)⁹⁰ but particular provisions may be derogated from where the reasons for so doing are explained “clearly and carefully” to shareholders.⁹¹ The 2010 SC states that signatories should provide statements containing details of how the principles of the SC have been applied, disclosure of specific information under certain Principles and, where these elements have not been complied with, an explanation. In terms of what constitutes an adequate explanation, the SC gives little information except to note that international institutional investors who comply with another international standards should not feel that the SC “duplicates or confuses their responsibilities.”⁹²

Prior to January 2020, there were seven principles of the UK SC and each was aimed toward enhancing institutional investor engagement with investee companies. These state that institutional investors should:

⁸⁷ Walker Review, recommendations 16 and 17, at par 5.40.

⁸⁸ See Financial Reporting Council, Stewardship Code, July 2010 [hereafter “2010 SC”], available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Stewardship-Code.pdf> at 1 (“Institutional shareholders are free to choose whether or not to engage but their choice should be a considered one based on their investment approach.”)

⁸⁹ Ibid.

⁹⁰ Financial Conduct Authority, Listing Rules, January 2020, available at <https://www.handbook.fca.org.uk/handbook/LR.pdf>, in particular rule 9.8.6(5) and Euronext Dublin Rulebook, Book II: Listing Rules, 21 July 2019, rule 6.1.82(6)

⁹¹ UK Corporate Governance Code (2016) at 4.

⁹² 2010 SC at 2.

1. publicly disclose their policy on how they will discharge their stewardship responsibilities,
2. have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed,
3. monitor their investee companies,
4. establish clear guidelines on when and how they will escalate their stewardship activities,
5. be willing to act collectively with other investors where appropriate,
6. have a clear policy on voting and disclosure of voting activity, and
7. report periodically on their stewardship and voting activities.

In the eighteen months after the introduction of the SC in 2010, 234 investors became signatories to the Code, 175 of which were asset managers.⁹³ However, the FRC identified weaknesses in the operation of the Code, which mainly involved the quality of disclosures of conflicts of interest, collective engagement and accessibility of disclosures. The FRC also acknowledged from the investee point of view, companies had observed “relatively little change in approach to engagement” after eighteen months.⁹⁴ After the publication of the SC in 2010, the Department of Business, Innovation and Skills in the UK began a consultation process, seeking to investigate the perceived problems of market short termism, investor engagement, directors’ remuneration and takeovers.⁹⁵

Following this consultation process, the Secretary for State for Business at the time, Vince Cable, announced that Professor John Kay had been appointed to conduct a wide ranging review of short termism in the UK equity market, which involved an analysis of

⁹³ Financial Reporting Council, *Developments in Corporate Governance 2011: The impact and implementation of the UK Corporate Governance and the Stewardship Codes*, December 2011, available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2011-The-impa.pdf>, at 22.

⁹⁴ *Ibid* at 25. The FRC noted that this was especially so for smaller companies.

⁹⁵ Department for Business, Innovation and Skills, “A Long-term Focus for Corporate Britain” (March 2011), available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207536/11-797-summary-responses-long-term-focus-corporate-britain.pdf. This process was an apparent response to the takeover, and subsequent controversy, of the UK company Cadbury Plc by Kraft Inc, see Wai Yee Wan, ‘Takeovers and countering short-termism in target boardrooms: Part 1’ (2013) 34 *Company Lawyer* 43

institutional investor behaviour and the SC.⁹⁶ An interim report of the Kay Review was published in February 2012, in which Kay noted a general satisfaction amongst market participants regarding the SC and that it should be given more “time to settle.”⁹⁷ The FRC acknowledged this in a subsequent consultation paper and cited it as the reason that the core principles of the SC should remain unchanged for the foreseeable future.⁹⁸ However, the FRC proposed that certain aspects of the SC ought to be amended, including introductory sections. The major reason given by the FRC for these amendments was that they recognised a lack of common understanding of what the term “stewardship” actually means. This involves a lack of understanding of the respective roles and responsibilities of asset managers and asset owners. In July 2012, the Kay Review was published, which examined, inter alia, whether UK equity markets fostered long term decision making. It leant a perspective to the question of the meaning of “stewardship”, arguing that the essential elements of stewardship are understanding and engagement.⁹⁹ It stated that asset managers have the responsibility to both analyse and engage with investee companies. Kay’s first recommendation was for the development of the SC to encompass a “more expansive form of stewardship.”¹⁰⁰

In September 2012 a revised Stewardship Code (the “2012 SC”)¹⁰¹ was produced and the preface of the earlier Code was replaced by a number of introductory sections explaining the concept of stewardship and how it ought to be applied by institutional investors. The 2012 SC makes clear that the “comply or explain” approach means that signatories can elect not to comply with either the principles or the guidance of the SC, provided that “meaningful explanations that enable the reader to understand their approach to stewardship” are given. It also expressed a clear distinction between asset owners and asset managers. Asset owners, according to the 2012 SC, include pension funds and insurance companies, who “set the tone” for stewardship, whereas asset managers “are well positioned to influence companies’ long-term performance through stewardship.”¹⁰² In this

⁹⁶ John Kay, “The Kay Review of UK equity markets and long-term decision making: Final Report” 10 July 2012, [hereafter “Kay Review”], at 9.

⁹⁷ John Kay, “The Kay Review of UK equity markets and long-term decision making: Interim Report”, February 2012, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31544/12-631-kay-review-of-equity-markets-interim-report.pdf at 39.

⁹⁸ FRC, “Revisions to the Stewardship Code: Consultation Document,” April 2012, available at <https://www.frc.org.uk/getattachment/69188de6-3dcf-46ab-afd9-050886ef0c5d/;.aspx> at 1.

⁹⁹ Kay Review at 44.

¹⁰⁰ Ibid at 45.

¹⁰¹ Financial Reporting Council, “The UK Stewardship Code” September 2012 [hereafter “2012 SC”].

¹⁰² 2012 SC at 1.

way, asset managers have the primary stewardship responsibility. “Stewardship” is given a broad meaning in the 2012 SC, including “monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration” as well as voting at general meetings.¹⁰³

In November 2016, the FRC announced a new initiative relating to the SC, in which they assessed the statements of signatories and place these signatories into one of three tiers.¹⁰⁴ Tier one signatories are described as those who “provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary.” The tier two signatories are those who “meet many of the reporting expectations but report less transparently on their approach to stewardship or do not provide explanations where they depart from provisions of the Code.” For tier three signatories, the FRC asserted that “[s]ignificant reporting improvements need to be made to ensure the approach is more transparent. Signatories have not engaged with the process of improving their statements and their statements continue to be generic and provide no, or poor, explanations where they depart from provisions of the Code.” This tiering system had an enforcement function with respect to the Code since the FRC stated in early 2017 that if signatories remained on the third tier for longer than six months, they would be removed as signatories to the Code.¹⁰⁵ The FRC reported a response to this tiering process in January 2017 that many asset managers who had been placed in tier two had improved their disclosures, such that the FRC had upgraded eighty tier two signatories to tier one.¹⁰⁶ The third tier was removed as a category by the FRC in mid-2017, after half of the tier three asset managers improved their reporting standards to the effect that they were re-categorised as tier one or two and the other half removed themselves as UK SC signatories.¹⁰⁷

¹⁰³ There have been criticisms of the vagueness of the definition of “stewardship” since 2012. See Reisberg, 'The UK Stewardship Code: On the Road to Nowhere?' at 227; James Noguera, 'Institutional investors and the stewardship code: an analysis of why institutional investors do not monitor or engage' (2017) *International Company and Commercial Law Review* 107 at 111.

¹⁰⁴ FRC statement, “FRC holds fund managers to account under Stewardship Code,” 14 November 2016, available at <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/November/Tiering-of-signatories-to-the-Stewardship-Code.aspx>

¹⁰⁵ The FRC has stated that those included in tier three this year will be removed in mid-2017 if they have not been promoted to tier two, see FRC, “Developments in Corporate Governance and Stewardship 2016” January 2017, available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewardship-2016.pdf> at 7.

¹⁰⁶ FRC, “FRC removes Tier 3 categorisation for Stewardship Code signatories” 3 August 2017, see <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2017/August/FRC-removes-Tier-3-categorisation-for-Stewardship.aspx> at 26.

¹⁰⁷ *Ibid.*

Asset owners who are signatories to the SC were also involved in a tiering exercise, without the disciplinary element of being removed as a signatory. Rather than the three tiers that asset managers were categorised into, asset owner signatories were categorised into two categories, which were described in identical terms as tier 1 and tier 2 for asset managers.¹⁰⁸ The difference in approach to enforcement by the FRC with respect to asset managers and asset owners further demonstrates that it is asset managers who are considered to bear the responsibility for stewardship and engaging with investee companies.

In 2018, the UK Secretary of State requested John Kingman to undertake an independent review of the FRC and the latter produced his report in December 2018.¹⁰⁹ Kingman was appointed after strong criticism of the FRC in the wake of the high profile collapse of the large company Carillion. Members of the UK Parliament had described the FRC and the Pensions Regulator as “chronically passive.”¹¹⁰ There had been persistent criticisms of the SC that Kingman would also review. It was widely accepted that neither the 2010 nor 2012 Codes had any noticeable effect on the levels or quality of engagement undertaken by institutional investors in the UK in the years that followed.¹¹¹ The Kingman Review addressed the ongoing operation of the 2012 SC under the maintenance of the FRC and made a series of recommendations with regard to it. Kingman criticised the tiering process as focusing on the content of stewardship statements rather than “on actual effectiveness or outcomes”.¹¹² He consequently recommended a “fundamental shift in approach” that

¹⁰⁸ See FRC, “Asset Owners” available at <http://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements/asset-owners>.

¹⁰⁹ John Kingman, “Independent Review of the Financial Reporting Council” December 2018, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf [hereafter “Kingman Review”]

¹¹⁰ House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, “Carillion: Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19 Tenth Report of the Business, Energy and Industrial Strategy Committee of Session 2017–19 Twelfth Report of the Work and Pensions Committee of Session 2017–19 Report, together with formal minutes relating to the report,” 16 May 2018, available at <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf> at 5.

¹¹¹ Paul L Davies, “The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?” Law Working Paper N° 506/2020, March 2020 at 10 (“Given the widespread and probably correct view that levels of engagement had not significantly increased over the decade, how might this be explained?”); Financial Reporting Council “Developments in Corporate Governance 2011: The impact and implementation of the UK Corporate Governance and Stewardship Codes, December 2011 at 25, observing “relatively little change in approach to engagement” in the 18 months after the Code came into effect in 2010.

¹¹² Kingman Review at 46.

focused on outcomes and effectiveness rather than on policy statements.¹¹³ Most notably, Kingman remarked in his recommendations, “[i]f the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition.”¹¹⁴ “Boilerplate reporting”, as will be discussed in more detail below,¹¹⁵ refers to a specific criticism of “comply or explain” codes that implicates the quality of disclosure statements, whether statements of compliance or explanation for non-compliance.¹¹⁶ Kingman, by observing that the Code was a driver of boilerplate reporting, was echoing the criticism that signatories’ statements were generic, vague and generally uninformative. It is perhaps strange then that Kingman would also criticise the tiering exercise for focusing on the quality of statements and not on stewardship outcomes, as the tiering exercise was very specifically designed to tackle boilerplate reporting.¹¹⁷ The FRC responded to the Kingman Review by proposing a revision of the SC in early 2019.¹¹⁸

Proposed changes to the 2012 SC included a new definition of “stewardship”, which broadens stewardship beyond equity as an asset class. Stewardship, according to the FRC is defined as “the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society.”¹¹⁹ This challenges the idea that stewardship is a function of shareholders of in respect of the investee company. Owners of other asset classes are limited contractually in how they can engage, since creditors typically are prevented from intervening unless their debt is not being paid as per the terms of their contract. As well as this, creditors, like all other stakeholders other than shareholders, do not possess voting rights and so cannot direct the company through the appointment of directors or challenges at a general meeting. It is submitted that this change is in line with a general emphasis on the returns to ultimate beneficiaries of investment. As the FRC stated “This new definition identifies the primary purpose of stewardship as looking after the assets of beneficiaries that have been entrusted to the care of others.”¹²⁰ As Davies has recently argued, “[t]he second version of the SC

¹¹³ Ibid.

¹¹⁴ Ibid.

¹¹⁵ See Chapter 5 at pp 166-167.

¹¹⁶ See Marc Moore, “Whispering sweet nothings: The limitations of informal conformance in UK corporate governance” (2009) 9 *Journal of Corporate Law Studies* 95 at 125-129; Andrew Keay, “Comply or explain in corporate governance codes: in need of greater regulatory oversight?” (2014) 34 *Legal Studies* 279 at 290.

¹¹⁷ See Financial Reporting Council, “Developments in Corporate Governance and Stewardship 2016” January 2017 at 7.

¹¹⁸ FRC, “Proposed Revision of the UK Stewardship Code”, January 2019, available at <https://www.frc.org.uk/getattachment/df25bf9-998e-44f6-a699-a697d932da60/;.aspx>

¹¹⁹ Ibid at 10.

¹²⁰ FRC, “Proposed Revision to the UK Stewardship Code”, January 2019 at 2.

clearly moves away from an almost exclusive focus on engagement as the recommended version of stewards.”¹²¹ He notes that “stewardship activities” are listed as including “investment decision-making, monitoring assets and service providers, engaging with issuers and holding them to account on material issues, collaborating with others, and exercising rights and responsibilities.”¹²² Issuers can be held to account, collaboration and the exercise of rights and responsibilities can all take place via “engaging with issuers”. Indeed, it is difficult to imagine how shareholders can hold issuers to account without even the mildest form of engagement, for example, through the exercise of rights such as voting.

This may seem like a natural and common sense broadening of emphasis to encompass all investments but in fact, it is submitted that it alters the very foundation of the meaning of “stewardship”. While it may be argued that there can be no harm in simply applying stewardship to how investor’s conduct business with all asset classes, rather than equity alone, the foundational basis of the SC was to encourage shareholders to act as stewards of the companies in which they were invested. Rather than “stewardship” meaning stewardship of companies, it is now stewardship of beneficiary assets. In other words, “stewardship” need not involve engagement with investee companies at all and indeed “stewardship” may under certain circumstances prohibit engagement, where it diminishes returns to beneficiaries. This, it is submitted, is a regressive approach that gives shareholders a licence to readily choose “exit” over “voice”, which fundamentally undermines the original purpose of the SC itself. Stewardship of companies implies an obligation to undertake stewardship actions in respect of investee companies, such as engagement and dialogue and undertaking productive monitoring. Stewardship of beneficiary assets does not imply an obligation to engage and, indeed, may imply an obligation to not engage in cases where such “stewards” weigh up the costs of engaging against the uncertain benefits. Notwithstanding this, as will be described, the eventual revision of the SC that is the product of these proposals does contain principles that are specific to engagement. This is discussed further below.

Other changes proposed by the FRC include asking SC signatories to establish “an organisational purpose, strategy, values and culture” which it is hoped will better enable signatories to fulfil stewardship objectives, an explicit reference to environmental, social and governance factors and increased reporting requirements. These latter reporting

¹²¹ Davies (n 111) at 7.

¹²² See 2020 SC at 7.

requirements include both a “Policy and Practice Statement” and an “Activities and Outcome Report.” The Activities and Outcome Report must be published annually and likely reflects a response to Kingman’s criticism. These added reporting requirements are in line with the developments of the SRD2, as will be discussed in the next section. In late 2019, the FRC published a revision to the SC, to come into effect from 1 January 2020.¹²³ The revised SC contains the changes proposed by the FRC, set out above, including a new list of 12 principles which asset owners and asset managers must apply and explain their application. These are:

1. Signatories’ purpose, investment beliefs, strategy, and culture enable stewardship that creates long term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.
2. Signatories’ governance, resources and incentives support stewardship.
3. Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first.
4. Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.
5. Signatories review their policies, assure their processes and assess the effectiveness of their activities.
6. Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.
7. Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.
8. Signatories monitor and hold to account managers and/or service providers
9. Signatories engage with issuers to maintain or enhance the value of assets.
10. Signatories, where necessary, participate in collaborative engagement to influence issuers.

¹²³ Financial Reporting Council, “The UK Stewardship Code 2020”, available at https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf [hereafter “2020 SC”].

11. Signatories, where necessary, escalate stewardship activities to influence issuers.
12. Signatories actively exercise their rights and responsibilities.

Notable are the inclusions of specific principles relating to engagement. In line with Kingman’s recommendations, each principle is accompanied in the 2020 SC with both guidance provisions and outcome based provisions. Regarding the engagement based principles, signatories to the 2020 SC are encouraged to explain outcomes of engagement that is ongoing or has concluded in the previous 12 months, which may involve describing actions that issuers have taken on foot of engagement, how outcomes of engagement have informed investment decisions and decisions regarding escalation and whether stated objectives have been met. While it has been argued here that redefining “stewardship” to involve stewardship of beneficiary assets could encourage asset owners and asset managers to reduce engagement, given the resources engagement necessarily involves, it is clear that this is not the intended outcome of the 2020 SC. The FRC clearly regard stewardship of beneficiary assets as encompassing stewardship of companies in which beneficiary assets are invested. If engagement is regarded as an activity that adds value, it follows that engagement of investee companies is necessarily consistent with stewardship of beneficiary assets. The problem that is sought to be emphasised in this thesis is that, while regulators such as the EC and, more relevantly for the present section, the FRC, assume engagement as a value adding action,¹²⁴ this conception is not always shared by shareholders all of the time. As will be described in greater detail in the next Chapter, the costs of engagement are often regarded as outweighing its benefits and, therefore, in these circumstances engagement is not consistent with stewardship of beneficiary assets.

The SC, in its 2010, 2012 and 2020 iterations, has been and continues to be profoundly influential across the world. It has also arguably paved the way for corporate governance reforms in the EU in the form of the revision of the SRD which occurred in 2017. These reforms are discussed in the next section. There is no Irish equivalent to the SC and so it does not apply to asset managers and asset owners who are domiciled in Ireland. This does not mean, however, that the SC is irrelevant in Irish corporate governance frameworks.

¹²⁴ With respect to FRC, it relies on the Kay Review’s recommendations in the development of both the 2012 and 2020 SC. The Kay Review emphasised that it is not the quantity but quality of engagement that matters, saying at par 5.32, “Effective engagement will directly increase the value of a company: thus even if its effects were immediately reflected in share prices some returns would immediately accrue to those who undertake it.” It is submitted that this view is an underlying foundation of the SC.

Companies that are listed on Euronext Dublin typically have a diverse body of shareholders and many Irish PLCs will have UK signatories to the SC on their shareholder registers. Irish companies then can be expected to encounter the engagement that the SC requires of its signatories. The Irish Association of Investment Managers states on its website that it “is in the process of formulating a Stewardship Code and, in recognition of international best practice, we will give due cognisance to the Code recently issued by EFAMA (European Fund and Asset Management Association).”¹²⁵ This latter Code is an entirely voluntary guidance produced by EFAMA, an organisation representing asset manager groups across Europe, including Irish Funds, the representative body for the international investment fund community in Ireland.¹²⁶ The EFAMA Code much more closely resemble the 2012 SC rather than its 2020 revision, with a strong emphasis on engagement.¹²⁷

Other Codes that bear similarities to the UK SC include Eumedion’s Best Practices for Engaged Share Ownership, which was developed in 2011 and updated in 2018.¹²⁸ Eumedion is a representative body of institutional investors that own shares in Dutch public listed companies.¹²⁹ It’s secretariat monitors the compliance with its best practices by institutional investors and asset managers that are participants in Eumedion or who have requested to be included in monitoring.¹³⁰ The Eumedion Code includes 11 principles which include having a “stewardship policy” that is “aimed at preserving and enhancing value for their beneficiaries and/or clients, and should promote long-term value creation at Dutch listed investee companies.”¹³¹ Other principles emphasise engagement, entering into a dialogue with directors of Dutch listed investee companies, cooperation with other shareholders, exercise voting rights and principles relating to the convening of extraordinary general meetings. Similarly, the International Corporate Governance Network (“ICGN”) set out a Statement of Principles for Institutional Investor

¹²⁵ See Irish Association of Investment Managers, “Corporate Governance”, <http://www.iaim.ie/industry/corporate-governance/>.

¹²⁶ European Fund and Asset Management Association, “Promoting stewardship in a more sustainable world” ICGN Yearbook 2018, available at https://www.efama.org/Publications/Public/Responsible_Investment/articlestewardshipcode.pdf.

¹²⁷ EFAMA Stewardship Code, “Principles for asset managers’ monitoring of, voting in, engagement with investee companies First Adopted on 6 April 2011, Revised in 2017-2018, available at https://www.efama.org/Publications/Public/Corporate_Governance/EFAMA%20Stewardship%20Code.pdf.

¹²⁸ Eumedion, Best Practices for Engaged Share Ownership, 20 June 2018, available at <https://www.eumedion.nl/en/public/knowledgenetwork/best-practices/2018-07-dutch-stewardship-code-final-version.pdf>.

¹²⁹ Eumedion, “About Eumedion”, <https://en.eumedion.nl/About-Eumedion.html>.

¹³⁰ Eumedion, Best Practices for Engaged Share Ownership, 20 June 2018, at 4.

¹³¹ Ibid at 5.

Responsibilities as early as 2003, which developed into the ICGN Global Stewardship Principles, the most recent version of which was published in 2016.¹³² These Principles encourage engagement by institutional investors, with a particular emphasis on environmental, social and governance issues.

ii. The Revised Shareholder Rights Directive

As mentioned above, the EC commissioned the Larosière committee to examine the causes of the GFC as it affected the EU, which was followed up in 2010 with a Green Paper, mentioned previously.¹³³ In this latter Green Paper, the EC called for “concrete solutions to improve corporate governance practices in financial institutions” in light of the GFC.¹³⁴ The EC queried: how the functioning of boards of directors could be improved, including board diversity and board skills; how to deal with conflicts of interest; and whether a risk committee should be compulsory. As well as this, the EC questioned the role of the Chief Risk Officer of the company and its auditors and supervisors. Most relevant for the present enquiry, the EC noted the issue of shareholder passivity and linked it with the issue of short termism in capital markets, saying:

“... shareholders sometimes seem to show little interest in the long-term governance objectives of the businesses/financial institutions in which they invest and may be responsible for encouraging excessive risk-taking in view of their relatively short, or even very short (quarterly or half-yearly) investment horizons.”¹³⁵

Accordingly, the EC noted that the alignment of shareholder and manager interests, undertaken to minimise the agency costs arising from the separation of ownership and control, could amplify risk-taking and contribute to excessive board remuneration where it was tied to short term rises in the company’s share price.¹³⁶ The 2010 Green Paper placed a particular focus on directors’ remuneration and how remuneration structures may have contributed to excessive risk-taking, which was at the heart of what caused the GFC.

¹³² ICGN, Global Stewardship Principles. 2016, available at <https://www.icgn.org/sites/default/files/ICGNGlobalStewardshipPrinciples.pdf>.

¹³³ See above, (n 65).

¹³⁴ EC 2010 Green Paper at 10.

¹³⁵ Ibid at 8.

¹³⁶ Ibid.

Without taking a view regarding whether directors' remuneration was itself excessive, the EC noted that the variable component (ie performance based) of directors' remuneration had increased substantially since the 1980s and that remuneration policies had been incentivising short term profits, which had led to the excessive risk taking seen in the run up to the GFC.¹³⁷

Mandating that companies allow shareholders to vote on the remuneration of directors, whether binding votes or not, is commonly known as "say on pay".¹³⁸ Historically, the calls to give shareholders a vote on directors' remuneration have been rooted in a perception that directors in public listed companies were paid excessively, especially where there had been poor performance by prominent public companies.¹³⁹ In the US, "say on pay" was an initiative of large shareholders, which was supported by shareholders and generally opposed by management.¹⁴⁰ "Say on pay" gained a legislative footing in the US as part of reforms following the GFC.¹⁴¹ The UK regulated "say on pay" much earlier, in 2002, when Parliament introduced the Directors' Remuneration Report Regulations. This followed years of sustained criticism of excessive executive pay practices in UK businesses.¹⁴² Similar to the US, a debate surrounding how best to hold management accountable raised the possibility of "say on pay" regulation in the EU since the corporate governance scandals of the early 2000s without any concrete action, until the GFC.¹⁴³ Agency theory clearly has a role to play in this debate as it has widely been considered that giving shareholders a vote on directors' remuneration is a means of constraining the agency costs directors may impose upon shareholders.¹⁴⁴ Ultimately, it is hoped that "say on pay" enhances directors' accountability.¹⁴⁵

¹³⁷ EC 2010 Green Paper at 9-10.

¹³⁸ Randall S Thomas and Christoph Van Der Elst, 'Say on Pay Around the World' (2015) 92 Washington University Law Review 653.

¹³⁹ Brian R Cheffins and Randall S Thomas, 'Should Shareholders Have a Greater Say over Executive Pay?: Learning from the US Experience' (2001) 1 Journal of Corporate Law Studies 277 at 278-279.

¹⁴⁰ Thomas and Van Der Elst (n 138) at 659.

¹⁴¹ Ibid at 659-660.

¹⁴² See Cheffins and Thomas (n 139).

¹⁴³ See Marisa Anne Pagnattaro and Stephanie Greene, "'Say on Pay': The Movement to Reform Executive Compensation in the United States and European Union' (2011) 31 Northwestern Journal of International Law and Business 593 at 613-614.

¹⁴⁴ Thomas and Van Der Elst (n 138) at 711.

¹⁴⁵ Jill Fisch, Darius Palia and Steven Davidoff Solomon, 'Is Say on Pay All About Pay? The Impact of Firm Performance' (2018) 8 Harvard Business Law Review 101 at 102.

Say on pay is a controversial practice for a number of reasons. It is complicated by the fact that “say on pay” is an imprecise phrase that could mean a shareholder vote on the compensation packages of directors or high level company executives or it could refer to a shareholder vote on the remuneration report or policy of these managers. Criticisms of “say on pay” may therefore not be applicable to the particular “say on pay” regime that is relevant to the development of the provisions of the SRD2.¹⁴⁶ Generally, criticisms of “say on pay” involve arguments that shareholders suffer from information asymmetries that mean they are not well placed to make good decisions about the compensation of company managers¹⁴⁷ and that shareholders tend to overwhelmingly support management remuneration when given a vote and therefore will be ineffective in curbing excessive pay practices.¹⁴⁸ Other commentators have argued that shareholders are not necessarily responsive to whether remuneration is “excessive”, often voting against remuneration packages where company performance is poor, regardless of the level of remuneration of directors or executives.¹⁴⁹ In other words, remuneration may be low but if performance is poor, directors are liable to have their remuneration voted against. Concurrently, if performance of the company is positive, directors are unlikely to suffer a defeat on their remuneration, regardless of how inflated it is.¹⁵⁰ In Ireland, there have been calls for shareholders to vote against company resolutions in protest of perceived “excessive” remuneration of executives.¹⁵¹ Irish companies have had remuneration policies rejected by

¹⁴⁶ Thomas and Elst make a similar point in Thomas and Van Der Elst (n 138) at 658 (“While Say on Pay has been the topic of several empirical studies at both the national and international level, many of these papers do not clearly define Say on Pay. This is important because different kinds of shareholder votes coexist and it is a serious mistake to treat them all as equivalent.”) (reference omitted)

¹⁴⁷ Stephen M Bainbridge, 'Is 'Say on Pay' Justified?' (2009) 32 Regulation 42.

¹⁴⁸ In both the US and UK, shareholder support for remuneration has been found to be over 90%, see Martin Conyon and Graham Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK' (2010) 18 Corporate Governance: An International Review 296; Randall S Thomas, Alan R Palmiter and James F Cotter, 'Dodd-Frank's Say on Pay: Will it Lead to a Greater Role for Shareholders in Corporate Governance?' (2012) 97 Cornell Law Review 1213 at 1248.

¹⁴⁹ Fisch, Palia and Solomon (n 145); Joseph E. Bachelder III, “Say-on-Pay Under Dodd-Frank” Harvard Law School Forum on Corporate Governance and Financial Regulation, 17 September 2011 (“There is significant correlation between negative say-on-pay votes and total shareholder return (TSR) for the one-to-three-year period immediately preceding the year of the vote. This suggests that at least some of those casting negative say-on-pay votes may be confusing a vote on the corporation’s executive compensation program with a vote on the corporation’s stock performance.”) (reference omitted).

¹⁵⁰ See Carsten Gerner-Beuerle and Tom Kirchmaier, “Say on Pay: do shareholders care?” Discussion Paper No 751, Discussion Paper Series, March 2016, available at <http://www.lse.ac.uk/fmg/assets/documents/papers/discussion-papers/DP751.pdf>.

¹⁵¹ See Ciarán Hancock, “Ires shareholders urged to vote in protest over CEO’s pay package,” *Irish Times*, 19 May 2020.

shareholders,¹⁵² but this remains rare, with shareholders generally voting in favour of management remuneration when given the opportunity.¹⁵³

The EC queried whether shareholder control was still a realistic aim of corporate governance policy.¹⁵⁴ It stated an aim of motivating shareholders to engage more in dialogue with financial institutions and sought views as to improve shareholder engagement in practice.¹⁵⁵ It appears that the EC views shareholders as a potential cause of short termism that increases risk-taking of companies and excessive remuneration for directors and also view the solution to this as greater engagement from shareholders. At first glance, this seems like contradictory thinking. How can the problems that shareholders cause be remedied by greater involvement by shareholders? However, the EC clarifies this apparent contradiction more clearly in a subsequent 2011 Green Paper on the corporate governance framework in the EU.¹⁵⁶

This 2011 Green Paper had a broader scope than its 2010 predecessor. While the 2010 Green Paper addressed the subject of corporate governance in financial institutions, the 2011 Green Paper looked at corporate governance in companies more generally. The EC focused on three distinct areas in this Green Paper, the board of directors, the role of shareholders and the application of a “comply or explain” approach.

With regard to shareholder engagement, the EC offer the following definition:

“Shareholder engagement is generally understood as actively monitoring companies, engaging in a dialogue with the company’s board, and using shareholder rights, including voting and cooperation with other shareholders, if

¹⁵² See Geoff Percival, “Greencore to review CEO Coveney’s annual pension contribution after shareholder vote,” *Irish Examiner*, 28 January 2020.

¹⁵³ See Shawn Pogatchnik, “Just four of 27 Irish-listed firms asked shareholders to approve pay,” *Irish Independent*, 7 November 2019.

¹⁵⁴ EC 2010 Green Paper at 16 (“Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?”)

¹⁵⁵ *Ibid.*

¹⁵⁶ European Commission, Green Paper, “the EU corporate governance framework,” 5 April 2011, available at http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf [hereafter “EC 2011 Green Paper”].

need be to improve the governance of the investee company in the interests of long-term value creation.”¹⁵⁷

It goes on to assert that it is “long term investors” who primarily have an interest in engagement.¹⁵⁸ In this way, it seeks to resolve the apparent contradiction noted above, whereby more involvement by shareholders is thought to improve the negative effects that shareholders cause. This implies that shareholders who do not engage will instead choose to sell their shareholding when unhappy with a company’s performance, thereby contributing to the downward pressure on the company’s share price. The EC acknowledges that “short term” shareholders¹⁵⁹ may occasionally engage with investee companies with a positive effect but it is clear that its view of engagement generally does not involve “short term” shareholders.¹⁶⁰ However, it is submitted that engagement involves a wide swath of activities and does not necessarily implicate long term motivations. Some shareholders who engage with investee companies have been accused of doing so in order to make short term profits at the expense of the long term health of the company.¹⁶¹ As well as this, the EC does not properly distinguish between long or short term “shareholders” and long or short term “engagement.” Shareholders can be “long term” in the generally understood sense that they hold their shares for a “long” period of time but this does not necessarily imply long term engagement. Similarly, just because a shareholder may have bought shares in a company only a short time ago does not necessarily imply that any engagement conducted by them will have a “short term” character.

With regard to directors’ remuneration, the EC noted that “a mismatch between performance and executive directors’ remuneration has also come to light” and that poor remuneration policies could have led to unjustified transfers of wealth from the company and could have incentivised the pursuit of short term profits at the expense of the long term

¹⁵⁷ EC 2011 Green Paper at 11.

¹⁵⁸ Ibid at 11 (“Although engagement on the part of short-term investors may have a positive effect, it is generally understood as an activity which improves long-term returns to shareholders.”) (references omitted).

¹⁵⁹ The meaning of a “short term” shareholder is far from clear but for present purposes it can be defined as a shareholder who holds shares for a short period of time, such as three years or less.

¹⁶⁰ EC 2011 Green Paper at 11 (“prove the governance of the investee company in the interests of long-term value creation. Although engagement on the part of short-term investors may have a positive effect, it is generally understood as an activity which improves long-term returns to shareholders”, references omitted).

¹⁶¹ See Hill (n 78) at 500-503; Anabtawi and Stout, 'Fiduciary Duties for Activist Shareholders' ; Anabtawi, 'Some Skepticism About Increasing Shareholder Power' at 579-580.

sustainability of the company.¹⁶² It also noted a recent tendency of Member States to legislate on this issue with respect to disclosure and a shareholders' vote on directors' remuneration.¹⁶³ In Ireland, section 305 of the Companies Act 2014 (replacing section 191 of the Companies Act 1963) requires directors of Irish companies to disclose aggregate remuneration information in the company's financial statements.

In 2012, the EC published an Action Plan on creating a modern legal framework for more engaged shareholders and sustainable companies in which it identified three lines of action: enhancing transparency, engaging shareholders and supporting companies' growth and competitiveness.¹⁶⁴ The first of these involved facilitating shareholder identification, an area which had been raised in the 2011 Green Paper, and the 2012 Action Plan noted particularly strong support for this from businesses and investors. Shareholder identification is a mechanism by which issuers can identify their shareholders in order to facilitate a dialogue and engagement. In the context of enhancing transparency, the EC also stated that it would strengthen the disclosure requirements of institutional investors in respect of their voting and engagement policies. As will be discussed, this disclosure based approach would become central to how the EC sought to increase engagement of institutional investors. With respect to shareholder engagement specifically, the 2012 Action Plan proposed extending shareholders' rights to entitle them to vote on remuneration policies and related party transactions. The EC saw better shareholder oversight of remuneration policies as a possible solution to the problem of poor remuneration policies creating short term incentives and incentives for excessive risk taking, as well as the disconnect between pay and the positive performance of directors. The EC also noted a desire to clarify the meaning of "acting in concert" among shareholders and to facilitate employee share ownership schemes in EU companies.¹⁶⁵

Two years later in 2014 the EC published a proposal for a revision of the SRD, which incorporated many of the suggestions and proposals from the 2010 and 2011 Green Papers

¹⁶² EC 2011 Green Paper at 9.

¹⁶³ Ibid.

¹⁶⁴ European Commission, "Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies," 12 December 2012, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0740&from=en> [hereafter "EC 2012 Action Plan"].

¹⁶⁵ Ibid at 11.

and the 2012 Action Plan.¹⁶⁶ This proposal again encapsulated a view of shareholder engagement that encompassed only “long term” shareholders and is thus a remedy for market short termism. As the EC notes:

“The financial crisis has revealed that shareholders in many cases supported managers' excessive short-term risk taking. Moreover, there is clear evidence that the current level of ‘monitoring’ of investee companies and engagement by institutional investors and asset managers is sub-optimal. Institutional investors and their asset managers do not sufficiently focus on the real (long-term) performance of companies, but often on share-price movements and the structure of capital market indexes, which leads to suboptimal return for the end beneficiaries of institutional investors and puts short-term pressure on companies.”¹⁶⁷

In this sense, engagement and monitoring are activities that are undertaken necessarily for long term benefits. According to the EC, where shareholders choose to be passive and fail to monitor investee companies and instead sell their shares when unhappy with the company’s short term financial performance, this indirectly pressures management to make decisions for the benefit of the short term only, in order to raise the share price in the short term. The EC pre-empts the criticism that this ignores “short term” shareholder engagement by inserting requirements for institutional investors to disclose how their equity investments contribute to the medium to long term performance of their assets. As well as this, the relationship between institutional investors and asset managers receives important new scrutiny in this proposal. Although “asset managers” can be thought of as a subspecies of “institutional investors”,¹⁶⁸ the proposal separates the terms and maintains a distinction between them.¹⁶⁹ This is similar to the distinction drawn in each iteration of the SC between “asset owners” and “asset managers.”¹⁷⁰ Under the proposal, an institutional investor must disclose the arrangements with an asset manager they utilise, including how this

¹⁶⁶ Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 4 April 2014 [hereafter “EC 2014 proposal”].

¹⁶⁷ Ibid at 4.

¹⁶⁸ Serdar Çelik and Mats Isaksson, 'Institutional Investors as Owners: Who Are They and What Do They Do?' (2013) 11 OECD Corporate Governance Working Papers at 15.

¹⁶⁹ This separation is also made in the EC 2011 Green Paper, in which an agency relationship between them and their institutional investor clients is described, at 12.

¹⁷⁰ For a greater discussion, see Chapter 1, above at pp 8-12.

arrangement incentivises the asset manager to make decisions based on medium to long term company performance and to engage with investee companies.¹⁷¹

The EC therefore have sought to restrict the influence of “short term” engagement while simultaneously increasing the “long term” engagement of institutional investors and asset managers. Another way in which “short term” engagement by asset managers and owners may be discouraged from engaging can be found in the shareholder identification provisions of the proposal. The 2014 proposal would require intermediaries to offer the possibility to reveal to companies the identity of their shareholders.¹⁷² One reason that identification provisions may discourage short term engagement however is that hedge fund activists, who are frequently identified as primarily having short term interests,¹⁷³ often rely on building a silent and significant stake in a company before waging an activist campaign and forcing disclosure would raise the costs of this campaign.¹⁷⁴ The EC does not take a position on hedge fund activism specifically but at the very least it can be implied that it prioritises the benefits it envisages will accrue from identification measures over the investment strategy of many activist hedge funds. In fact, it is clear that the benefits it sees as flowing from shareholder identification are primarily the facilitation of the exercise of shareholder rights and therefore shareholder engagement. In chains of intermediaries, the EC notes that shareholders may lose access to their rights, including voting rights, and allowing identification would allow these shareholders to become engaged and use their rights.¹⁷⁵ Transparency and identification, while possibly encouraging engagement, may be a double edged sword, as it may simultaneously discourage other forms of engagement. While identification may allow certain shareholders to be seen and therefore give companies a greater ability to engage with them, other shareholders such as hedge fund activists specifically require an absence of identification as a prelude to engagement.¹⁷⁶ This is important because some commentators have argued that hedge fund activists are the main initiators of institutional investor engagement more generally by proposing

¹⁷¹ EC 2014 proposal at 20.

¹⁷² *Ibid* at 17.

¹⁷³ See Chapter 4: Regulatory Impediments to Shareholder Engagement below at pp 129-130.

¹⁷⁴ See Alessio M Paces, 'Hedge Fund Activism and the Revision of the Shareholder Rights Directive' (2017) ECGI Law Working Paper No 353/2017 1.

¹⁷⁵ *Ibid* at 5-6.

¹⁷⁶ Hedge fund activism is described in more detail above, in Chapter 1 at pp 20-21.

governance or strategy changes, to which other institutional investors respond.¹⁷⁷ This issue will be discussed in more detail below.¹⁷⁸

The 2014 proposal proved to be controversial in both the European Council and Parliament. Hopt described a conflict in which the Council did not want the Directive to go as far as the proposal and the Parliament wanted the Directive to go even further than the proposal.¹⁷⁹ In the Council, greater emphasis was placed on the discretion for Member States in providing exemptions in transpositions, including with regard to related party transactions and allowing advisory shareholder voting rather than binding votes in relation to directors' remuneration.¹⁸⁰ The European Parliament's Committee on Legal Affairs produced a Report that proposed adding provisions encouraging companies to adopt loyalty shares.¹⁸¹ This Report also proposed encouraging the involvement of more stakeholders, particularly employees, rather than just shareholders in the oversight process.¹⁸² The Directive ultimately did not contain provisions seeking to encourage the involvement of non-shareholder stakeholders and this was criticised by commentators.¹⁸³ Commentators challenged the EC's proposals as failing to be empirically sound.¹⁸⁴ A finalised text of the SRD2 was published in May 2017.¹⁸⁵

Like the 2014 proposal, a distinction between "institutional investors" and "asset managers" is maintained and different obligations attach to each. As noted in chapter 1, in the SRD2, "institutional investors" are defined as being certain undertakings involving insurance and pension funds¹⁸⁶ and "asset managers" are defined as investment firms that

¹⁷⁷ See in particular 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.

¹⁷⁸ See Chapter 4 below at pp 126-131..

¹⁷⁹ Klaus J Hopt, 'Corporate Governance in Europe: A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance' (2015) 12 *NYU Journal of Law and Business* 139 at 155.

¹⁸⁰ Corrado Malberti, "The proposed Directive on the encouragement of long-term shareholder engagement in European listed companies: a critical appraisal," in M. Vasudev and Susan Watson, eds, *Global Capital Markets: A Survey of Legal and Regulatory Trends* (Edward Elgar 2017, Chapter 3, at 84-85.

¹⁸¹ Jeroen Delvoie and Carl Clottens, 'Accountability and short-termism: some notes on loyalty shares' (2015) 9 *Law and Financial Markets Review* 19 at 19.

¹⁸² Hopt (n 179) at 158.

¹⁸³ Andrew Johnston and Paige Morrow, 'The revised Shareholder Rights Directive 2017: policy implications for workers' ETUI Policy Brief: European Economic, Employment and Social Policy, No. 2/2018, March 2018 at 4.

¹⁸⁴ Malberti (n 180) at 82-83.

¹⁸⁵ Directive (EU) 2017/828.

¹⁸⁶ Directive (EU) 2017/828, Article 1(2)(b), as defined in Directive 2009/138/EC, Article 2(3).

provides portfolio management services.¹⁸⁷ Many of the provisions in the 2014 proposal are replicated in the SRD2, including the mechanisms which encourage greater engagement by both asset managers and institutional investors. However, like all of the iterations of the SC in the UK, it is clear that the primary responsibility for engagement under the SRD2 lies with asset managers and the role of institutional investors is to monitor their asset managers to make sure they are engaging and also to set a framework of incentives for asset managers in order to encourage engagement.

First and foremost, the SRD2 extends transparency requirements significantly and in two major ways concerning institutional investors. First, institutional investors and asset managers must create and disclose an engagement policy. Article 3g(1)(a) of the SRD2 states:

“Institutional investors and asset managers shall develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy. The policy shall describe how they monitor investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance, conduct dialogues with investee companies, exercise voting rights and other rights attached to shares, cooperate with other shareholders, communicate with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement.”

Article 3g(1)(b) requires disclosure of the manner in which this policy has been implemented. Article 3g(1) generally requires that where institutional investors and asset managers do not comply with this provision, they must give a “clear and reasoned explanation” why they are choosing to not comply. Therefore, shareholders may choose to assert that engagement is not relevant for their investment strategy and disclose the reasons for this. However, it has been argued that the provision in Article 3g “to some extent... [imposes] requirements on certain investor categories that, in practice, remove their option

¹⁸⁷ Directive (EU) 2017/828, Article 1(2)(b), as defined in Directive 2014/65/EU, Article 4(1). This also includes alternative investment fund managers, as defined in Directive 2011/61/EU, Article 4(1).

to abstain from active engagement.”¹⁸⁸ Chiu argues that despite the availability of an explanation in lieu of compliance in Article 3g, “such an approach is likely to be regarded as the outlier and not the norm” since the provision “could be regarded as presuming in favour of the optimality of shareholder engagement.”¹⁸⁹ Chiu develops this argument with Katelouzou, opining that while an institutional investor or asset manager can elect to explain non-compliance and ignore engagement altogether, “the proposed [as it then was] Directive is not far short of imposing a *duty to demonstrate engagement*, as there is a duty to publicly disclose the implementation and achievement of such engagement under Article 3g.”¹⁹⁰ While the SC is entirely voluntary, the SRD2 provisions require disclosures, including disclosures of how the asset manager has carried out the engagement on behalf of the institutional investor. For this reason, Chiu and Katelouzou suggest that certain engagement may be required “in order for there to be sufficient matters to report” and that the SRD2 therefore represents “a step towards hardening stewardship norms into an engagement behaviour that is transparent and accountable, balancing a range of interests which are long-termist in nature.”¹⁹¹

It is respectfully submitted that the above is a stretch of the meaning of article 3g. Although practical problems with the SRD2 are discussed in Chapters 3 and 4, it is worth noting that it is unlikely that institutional investors will comply with Article 3g and will instead choose to give an explanation for non-compliance if the costs of compliance are deemed to exceed the benefits. Article 3g does not constitute mandatory engagement because of the availability of this “explain” mechanism. It is not the case that some engagement is required for there to be sufficient matters to report, since all that is required to be reported can be an explanation regarding the irrelevance of engagement for the institutional investor or asset manager. If, however, institutional investors widely take the view that it is unacceptable that their asset managers are choosing to not engage because the costs are too high and, as such, they refuse to use asset managers that give these explanations, this will create a market pressure to comply. It is unclear to what extent asset managers will have the discretion to disclose full compliance with Article 3g. An asset manager could disclose compliance with the “monitoring” and “dialogue” elements of Article 3g by reference to

¹⁸⁸ Therese Strand, 'Short-Termism in the European Union' (2015) 22 Columbia Journal of European Law 15 at 21.

¹⁸⁹ Iris H-Y Chiu, 'European Shareholder Rights Directive proposals: a critical analysis in mapping with the UK Stewardship Code?' (2016) 17 ERA Forum 31 at 35.

¹⁹⁰ Iris H-Y Chiu and Dionysia Katelouzou, “From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?” in Hanne S Birkmose (ed), *Shareholders’ Duties* (Kluwer Law International BV, 2017) at 143 (emphasis in original).

¹⁹¹ *Ibid.*

their own interpretation of the terms “monitoring” and “dialogue” that are potentially at odds with the expectations of asset owners, regulators and other company stakeholders. This ambiguity could allow asset managers and asset owners to create their own versions of key concepts for the purposes of staying in compliance and it is not clear how higher standards of “engagement” can be maintained.

Birkmose argues that the elements of article 3g (and the provisions of the SRD2 more generally) constitute a substantial step away from traditional agency theory.¹⁹² Agency theory can provide an explanation for extending or creating rights for the principal, in order to allow them to control or influence the behaviour of the agent. Imposing duties such as the disclosure duties under the SRD2 upon a principal cannot be explained by agency theory since legal duties necessarily constrain the principal’s behaviour.¹⁹³ Birkmose notes that shareholders are the principals in other relationship, with stakeholders of the company and with other shareholders.¹⁹⁴ Agency theory can provide a basis for imposing duties upon shareholders where shareholders are the agents of the particular relationship, in order to address information asymmetries and conflicts of interest. Indeed, institutional investors and asset managers are necessarily both agents and principals, depending on which relationship is being focused upon. With regard to the company and its controllers, both institutional investors and asset managers are considered principals. With regard to asset managers, they are the agent of their investors, whether these are institutional investors or individuals. Similarly institutional investors are agents of the individuals contributing assets in the form of pension plan contributions or savings. This “double agency” problem affects all institutional investors and provides a basis from an agency theory perspective for imposing duties on shareholders.¹⁹⁵ It is clear from the recitals of the SRD2 that the EU regards the imposition of shareholder duties as providing an opportunity for other principals to make sure institutional investors are fulfilling a governance role. Recital 16 states:

“Institutional investors and asset managers are often not transparent about their investment strategies, their engagement policy and the implementation thereof. Public disclosure of such information could have a positive impact on investor awareness, enable ultimate beneficiaries such as future pensioners optimise

¹⁹² Hanne S Birkmose, 'Shareholder Duties - A Transformation of EU Corporate Governance in a Sustainable Direction' (2018) 5 *Intereulaweast* 69.

¹⁹³ *ibid*

¹⁹⁴ *Ibid.*

¹⁹⁵ Gilson and Gordon (n 177) at 865-866.

investment decisions, facilitate the dialogue between companies and their shareholders, encourage shareholder engagement and strengthen their accountability to stakeholders and to civil society.”

Mandatory disclosures therefore are aimed at establishing the accountability of institutional investor and asset manager behaviour, including how they engage. To this end, article 3h imposes transparency requirements upon institutional investors and asset managers in respect of their contractual relationships. Under this provision, institutional investors must disclose how their equity investment strategy is consistent with the “medium to long term” performance of their assets. These time horizons are not given any definition in the SRD2, although they are used throughout. Where institutional investors use an asset manager, they must disclose certain aspects of the relationship that are clearly designed to orient both parties to the long term. In line with the 2014 proposal, institutional investors must disclose how their arrangements with an asset manager incentivise the asset manager to align its strategy with long term liabilities and make decisions based on medium to long term performance of investee companies. Institutional investors must also disclose how they monitor and evaluate the asset manager and the duration of the arrangement. As well as this, institutional investors must disclose how the arrangements incentivise the asset manager to engage with investee companies in order to improve their performance in the “medium to long term.” Ultimately, it is clear that this provision, as well as others, indicates that the action of engaging with investee companies is expected to come from asset managers rather than institutional investors. For example, in Art 3g, it is noted that “[w]here an asset manager implements the engagement policy, including voting, on behalf of an institutional investor, the institutional investor shall make a reference as to where such voting information has been published by the asset manager.”

Article 3i contains transparency requirements that apply to asset managers and place an obligation upon them to make these disclosures to their institutional investor clients. These disclosures are again designed to orient the asset manager to the longer term. The disclosures include the “medium to long term” risks associated with their investments, use of proxy advisors for the purposes of engagement and whether conflicts of interests have arisen in relation to their engagement activity and the manner in which they were managed. Asset managers must also disclose their policy on securities lending and how it is applied to fulfil their engagement activities.

With regard to shareholder identification, the SRD2 goes further than the 2014 proposal. There is a possible tension in the aims of identification provisions because they may either promote engagement by allowing companies to identify their shareholders behind chains of intermediaries or discourage certain forms of shareholder activism by making them more expensive through identification.¹⁹⁶ Article 3a of the SRD2 allows Member States to allow companies to only request identification of shareholders if that shareholder has amassed a certain percentage of voting rights in the company, not exceeding 0.5%. What this means is that Member States cannot prevent a company from requesting identification of shareholders who own more than 0.5% of the voting rights of a company. As noted, many hedge fund activists target a company by amassing a sizable stake, usually far in excess of 0.5%, and then engaging with that company in order to seek to raise the share price.¹⁹⁷ For this reason Alessio Paces has described the SRD2 as “a missed opportunity” and commented that “[w]hile such a rule seemingly facilitates shareholder voice by increasing transparency, it undermines the business model of the main activator of such voice – the hedge funds.”¹⁹⁸ This potential practical hurdle for hedge fund activists is discussed in more detail in Chapter 4.

The next major development involves extensions of categories in which shareholders are given a vote in the SRD2. These categories are director remuneration and related party transactions, which, as is described above, were both brought up as potential areas for facilitating shareholder voting in the 2010 and 2011 Green Papers and 2012 Action Plan.¹⁹⁹ Under Article 9a boards of directors are required to disclose their individual remuneration, as well as their remuneration policy in an annual remuneration report. Article 9b sets out what must be included in a remuneration report, which includes the total remuneration for each director, split into its components and an explanation as to how this remuneration is consistent with the remuneration policy of the company and contributes to its long term performance.²⁰⁰ An express remuneration policy must now be drawn up and disclosed and the remuneration of directors must be based on this policy. Shareholders have a right under Article 9a to approve or reject a remuneration policy at least every three years and have the right to vote to approve or reject a remuneration report each year. Where shareholders vote

¹⁹⁶ For further discussion, see Chapter 4 below at pp 125-132.

¹⁹⁷ Alon Brav and others, 'The Returns to Hedge Fund Activism' (2008) 64 *Financial Analysts Journal* 45 find that hedge fund activists purchase on average 5-10% of a target's shares in their sample of 236 hedge funds making “schedule 13D” disclosures between 2001-2006 in the US. Schedule 13D is the US requirement for disclosure of a greater than 5% stake in a company.

¹⁹⁸ Paces (n 174) at 17.

¹⁹⁹ See above at pp 57-61.

²⁰⁰ SRD2, Article 9b.

against a remuneration report, directors must explain in the following year's report how or whether shareholder concerns have been taken into account. A company may not set remuneration without a remuneration policy being approved by shareholders under the proposal.²⁰¹

With regard to related party transactions, Article 9c requires Member States to define what constitutes a "material transaction with a related party" and enact legislation requiring companies to disclose when such transactions occur.²⁰² Member States must also ensure that such transactions are approved at the general meeting of the company or by "the administrative or supervisory body" of the company.²⁰³ Providing a right for shareholders to vote to approve these transactions is not mandatory under Article 9c but if Member States do provide such a voting right, the shareholder or director who is the "related party" must not get a vote to approve or reject the transaction. The Companies Act 2014 may provide guidance regarding how Ireland will define "material transactions with related parties." It is already a statutory requirement that companies disclose material related party transactions under Schedule 3 of the 2014 Act.²⁰⁴ Section 309 of the 2014 Act requires the company to disclose arrangements and transactions in which a director has a "material interest."

The SRD2 was transposed into Irish law by virtue of the European Union (Shareholders' Rights) Regulations 2020.²⁰⁵ These Regulations introduce several new Chapters into Part 17 of the Companies Act 2014, and each of these in turn contains provisions that correspond with provisions in the SRD2. Chapter 8A provides for the identification of shareholders by PLCs and does not include the 0.5% upper limit in article 3a.²⁰⁶ What this means is that public limited companies subject to Part 17 of the 2014 Act may identify their shareholders under this provision regardless of the percentage of voting rights any given shareholder

²⁰¹ See SRD2, Article 9a.

²⁰² SRD2, Article 9c gives some guidance on this in the following terms: "Member States shall define material transactions for the purposes of this Article taking into account: (a) the influence that the information about the transaction may have on the economic decisions of shareholders of the company; (b) the risk that the transaction creates for the company and its shareholders who are not related party, including minority shareholders. When defining material transactions Member States shall set one or more quantitative ratios based on the impact of the transaction on the financial position, revenues, assets, capitalisation, including equity, or turnover of the company or take into account the nature of transaction and the position of the related party."

²⁰³ SRD2, Article 9c(2).

²⁰⁴ Part 67 of Schedule 3 of the Companies Act 2014.

²⁰⁵ SI No. 81/2020 – European Union (Shareholders' Rights) Regulations 2020.

²⁰⁶ See Companies Act 2014, section 1110B, as inserted by the 2020 Regulations.

has. Chapter 8B includes the engagement provisions and contains a statutory definition of “engagement activity” as “any activity, action, plan or document that is carried out or made for the purpose of giving effect to an engagement policy.”²⁰⁷ This links the definition of engagement to the elements required to be included within an engagement policy, namely the integration of engagement into an investment strategy, monitoring investee companies on financial and non-financial matters, conducts dialogues, exercises voting rights, cooperates with other shareholders, communicates with other stakeholders and manages conflicts of interest. As noted, several of these elements cannot necessarily be described as “engagement” since they do not necessarily send a signal of any kind to company management, including cooperation with other shareholders and other stakeholders and the management of conflicts of interest. However, despite the link to the “engagement policy”, an “engagement activity” can, under this definition include “any activity, action, plan or document”, provided it is undertaken for the purpose of giving effect to such a policy, which conceivably could be far broader than the elements listed in Article 3g. For example, merely hiring extra employees for the purpose of creating an engagement policy would fall within this definition, considering it is an “activity” or “action” undertaken for the purpose of giving effect to an engagement policy. This broadening of the definition threatens to undermine a clear understanding of exactly what outcomes are expected of “engagement”.

Sections 110G and 110H correspond with article 3g, requiring institutional investors and asset managers acquiring shares on a regulated market for which Ireland is the competent Member State to produce an engagement policy in accordance with the elements listed in article 3g. The transparency requirements of the asset manager-institutional investor relationship of article eh are contained in section 1110I and disclosure requirements of asset managers are contained in section 1110J.

The remuneration policy and related party transaction requirements from articles 9a, 9b and 9c of the SRD2 are contained in Chapter 8C of the 2014 Act, as inserted by the 2020 Regulations. These provisions are broadly identical in terms to their equivalents in the SRD2. It is worth pointing out that the 2020 Regulations do not require that the shareholder vote on the remuneration policy that is required by the Regulations is advisory and not binding, unless a PLC’s constitution provides for a binding vote.²⁰⁸ Article 9a, as noted above, allows Member States to require the shareholder vote on the remuneration policy to

²⁰⁷ Companies Act 2014, section 1110F(1), as inserted.

²⁰⁸ Companies Act 2014, section 1110M, as inserted.

be binding. It is perhaps notable that the UK has previously required shareholder votes on remuneration policies to be binding.²⁰⁹ For shareholder approval of related party transactions, the 2020 Regulations define “material transaction as “a transaction in which any percentage ratio, calculated in accordance with one or more class tests, is 5% or more.”²¹⁰

The final point worth discussing in relation to the SRD2 and its implementation, is how the various provisions will be enforced. The SRD2 contains no enforcement mechanisms for most of its provisions. Article 14b of the SRD2 asserts that “Member States shall lay down the measures and penalties applicable to infringements of national provisions adopted pursuant to this Directive and shall take all measures necessary to ensure that they are implemented.” This provision also states that such measures and penalties must be effective, proportionate and dissuasive.²¹¹ Sergakis has argued that “the wording of this article is very broad and can be interpreted in many different ways, raising concerns about its applicability across the EU and the ensuing consequences for the reliability of legal enforcement actions in this context.”²¹² As will be described extensively, enforcement of many provisions of the SRD2, including the engagement provisions of article 3g, is the responsibility of asset owners, who must ensure that their asset managers are either complying with article 3g or making adequate explanatory disclosures.

Member States had a broad discretion in transposing the SRD2 with regard to enforcement of its provisions. Sergakis, again, argues that administrative sanctions might be appropriate in the case of failures of disclosure. He states, “[National competent authorities] should be able to simply verify if such disclosure (or the explanation required according to Article 3g) has been published, and could be in a position to proceed with the imposition of sanctions or measures if this is not the case.”²¹³ The experience of the FRC in the UK has shown that enforcement bodies have an ability to determine whether a required disclosure

²⁰⁹ See Companies Act 2006 (UK), section 439A.

²¹⁰ Companies Act 2014, section 1110O(11).

²¹¹ SRD2, Article 14b.

²¹² Konstantinos Sergakis, “Legal vs social enforcement of shareholder duties” in Hanne S Birkmose and Konstantinos Sergakis (eds), *Enforcing Shareholders’ Duties* (Edward Elgar, 2019) at 143.

²¹³ Sergakis (n 212) at 143.

has been made and to evaluate the quality of such disclosures.²¹⁴ Sergakis argues that administrative enforcement bodies (“national competent authorities”) suffer from limitations with respect to “the contours of overall compliance [with the SRD2] due to the inevitably variable circumstances within which engagement and investment strategies constantly evolve.”²¹⁵ This point gets to the heart of a major difficulty with the SRD2 that is emphasised repeatedly in this thesis in contexts other than enforcement: the meaning of engagement is complex and can represent a variety of different actions depending on the particular shareholder at any given time. An alternative form of enforcement, explored elsewhere in this thesis, is the role of public opinion and reputational costs of institutional investors for non-compliance. For example, social media can (and has) been utilised to pressure large asset managers to take firmer action on social issues, such as gun control, and environmental issues.²¹⁶ In this way, the SRD2 could serve as a source of illumination on the practices of institutional investors and asset managers that can be leveraged by those in society most interested in particular social and environmental norms. Environmental groups can latch on to the disclosures of the most powerful asset managers and use these disclosures to form the basis of public pressure campaigns that threaten the reputation of these asset managers.

There has been a wide variation in how Member States have decided to enforce the SRD2 in their national laws. Katelouzou and Sergakis note two trends in the transposition of enforcement provisions across Member States, of Member States that impose no public enforcement mechanisms and Member States that impose strict, formalistic public enforcement mechanisms.²¹⁷ Perhaps surprisingly, given the reticence in relation to other provisions such as providing only for an advisory vote on directors’ remuneration reports, Ireland has clearly opted for the latter of these two trends. Chapter 8D of Part 17 of the Companies Act 2014, as inserted by Regulation 7 of the 2020 Regulations, create new corporate offences for non-compliance with the disclosure requirements of the SRD2. For example, it is now an offence for an institutional investor or asset manager (or officer of the institutional investor or asset manager) to fail to give a clear and reasoned explanation for not creating and disclosing an engagement policy with all the elements contained in

²¹⁴ As seen in both the tiering exercise conducted above in relation to the 2012 SC and FRC, “What Constitutes an Explanation under ‘Comply or Explain’? Report of Discussions Between Companies and Investors” February 2012 in relation to the UK Corporate Governance Code.

²¹⁵ Sergakis (n 212), at 144.

²¹⁶ See Chapter 6 at pp 210-211.

²¹⁷ Dionysia Katelouzou and Konstantinos Sergakis, “Shareholder Stewardship Enforcement” ECGI Law Working Paper N° 514/2020, May 2020 at 18-19.

article 3g.²¹⁸ This is a category 3 offence, and so carries a liability for a fine of between €4,000 and €5,000²¹⁹ and/or imprisonment of up to 6 months.²²⁰ The Office of the Director of Corporate Enforcement has the jurisdiction to enforce offences under the 2014 Act and so it will fall to this office to police disclosures of relevant institutional investors and asset managers relating to the SRD2.²²¹

Regardless, the relevant authority will have to keep track of which practices constitute “engagement” for the purposes of the SRD2 in order to fairly assess the quality of disclosures required by it. It remains to be seen how successful the relevant authority will be in doing so or how willing and well-resourced it is to undertake such an interventionist role.

iii. Legal Context in Ireland

Finally, it is worth briefly setting out the legal context in Ireland to which the SRD2 will be added. This is because the SRD2, like the SC, is designed to create a culture of engagement. Whether or not this will be successful partly depends on the existing legal framework and the extent to which shareholders are empowered in national corporate governance. Ireland, like the UK, has long had a shareholder centric model of corporate governance law. Unlike other EU jurisdictions that give more voice to other stakeholders, the SRD2 will further contribute an element of shareholder democracy that is consistent with the pre-existing company law system. The Irish Companies Act 2014 (“the 2014 Act”) asserts that the business of the company is managed by its directors, subject to the qualified directions of its shareholders.²²² Under section 158(2), shareholders can direct the management of company with a special resolution, which requires three quarters of the votes at a general meeting. The constitution of many Irish companies contains a provision that allows shareholders to give directions with an ordinary resolution, which only requires a majority of votes by virtue of section 158(1) of the 2014 Act and its legislative predecessor, Regulation 80 of Part 1 of Table A of the Companies Act 1963.²²³ Other provisions in Irish law were introduced through the SRD, such as the right to table resolutions, which would allow shareholders to initiate changes in the company. In *Ryanair*

²¹⁸ See Companies Act 2014, sections 1110P(g) and (h), as inserted.

²¹⁹ This is the penalty for liability for a “class A fine” under the Fines Act 2010, section 4(3).

²²⁰ Companies Act 2014, section 871(3).

²²¹ Companies Act 2014, section 949.

²²² Companies Act 2014, s 158(1)-(2).

²²³ See Thomas B Courtney, *The Law of Companies* (4th ed, Bloomsbury, 2016), at para. 13.170.

v Aer Lingus Group plc,²²⁴ the plaintiff company was a major shareholder in the defendant and sought to table resolutions at the general meeting that would have had the effect of the defendant company declaring a €30 million dividend and stopping further payments to the defendant's pension plan for its employees. While section 133B of the Companies Act 1963 (as inserted by the SRD²²⁵), which is replicated in section 1104 of the 2014 Act, gives a shareholder the right to add items to the agenda, the directors of Aer Lingus refused to allow Ryanair to table their resolutions on the basis that it subverted the authority of the directors. The articles of association of Aer Lingus gave the directors the authority to declare a dividend. The Court held that "the division of powers between the board of directors and the company in general meeting depended, in the case of registered companies, entirely on the construction of the articles of association, and that, where powers had been vested in the board, the general meeting could not interfere with their exercise."²²⁶ In other words, shareholder rights are subject to the articles of association and could be limited by them.

Other cases have emphasised the importance of the company's articles of association in setting the balance of power in companies, to the disadvantage of shareholders seeking to exert influence. In *O'Sullivan v Conroy Gold and Natural Resources plc*,²²⁷ a major shareholder (this time an individual rather than an institutional investor or company) sought to propose several resolutions at the defendant company's general meeting that would have had the effect of removing six board members and appointing three others to the board. The plaintiff shareholder requisitioned an extraordinary general meeting, as he was entitled to do under section 178 of the 2014 Act and submitted the resolutions. In the course of his judgment, Barrett J noted that "the true 'democratic will' of all of the members of a company finds expression in the articles of association by which each of those members have agreed to be bound."²²⁸ The defendant company contended that the execution of the resolutions nominating the three new directors were invalid, despite being passed by a majority of shareholders present. According to the 2014 Act and article 85 of the defendant company's articles of association, in order to be validly appointed the director must give notice to the company of their willingness to act as a director. The proposed directors did not give the necessary notices to the company in advance of the EGM and were, thus, not

²²⁴ [2011] 3 IR 69.

²²⁵ In particular Regulation 7 of SI No. 316/2009 - Shareholders' Rights (Directive 2007/36/ec) Regulations 2009.

²²⁶ [2011] 3 IR 69 at 78-79, citing *Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame* [1906] 2 Ch. 34.

²²⁷ [2017] IEHC 543.

²²⁸ [2017] IEHC 543 at par 11.

validly appointed. The High Court rejected various arguments put forward by the plaintiff that the company had waived or was estopped from relying on its articles on the basis that the company had not requested the relevant notices or warned that they were needed. Barrett J concluded “The notification requirements are simple and clearly worded, there is good reason why they exist and fall to be satisfied, and they were not satisfied.” There are number ways of reading this judgment. One could say that the strict application of the rules set out in statute and the articles of association places an undue obligation on shareholders seeking to engage, since there did not seem to be any indication that the proposed directors did not consent to being appointed, apart from the absence of notices to this effect. More persuasively, the obligations upon shareholders seeking to engage in the manner the plaintiff did in *O’Sullivan*, requisitioning a general meeting, tabling resolutions and removing directors, are not unduly onerous and O’Sullivan would have been successful in having the three new directors elected to the board if the proposed directors had undertaken the relatively simple step of giving the company notice of these directors’ willingness to serve as directors.

In sum, the provisions of the articles of association are taken seriously by Irish courts and engaging shareholders are well advised to cater their engagement to such provisions. It might be suggested that this may raise the costs of engaging for shareholders, since legal advisors will be needed to carefully go through the articles of the company to make sure the engagement is not a costly and fruitless exercise, as it ultimately was for the plaintiff in *O’Sullivan*. This was the case despite the plaintiff in this case having secured majority support from the rest of the voting shareholders, which is often itself a costly and time consuming exercise. However, a strict application of the articles creates certainty for engaging shareholders. Other areas of Irish law with regard to the primacy of shareholder interests are less clear. The next section will discuss whether directors owe legal duties to shareholders, which would give primacy to shareholder voices when engaging, rather than having such voices diluted by, and balanced against, the interests of other company stakeholders.

With respect to directors’ duties in Irish company law, there are two distinct areas of consideration: to whom are directors’ duties owed and in whose interest must the company act? Taking the former question first, by virtue of the 2014 Act, directors owe fiduciary

duties “to the company (and the company alone).”²²⁹ Courtney, a leading commentator on Irish Company Law, has interpreted this provision as asserting “the primacy of shareholder value” in Irish company law.²³⁰ The primacy of shareholder value as enshrined in law does not imply that directors owe fiduciary duties to shareholders in particular. Case law has supported this point. *Percival v Wright*²³¹ was the first authority that stated the proposition that directors owe their duties to the company alone and not to shareholders. *Percival* has been cited with approval in Ireland regularly²³² and is based on the principle that a company is a separate legal entity from its shareholders. The Irish Supreme Court has made statements that support the contention that the company and its shareholders are not equivalent in law. In *Crindle Investments v Wymes*, Keane J noted that “There can be no doubt that, in general, although directors of a company occupy a fiduciary position in relation to the company, they do not owe a fiduciary duty, merely by virtue of their offices, to the individual members” and cited *Percival* with approval.²³³ Keane J went on to consider the case of *Coleman v Myers*,²³⁴ in which the New Zealand Court of Appeal held that in certain circumstances directors do owe fiduciary duties to individual shareholders. In this case, a number of factors were listed that suggest duties will be owed to shareholders, which were “dependence upon information and advice, the existence of a relationship of confidence, the significance of some particular transaction for the parties and, of course, the extent of any positive action taken by or on behalf of the director or directors to promote it.”

In relation to the question of in whose interest must the company act, directors in the course of their management of the company must consider the interests of shareholders, as well as certain other stakeholders. Section 228 of the 2014 Act provides that directors must “have regard to the interests of its members [shareholders].”²³⁵ This is distinct from owing a fiduciary duty directly to shareholders. Similarly, section 224 requires that directors “have regard” to the interests of employees of the company.²³⁶ This provision has been criticised by commentators for providing no guidance where a conflict arises between employees and

²²⁹ Companies Act 2014, s 227(1).

²³⁰ Courtney, (n 223) para 16.006.

²³¹ [1902] 2 Ch 421.

²³² Most recently in *O’Sullivan v Conroy Gold and Natural Resources plc* [2017] IEHC 543; *Jones v Gunn* [1997] 3 IR 1 at 18.

²³³ [1998] 4 IR 567 at 591. Strictly speaking “members” and “shareholders” are not equivalent terms, since certain companies do not have a share capital and therefore their members are not shareholders. However, considering the present focus and the fact that all shareholders will be entered onto the register of members, these terms will be treated as indistinct.

²³⁴ [1977] 2 NZLR 225.

²³⁵ Companies Act 2014, s 228(1)(h).

²³⁶ Companies Act 2014, s 224(1).

shareholders.²³⁷ Furthermore, subsection 2 of section 224 clarifies that the duty to have regard to employee interests is owed to the company alone and enforceable only by the company.²³⁸ Certainly, the Irish legislature had an opportunity to follow the UK's "enlightened shareholder value", which incorporates considerations of stakeholders other than shareholders into directors' duties, and chose against it.²³⁹ As Courtney says, "...unlike in the UK, directors in Ireland are not mandated to have regard to as extensive a body of interests as UK directors who while being obliged to promote the success of the company must do so having regard to the extensive interests of others."²⁴⁰

The fact that directors must run the company in the interests of the company without reference to the "extensive" interests of company stakeholders may place shareholders in a privileged position where the law equates the interests of the company with the interests of shareholders. In *G&S Doherty v Doherty*²⁴¹ it was noted that "directors are in a fiduciary position, and must exercise their power bona fide for the benefit of the company as a whole, that is to say, the shareholders as a whole." This language clearly seeks to equate the company with its shareholders in relation to directors' duties. As Courtney notes, this may simply be a reference to the idea that shareholders are regarded as "ultimate owners" of the company.²⁴² Barron J in *Irish Press plc v Ingersoll Irish Publications Ltd*,²⁴³ asserted that "acting in the interests of the company is no more than acting in the interests of all shareholders." Barron J made this statement in the context of the duties of nominee directors and whether they owe duties to their nominating shareholder. Ahern has argued, with respect to Barron J's comments, that "[t]hese pronouncements show a pragmatic judicial response to mediating between the demands of a nominee director's appointer and the need to respect the primacy of the collective interests of the company's members."²⁴⁴ The Supreme Court in *Re Frederick's Inns*²⁴⁵ endorsed this line of thinking in a direct way. This case involved insolvent companies and is primarily an authority for the proposition

²³⁷ G Brian Hutchinson, *Keane on Company Law* (5th ed, Bloomsbury, 2016) at 428

²³⁸ Companies Act 2014, s 224(2).

²³⁹ "Enlightened shareholder value" is the phrase given to the statutory duty to promote the success of the company in UK company law, see Companies Act 2006, s 172.

²⁴⁰ Courtney (n 223), at para 16.006.

²⁴¹ Unreported, High Court, Henchy J, 19 June, 1969.

²⁴² Courtney (n 223) at para 16.043, ("This reference to fiduciary duties being owed to 'the shareholders as a whole' does not detract from the principle that those duties are owed to the company. Rather, such a statement is indicative of a recognition of the reality that the shareholders are the ultimate owners of the separate entity which is the company.")

²⁴³ Unreported, (15 December 1993) High Court, Barron J.

²⁴⁴ Deirdre Ahern, 'Irish legislative proposals for clarification of nominee directors' best interests duty' (2010) 31 *Company Lawyer* 291 at 293.

²⁴⁵ [1994] ILRM 387.

that when a company is insolvent, the directors owe their statutory duties to creditors.²⁴⁶ However, Blayney J also commented upon the duty where a company is solvent, which was not directly relevant to the issue in the case before him (making the comments *obiter*). Quoting from an Australian authority²⁴⁷ with approval, he said “[i]n a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise.”²⁴⁸

It is worth noting the extent to which shareholders owe duties to the company in Irish law, beyond the disclosure obligations of institutional investors and asset managers detailed in the SRD2 and its Irish transposition. In Irish law, shareholders do not owe fiduciary duties to companies in which they are invested. Blayney J in the Supreme Court in *Irish Press plc v Ingersoll Irish Publications Ltd*²⁴⁹ adopted the following statement from Gower's Principles of Modern Company Law:²⁵⁰

“In talking about the duties of shareholders, whether they be to refrain from fraud on the minority or to refrain from oppression, the duties differ markedly from those of directors and officers — and not only because they fall short of those of a fiduciary. The duties of directors, as such, are owed only to the company; those of members may be owed either to the company or to their fellow shareholders. The remedies for a breach of the members' duties are much more restrictive. There is no duty in the sense of an obligation giving rise to damages or compensation in the event of breach; the duties can be enforced only by injunction, declaration, winding-up or a regulating order under s. 210.”²⁵¹

Hutchinson notes in Keane on Company Law that a shareholder owes a duty to pay the amount agreed for the shares that they hold.²⁵² This duty arises in contract only and only relates to the ownership of the share.

²⁴⁶ *Ibid* at par 38.

²⁴⁷ *Kinsela v. Russell Kinsela Property Ltd (in liquidation)* [1986] 4 NSWLR 722.

²⁴⁸ [1994] ILRM 387 at par 46.

²⁴⁹ [1995] 2 ILRM 270.

²⁵⁰ *Gower: Principles of Modern Company Law*, (4th ed, Sweet & Maxwell, 1979) at 630.

²⁵¹ [1995] 2 ILRM 270 at 280.

²⁵² Hutchinson (n 237) at para 17.06.

The present question relates to the pre-existing legal context in which the SRD2 will operate and whether it is consistent with the shareholder democracy vision the SRD2 seeks to produce. Even if directors were statute bound to pursue the interest of shareholders, this does not necessarily imply shareholder democracy, since shareholder democracy requires shareholder involvement. However, where company law requires directors to consider the position and views of stakeholders other than shareholders, the position and views of shareholders is diluted since the latter must be balanced against those of stakeholders. As can be seen, the law in Ireland goes no further than requiring directors to run the company in the interests of company, which has been interpreted to mean the interests of shareholders. Beyond this, only “regard” must be had to a wider group of shareholders.

E. Conclusion

Corporate governance scandals in the early 2000s started a process of reform that sought to give shareholders in public listed companies more influence in corporate decision making. In a European context, this manifested in the SRD, which clarified and extended the rights of access of shareholders in public listed companies to use their voting rights to influence how investee companies are governed. After the GFC, inadequate shareholder engagement was identified by the EC and FRC as a contributing factor to the crisis. Consistent with the shareholder empowerment reforms of the 2000s, these regulators sought to further enhance the influence of shareholders in companies. This was done through disclosure provisions of institutional investors and asset managers of an “engagement policy” that the EC hopes will enhance the levels and quality of engagement. If shareholders do increase their engagement, their influence over individual decisions in companies will undoubtedly grow.. However, as the next chapter will detail, there are a number of practical difficulties with the regulatory and legislative attempts, detailed above, to engage institutional investors and asset managers that may defeat the aims of this “engagement agenda.”

3. Market Impediments to Shareholder Engagement

A. Introduction

The regulatory push to increase the level and quality of engagement of shareholders, described in Chapter 2, has as its premise the assumption that if shareholders were to be more engaged and active, with the long term interests of the company as their priority, corporate governance would improve and value would be added.¹ The question of whether this regulatory push to engage shareholders for the long term is likely to succeed must be addressed. As described, the main means of engaging shareholders under the SRD2 is transparency, since institutional investors and asset managers will be required to disclose an “engagement policy”, detailing their engagement activities.² It is entirely possible that transparency alone will be insufficient to raise the level of engagement or improve the quality of this engagement. The reasons why this may be the case relates to a discordance between the conceptions of engagement that regulators have sought to embed in regulation and the conceptions of engagement that shareholders themselves hold. It is in this context that the “impediments” that are described in the following two Chapters operate. The various “impediments” here impede the actions of “engagement” as interpreted by the shareholders subject to the SRD2. These impediments also impede the actions of “engagement” as described in Chapter 1 of this thesis and the following two Chapters are concerned not just with impediments to the most narrow possible conception of engagement under Article 3g of the SRD2 but also impediments to the conception of engagement set out in this thesis, as it stands separate from the SRD2.

The following two Chapters will address the operational impediments to shareholder engagement that fall under two headings: This Chapter will examine market based impediments and Chapter 4 will examine regulatory impediments. The former Part is concerned with impediments to shareholder engagement that arise naturally during the course of business in the investment market environment. These include: the free rider problem that shareholders face and the related cost-benefit analysis undertaken; the

¹ Recital 14 of the Directive (EU) 2017/828 [hereafter “SRD2”] reads, “Effective and sustainable shareholder engagement is one of the cornerstones of the corporate governance model of listed companies...”; Chapter 2: The Shareholder Rights Directive, its Development and its Revision, above at p 60.

² SRD2, Article 3g.

increasing intermediation of the investment chain; and the existence of control enhancing mechanisms in companies. Chapter 4 will examine regulation that presents a direct barrier to shareholder engagement, including the “acting in concert” provisions of the mandatory bid rule, shareholder identification provisions, market abuse rules and the legal formalities of the AGM.

Of course, the distinction between market based and regulatory impediments is highly imperfect; there is no clear line between them and a great deal of overlap will be observed. This is because very few market practices truly “naturally” arise and many are responses to a form of regulation. For instance, intermediation between the shareholder and investee company will be discussed in relation to how it operates to impede the shareholder from engaging. Intermediaries populate the market and the decision to use an intermediary is a market decision for each participant which is why they are classified in this chapter as a “market” impediment. However, as Professor Kay noted in the aforementioned review of equities markets in the UK, “[t]he existing structure of the investment chain is the product of a highly regulated environment, and an overriding principle of such regulation is that since agents cannot be trusted, layers of oversight are required.”³ For present purposes, the growth of intermediation in the investment chain is viewed as a market phenomenon.

B. The free rider problem and rational apathy

Much has been written about the “rational apathy” of shareholders.⁴ Shareholders, when deciding whether to undertake or decline from undertaking any given action, will weigh up the relative costs and benefits. In theory, if the costs outweigh the benefits, the shareholder will decline to undertake the action. The relevant action in question is “engagement”, which, as described in Chapter 1 is an extremely amorphous concept with different conceptions and understandings.⁵ The theory of rational apathy asserts that because most public listed companies have a dispersed and diffuse shareholder base, the costs of

³ The Kay Review of UK Equity Markets and Long Term Decision-Making: Final Report, July 2012 [hereafter “Kay Review”] at 43 (par 5.36).

⁴ For example, Jeffrey N Gordon, 'Ties That Bind: Dual Class Common Stock and the Problem of Shareholder Choice' (1988) 76 California Law Review 1 at 43; John C Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277 at 1281; Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' at 821; Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' at 558.

⁵ See Chapter 1: Introduction at pp 12-22.

engaging with an investee company for any one of these shareholders will almost always outweigh the benefits and so it will usually be irrational for shareholders to engage.⁶ In theory, for many shareholders, the predicted benefits of proactively monitoring and engaging with investee companies are so low due to their small stake in the company. The predicted benefits are also generally uncertain *ex ante* and in these circumstances the certain costs of engagement are frequently going to be considered to be excessive.⁷ This is especially so because the costs of the shareholder's engagement will be borne only by the engaging shareholder and any benefits, as "non-excludable group goods" will be shared by all other passive shareholders.⁸ Rational shareholders, according to the theory, will generally prefer to "free ride" on the engagement of others, resulting in little to no actual engagement.⁹

This idea is inextricably linked to Berle and Means' separation of ownership and control argument described in Chapter 1.¹⁰ Berle and Means made the point that companies' share registries were comprised of a great many dispersed shareholders, none of whom had a large enough stake to have a realistic interest in the day to day running of the business.¹¹ As shareholders were too dispersed to possibly have any meaningful control in a given company, corporate management could control the direction of the company with essentially unchecked power. Berle and Means' 1932 theory of the separation of ownership from control is amongst the earliest examples of shareholder "apathy" or "passivity" being put forward as a governance problem for companies.¹²

⁶ Ige Omotayo Bolodeoku, 'Corporate Governance in the New Information and Communication Age: An Interrogation of the Rational Apathy Theory' (2007) 7 *Journal of Corporate Law Studies* 109.

⁷ Stephen M Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 199 *Harvard Law Review* 173 at 1745.

⁸ Bolodeoku (n 6), referring to Mancur Olson, *The Logic of Collective Action*, (2nd ed, Harvard University Press, 1991) at 55.

⁹ Andrei Shleifer and Robert W Vishny, 'Large Shareholders and Corporate Control' (1986) 94 *Journal of Political Economy* 461; Sanford J Grossman and Oliver D Hart, 'Takeover Bids, The Free-Rider Problem, and the Theory of the Corporation' (1980) 11 *The Bell Journal of Economics* 42; Edward B Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1991) 79 *Georgetown Law Journal* 445 at 456 ("the shareholders may find themselves in a classic collective action dilemma: while it is better for all if each contributes, it is better for each not to contribute, with the result that discipline, while in the collective interest of the shareholders, is not provided.")

¹⁰ See Chapter 1, above at p 22.

¹¹ Adolf A Berle Jr and Gardiner C Means, *The Modern Corporation and Private Property*, (Macmillan, 1933) (1932) at 81.

¹² See Colin Mayer, *Firm Commitment* (Oxford University Press, 2013) at 75. ("[Berle and Means] were... early proponents of what is now widely advocated as shareholder activism or the engagement in corporate governance...")

Rational apathy and the free rider problem will not affect all shareholders in the same way. The greater the stake an investor has in a company, the less effect the free rider problem will have, since the benefits of monitoring will be proportionately higher for an investor with a larger shareholding.¹³ So where a company has a blockholder investor, which are common in many European companies,¹⁴ the managers and directors of the company can expect higher levels of monitoring by the blockholder.¹⁵ This also explains why “shareholder activists” typically have an investment strategy that involves quietly accumulating a “toehold” investment before conducting their activism.¹⁶ However, since most shareholders are not blockholders or “activists”, rational apathy theory holds that most will not conduct monitoring. Adherents to the theory that shareholders are rationally apathetic would appear to make the argument that shareholder monitoring is largely a fantasy, conducted only by shareholders who either have a relatively large stake in the company or are behaving irrationally. It is notable here that UCITS funds, which are a very common fund through which asset managers invest, are legally prohibited from purchasing shares that carry voting rights enabling the fund to exercise “significant influence” over the investee company.¹⁷ UCITS funds will therefore never own more than a small percentage of the voting stock of a company, reducing the incentives to engage with any investee company.

There is survey evidence of institutional investors to the effect that costs are the most important impediment to engagement. In 2012, the Investment Management Association of the UK conducted a survey on behalf of the Financial Reporting Council (“FRC”) of 83 Stewardship Code (“SC”) signatories, of which 58 were asset managers, representing

¹³ Shleifer and Vishny (n 9); Danny Miller and Isabelle Le Breton-Miller, 'Family Governance and Firm Performance: Agency, Stewardship, and Capabilities' (2006) 19 *Family business review* 73 at 77; James S. Ang, Rebel A Cole and James Wuh Lin, 'Agency Costs and Ownership Structure' (2000) 55 *The Journal of Finance* 81 Miller and Breton-Miller, 'Family Governance and Firm Performance: Agency, Stewardship, and Capabilities' at 100 (“...the returns to monitoring decrease and free-rider problems increase with the number of nonmanager shareholders”); John C Coffee, 'The Future as History: The prospects for global convergence in corporate governance and its implications' (1999) 93 *Northwestern University Law Review* 641 at 641-642 (“in-depth studies of individual countries show that shareholder activism increases in direct proportion to ownership concentration.”)

¹⁴ See Fabrizio Barca and Marco Becht (eds), *The Control of Corporate Europe*, (Oxford University Press, 2002).

¹⁵ A “blockholder” is usually defined as a shareholder with at least 5% of the shares of the company, which is distinct from a “controlling” shareholder. See below at pp 112-113.

¹⁶ Shareholder activists are discussed in greater detail in Chapter 4: Regulatory Impediments to Shareholder Engagement at pp 128-133.

¹⁷ Directive 2009/65/EC, Article 56(1).

approximately 40% of the UK market at the time.¹⁸ This survey revealed costs and shortage of resources as the main barriers to stewardship and engagement.¹⁹ The costs of engagement include the time taken by the shareholder to analyse proposals or the hiring of an expert to analyse the various proposals.²⁰ The latter increasingly involves the hiring of proxy advisory firms.²¹ In the survey conducted for this thesis, one respondent of three cited the direct costs of engagement, the allocation of resources for the purposes of engagement as a particular barrier to engagement.²² It is perhaps interesting to note that the other two respondents did not cite costs as a particular barrier to engagement but no conclusions or inferences are drawn from this. It has been questioned whether the disclosure based approach of the SRD2 can be effective in encouraging engagement since disclosure alone does not reduce the costs of engagement.²³

However, since engagement involves a wide array of different actions, the cost-benefit analysis must be undertaken for all of them in order for rational apathy to overcome all forms of engagement. For example, voting one's shares in accordance with a proxy advisor's advice is usually less costly than entering into a dialogue with many investee companies and both of these will be more costly, at least in the near term, than remaining entirely passive. Shareholders can reduce the costs of engagement through coordination

¹⁸ See FRC, "Developments in Corporate Governance 2012" December 2012 at 22. See also in respect of US shareholders, IRRC Institute, "The State of Engagement between US Corporations and Shareholders: A Study Conducted Institutional Shareholder Services for the Investor Responsibility Research Center Institute", 20 February 2011, at 20 ("For both asset owners and asset managers, the most significant obstacles to engagement are related to resources.")

¹⁹ Ibid at 27.

²⁰ Gordon (n 4) at 44.

²¹ Joseph A McCahery, Zacharias Sautner and Laura T Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' (2016) 71 *Journal of Finance* 2905 at 2924-2926; David F. Larcker, Allan L. McCall and Gaizka Ormazabal, 'Outsourcing Shareholder Voting to Proxy Advisory Firms' (2015) 58 *The Journal of Law and Economics* 173.

²² In fact, of the three respondents, each mentioned a different barrier to engagement by way of answer to the question of what they believed was a barrier to their engagement. The respondents were not limited to choosing just one barrier, but each did. The other selected barriers will be mentioned in the relevant sections (dual class structures and the mandatory bid rule were cited by the other two respondents). While it is not implied that these responses constitute sound evidence for what are and are not substantial barriers to engagement, since only one respondent selected each, the fact that three respondents chose three different barriers may reflect that different barriers to engagement operate in respect of different forms of engagement or operate in respect of different approaches of asset manager.

²³ Hanne Søndergaard Birkmose, 'European Challenges for Institutional Investor Engagement – Is Mandatory Disclosure the Way Forward' (2014) 11 *European Company and Financial Law Review* 214 at 236 ("A mandatory disclosure requirement cannot be expected to increase the low levels of engagement because it neither creates financial incentives nor lowers the costs of engagement."). It is arguable that the disclosure based approach increases the costs of *not* engaging, which is an argument detailed in Chapters 5: Overcoming the Impediments to Shareholder Engagement and 6: Shareholder Engagement and Passive Investing, at pp 170-172; 210.

and collective action since this shares the costs among the group.²⁴ Coordinated engagement also provides the group with a disproportionately larger voice when confronting corporate decision makers, reducing the likelihood of their views being dismissed or ignored. While the difficulties of forming “efficacious subgroups” are well documented, where they are formed the ability of shareholders to effectively engage is enhanced.²⁵

An example of varying engagement costs involves governance proposals, which are items on the agenda voted upon by shareholders at a general meeting.²⁶ Creating governance proposals and responding to governance proposals are both actions of engagement but the former requires far more time and effort, and therefore cost, than responding to the proposal.²⁷ For this reason, it is more irrational for a shareholder to initiate a proposal than to simply evaluate a proposal and to decide which way to vote, provided the benefits accruing remain equal. This is why those shareholders who specialise in creating governance proposals must have a greater initial stake in the investee company in order to increase the proportional benefits they can expect.²⁸

It is important to note that “rational apathy” cannot be assumed of all shareholders and all forms of shareholder engagement. Notwithstanding this, there is important recent evidence from Hermes, the investment management company, that suggests a widespread under preparation of institutional investors and asset managers across Europe. According to a Hermes survey of 175 institutional investors and asset managers from the UK, Netherlands, Germany, Italy, Spain and the Nordic countries, only 3% of respondents, at the time of taking the survey, during December 2018, believed their organisation meets all the requirements of the SRD2.²⁹ This suggests that asset managers and institutional investors do not devote the requisite amount of resources to engagement and will have to begin redirecting resources rapidly if they are to ultimately meet the requirements of the SRD2 when implemented. This survey also revealed that only 58% of respondents were even

²⁴ Kay Review at 50 (par 7.1).

²⁵ Rock (n 9) at 457-459.

²⁶ In Irish law, the right for shareholders of a PLC to do this is found in section 1104, Companies Act 2014.

²⁷ 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 describe the difference in detail.

²⁸ See *ibid*.

²⁹ Hans-Christoph Hirt and Andy Jones, “The Shareholder Rights Directive II”, Harvard Law School Forum on Corporate Governance and Financial Regulation, 4 April 2019.

aware of the SRD2's existence. For UK respondents, awareness is at 45% and 8% believe their organisation meets all the SRD2 requirements. 4% of German respondents and no Dutch, Italian and Spanish respondents believed their organisation met all the requirements of the SRD2. From looking at this survey, it is clear that, at the very least, it will take time for many institutional investors and asset managers to become ready to meet all the reporting requirements of the SRD2. With regard to cost as an impediment, this survey represents another piece of evidence that shareholders tend to avoid the costs involved in engagement. The Hermes authors hinted at the quasi-mandatory nature of the SRD2, saying "[t]hose who do not engage with investee companies will find themselves on the wrong side of the Directive."³⁰ In the context of Asian countries, they also make the point that creating a "stewardship culture" does not happen overnight, but "will take years of continuous proactive investor-led engagement in the region."³¹ While Hermes itself may have a long history of proactive engagement,³² it is submitted that this survey shows that most investors lean toward passivity.

There are many structural market impediments that increase the costs of engaging, which will exacerbate any rational apathy by adding to the "cost" side of the cost-benefit calculus. The next section will examine one such potential structural impediment, the intermediation of the investment chain.

C. Intermediation in the Investment Chain

i. Introduction

As noted in the introduction, the line between "market" and "regulatory" impediments to shareholder engagement is often blurred and investment chain intermediation does not arise in a regulatory vacuum.³³ The high growth in intermediation may have been an indirect response to the regulatory environment but it is submitted that intermediaries have long existed in capital markets and for reasons that precede many of the regulations that may

³⁰ Ibid.

³¹ Ibid.

³² See Marco Becht and others, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2009) 22 *The Review of Financial Studies* 3093.

³³ See above, at p 83.

have contributed to the intermediation. Intermediaries populate the market and this is why this potential impediment is most appropriately categorised as “market”, rather than “regulatory”.

The investment chain broadly describes the intermediaries that sit between an investee company and the ultimate beneficiary of the investment.³⁴ An investment chain without intermediaries would involve only two links: the shareholder and the company issuing the shares. The addition of different intermediaries represented a need to introduce more expertise, trust and diversification between the investor, investee company and intermediary. Individuals who may wish to invest in equity markets but lack the expertise to do so may seek an expert intermediary to take their money and invest it on their behalf. The rise of defined contribution pension plans across the world has led to a greater dependence of individuals saving for retirement on equities markets, which has in turn strengthened the role of institutional investors.³⁵ Certain intermediaries, though having an expertise in investment, will lack expertise in another important area, such as the administration and settlement of trades. For this, another intermediary is required.

As well as this, intermediaries offer diversification to investors, even if they have an expertise in investing. Many professional investors will have an expertise in one industry or asset class but not another and many will have an expertise in one investment strategy but not another. In order to have a balanced exposure to different industries, asset classes and investment strategies, it makes sense for professional investors to seek out other experts who intermediate them from the ultimate issuer company.

Notwithstanding expertise and diversification as reasons for the intermediation in the investment chain, Professor John Kay, in the Kay Review, identified the “principal driver” of intermediation as being “the decline of trust and confidence in the investment chain.”³⁶

³⁴ See generally, UK Department for Business, Innovation and Skills “Exploring the Intermediated Shareholding Model”, BIS Research Paper No 261, January 2016 [hereafter “BIS ‘Exploring’”], which differentiates between an individual investment chain and an institutional investment chain. Considering the fact that institutional investors are the target of the engagement legislation, it is the institutional investor chain that will be focused upon here.

³⁵ Martin Gelter, 'The Pension System and the Rise of Shareholder Primacy' (2013) 43 *Seton Hall Law Review* 909 at 914. Even before defined contribution pension plans became popular, many employers in charge of defined benefit plans also likely lacked the expertise in investing and so would have required an intermediary to invest the pension fund on its behalf.

³⁶ Kay Review at 30 (par 3.9).

As he describes it, the importance of different intermediaries grew because other intermediaries lack trust in each other to perform their function. Arguably, this is another way of characterizing “expertise.” An asset manager may not be trusted to perform the role of a custodian and so the importance of the custodian increases but it could also be said that the custodian is better placed to perform the functions of a custodian and therefore trusted to carry out that role due to increased expertise.

As will be described, the growth of intermediation in the investment chain has been presented as a significant barrier to shareholder engagement. This market phenomenon is an example of the “separation of ownership from ownership” since the shareholders themselves are no longer the ones in control of the shares in which they are invested.³⁷ Before describing why intermediation is a potential barrier to engagement, those populating the investment chain who potentially present the barriers must be described as there are many intermediaries in the investment chain some of whom constitute a barrier to engagement and some of whom do not.³⁸ The constituents of the investment chain which operates as a potential barrier to shareholder engagement will be identified in the next section, starting with the shareholders themselves.

ii. The different constituents of the investment chain and their role

a. Asset Owners and Asset Managers

The focus on asset owners and asset managers is because the regulations that seek to enhance the levels of shareholder engagement focus on the relationship between asset owner and asset manager, although the SRD2 uses the term “institutional investor” in place of “asset owner”.³⁹ As noted, institutional investors are defined in the SRD2 as encompassing certain undertakings involving insurance and pension funds.⁴⁰ The 2012 SC defined “asset owners” as including pension funds, insurance companies, investment trusts and other collective investment vehicles.⁴¹ It went on to call asset owners “providers of capital.” Both of these regulatory frameworks distinguish between asset owners

³⁷ See Usha Rodrigues, 'Corporate Governance in an Age of Separation of Ownership from Ownership' (2011) 95 Minnesota Law Review 1822.

³⁸ John Kay identifies “registrars, nominees, custodians, asset managers, managers who allocate funds to specialist asset managers, trustees, investment consultants, agents who ‘wrap’ products, retail platforms, distributors and independent financial advisers” in the Kay Review at 30 (par 3.7).

³⁹ See Chapter 1 at p 8. Each term will be used interchangeably here.

⁴⁰ Ibid.

⁴¹ Financial Reporting Council, “The UK Stewardship Code” September 2012, at 1.

(institutional investor) and asset managers. Where an asset owner invests with a separate asset manager, very often the manager will pool the owner's money with all other client's money. The very nature of a mutual fund, the most common form of investment vehicle an asset manager uses, involves the pooling of investor assets and the collective investment of those assets.⁴² Larger asset owners have a greater ability to make use of a segregated account, wherein their assets are invested separately from other investor's assets.⁴³ Smaller funds also achieve diversification by investing in pooled funds.⁴⁴ Certain asset owners, such as pension funds, require trustees to administer the assets to be invested. Trustees are charged with a fiduciary duty, owed to the pension fund investors, and are will often be responsible for hiring asset managers, often with the help of investment consultants.⁴⁵

b. Custodians and Central Securities Depositories

Another important intermediary is the custodian. As Kay has noted, the custody industry arose because asset managers could not be trusted to hold shares on behalf of the ultimate investor.⁴⁶ The role of custodian originally came into being where the securities being purchased by investors were physical pieces of paper.⁴⁷ In order to safely store these securities, an investor would require a level of safekeeping and security to which many investors did not personally have access. It made sense that a financial intermediary, usually a bank with a vault, could safely hold them on behalf of the investor.⁴⁸ Settlement of trading in securities therefore required the physical movement of the paper securities from one custodian to another.⁴⁹

One way in which the inefficiency of this system was addressed was the setting up of central securities depositories (CSDs) which could hold the securities on behalf of the entire market.⁵⁰ A country or market would set up a CSD in order to avoid favouring any

⁴² Robert C Pozen defines the term "mutual fund" as "an investment company that pools money from shareholders and invests in a diversified portfolio of securities" in Robert C Pozen, *The Mutual Fund Business*, (MIT Press, 1998) at 16.

⁴³ See BIS 'Exploring' at 89.

⁴⁴ *Ibid* at 91.

⁴⁵ See BIS 'Exploring' at 94. For a greater discussion on pension fund trustees, see below at p 94.

⁴⁶ *Ibid* at 30.

⁴⁷ See Diana Chan, Florence Fontan, Simonetta Rosati and Daniela Russo, "The Securities Custody Industry", European Central Bank Occasional Paper Series: No.68, August 2007 at 6 (par 1.1).

⁴⁸ *Ibid*.

⁴⁹ Madeleine Yates and Gerald Montagu, *The Law of Global Custody*, (4th ed, Bloomsbury Professional, 2013) at 205.

⁵⁰ This process is called "immobilisation". See Chan, Fontan, Rosati and Russo (n 46) at 7.

particular custodian and in these markets custodians tended to shift their business focus from safekeeping to the provision of information on their clients' securities.⁵¹ Many CSDs were set up not by national legislators or regulators but by custodians themselves, who had the primary economic interest in making the system more efficient, and issuer companies and investors were not involved.⁵² Membership of a CSD will vary from country to country but is in principle relatively unrestricted. For example, the relevant CSD for Ireland at the moment, CREST, is owned and run by Euroclear UK and Ireland Ltd,⁵³ and any person can be a member.⁵⁴ However, in practice, direct membership tends to be held by a select group of custodians. This is because investors will tend to not have access to CREST's computer system software and hardware, a prerequisite for membership.⁵⁵

A brief note should be included about future changes to this system in Ireland that will likely come into place in early 2021. Euroclear UK and Ireland Ltd currently "passports" its services for Irish securities under European law.⁵⁶ This will no longer be possible after the UK ceases to be a member of the EU. Anticipating a UK exit from the EU without an agreement between it and the EU with regard to regulatory alignment, the European Securities and Markets Authority ("ESMA") recognized Euroclear UK and Ireland Ltd as a third country provider in accordance with EU law,⁵⁷ which will allow securities to be settled through CREST until 30 March 2021.⁵⁸ This is a stop gap measure and longer term

⁵¹ Ibid. There have been arguments that in fact the distinction between the roles of custodian and CSD are not always clear and that there is a great deal of overlap between the services they provide, see Sophia Greene, "Rules of Engagement Become Blurry", *Financial Times*, 1 February 2009.

⁵² Ibid.

⁵³ Euroclear UK and Ireland Ltd is itself owned by the Belgian company Euroclear SA/NV. See Yates and Montague (n 49), at 243-244.

⁵⁴ CREST is regulated in Ireland by SI No. 68/1996 - Companies Act, 1990 (Uncertificated Securities) Regulations, 1996 and in the UK by the Uncertificated Securities Regulations 2001 (SI 2001/3755). Membership of CREST can be direct or sponsored which involves using a connection of a direct member to access CREST's system. See Michael Bridge, Louise Gullifer, Kelvin Low and Gerard McMeel, *The Law of Personal Property*, (2nd ed, Sweet & Maxwell, 2018) at 139 (par 6-041).

⁵⁵ BIS, 'Exploring' at 97 ("Euroclear told us [UK Department for Business, Innovation and Skills] that there are a relatively small number (a couple of hundred) of 'Direct Members' who have the hardware and software to enable them to interact directly with CREST using dedicated secure networks for exchanging electronic messaging. These tend to be the banks (custodians), investment houses and larger stockbrokers.")

⁵⁶ Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012, (CSDR) article 23.

⁵⁷ CSDR, article 25.

⁵⁸ ESMA Press Release, "ESMA to recognise the UK Central Securities Depository in the Event of the No-Deal Brexit", 1 March 2019; Joe Brennan, "EU confirms plan to keep Irish shares trading

solutions have been proposed by Euroclear that will change the shape of the Irish investment chain.⁵⁹ Initially Euroclear had planned to establish a standalone CSD in Ireland, which would have been called Euroclear Ireland, making Ireland no longer the only EU country without its own CSD. After consultation with the Irish Central Bank, this plan was abandoned.⁶⁰ The proposal put forward by Euroclear involves Euroclear Bank in Belgium taking over as CSD for Irish securities from Euroclear UK and Ireland. According to Euroclear, the Euroclear Bank model differs from the Euroclear UK and Ireland model in that it is “intermediated” and “indirect”.⁶¹ Irish securities deposited with Euroclear Bank will be legally held by a wholly owned subsidiary of Euroclear Bank. This will add another link to the investment chain in the form of a trust relationship (governed by English law) between Euroclear Bank and its subsidiary.⁶² Legislation facilitating the migration of securities from CREST to Euroclear Bank in Belgium was adopted in December 2019.⁶³ This legislation requires each affected company to pass a special resolution in order for the necessary migration of securities.⁶⁴ This must be in place in the relevant companies by 30 March 2021,⁶⁵ at which time ESMA’s interim measures will expire.

Computerisation created efficiencies in the trading of securities, as adoption of electronic records in the place of paper securities became widespread. Rather than transporting the physical securities from one holder to another, the transfers are now generally conducted through “book entry transfer” whereby matching electronic instructions are sent to the accounts of the participants in the trade.⁶⁶ Custodians preserved the specialisation in settling and clearing of electronic securities trades through the electronic system.⁶⁷ They also developed economies of scale that allowed them to charge each institutional investor client a fee that was likely less than each client would have to spend in order to individually settle and clear each trade.⁶⁸

under no-deal Brexit,” *Irish Times*, 1 March 2019; Philip Stafford, “EU gives investors in Irish assets the all-clear in hard Brexit,” *Financial Times*, 1 March 2019.

⁵⁹ Euroclear Bank, “Delivering continuity of Irish securities settlement in the long term post Brexit,” White Paper, May 2019.

⁶⁰ See *ibid.*

⁶¹ *Ibid.* at 17.

⁶² *Ibid.*

⁶³ Migration of Participating Securities Act 2019.

⁶⁴ Migration of Participating Securities Act 2019, section 4(1).

⁶⁵ Migration of Participating Securities Act 2019, section 16.

⁶⁶ Yates and Montagu (n 49) at 14 (par 2.6).

⁶⁷ See *ibid.* at 13-15.

⁶⁸ Chan, Fontan, Rosati and Russo (n 47) at 6 (par 1.1.1).

The computerisation of securities coincided with increased intermediation.⁶⁹ So much trade is cross-border, especially in Europe, and custodians tend not to have a branch in each separate country in which their clients trade.⁷⁰ This results in a reliance on a network of “sub-custodians” in each jurisdiction in which the client holds assets.⁷¹ These sub-custodians are separate legal entities who have a contractual relationship with the original custodian.⁷² The growing importance of cross border trading has led to the rise of the “global custodian” who is member of many CSDs and has such a network of sub-custodians in different countries.⁷³ CSDs tend to be situated toward the end of an investment chain as the investee company will make its securities eligible for the CSD to hold and the CSD will allow the shares to be admitted.⁷⁴

Like asset managers, custodians will often make use of pooled accounts when conducting business.⁷⁵ It is not uncommon for a CREST member with many investor clients to pool all the client assets together.⁷⁶ Where an institutional investor client is a large investor (by assets under management), they have a greater negotiating power with the custodian to seek a segregated account but smaller investors are much more likely to have their assets pooled together.⁷⁷ Where accounts are pooled, the custodian can “net” transactions, resulting in a greater ease of settlement for the custodian.⁷⁸ Netting involves taking the totality of transactions and setting them off against each other so that only the net transfer is recorded. Rather than sifting through the investment chain in order to see exactly which investor

⁶⁹ Yates and Montagu (n 49) at 21 (“...the introduction of electronic settlement has been accompanied by two other related developments. These are intermediation and commingling.”); Eva Micheler, ‘Custody Chains and Asset Values: Why Crypto-Securities are Worth Contemplating’ (2015) 74 Cambridge Law Journal 505 at 505.

⁷⁰ Yates and Montagu (n 49), at 86.

⁷¹ Ibid; Chan, Fontan, Rosati and Russo (n 47) at 18.

⁷² Ibid; Micheler (n 69) at 509.

⁷³ Group of Thirty, “Global Clearing and Settlement: A Plan of Action”, 2003, available at http://group30.org/images/uploads/publications/G30_GlobalClearingSettlement.pdf at 22; Yates and Montagu (n 49) at 1 (par 1.4).

⁷⁴ For CREST, eligibility requires the company to agree to having the shares be dematerialised, which means having no physical form and only having an electronic version of the share. CREST has a strong commercial incentive to admit the shares to its platform and cannot improperly discriminate between companies, see Bridge, Gullifer, Low and McMeel (n 54) at 140 (par 6-043).

⁷⁵ At the level of custodian, these pooled accounts tend to be referred to as “omnibus” accounts, at least in the UK. See BIS, ‘Exploring’ at 10.

⁷⁶ Yates and Montagu (n 49) at 254 (par 9.33). Custodians also call pooled accounts “omnibus” accounts, see BIS ‘Exploring’ at 10.

⁷⁷ See BIS, ‘Exploring’ at 89.

⁷⁸ On this point see, Louise Gullifer, “Ownership of Securities: the Problems Caused by Intermediation” in Louise Gullifer and Jennifer Payne (eds), *Intermediated Securities: Legal Problems and Practical Issues* (Hart Publishing, 2010) at 14; Bridge, Gullifer, Low and McMeel (n 54) at 146.

transferred to who, the higher chain custodian⁷⁹ can simply look at the net transfers. If the custodian did not net the totality of transactions, they would have to credit and debit each transaction and this could prove costly and time consuming, whereas netting cuts this crediting and debiting to a minimum.⁸⁰ This pooling however will have the effect of obscuring what exactly each investor owns.⁸¹

iii. Intermediation as an impediment to shareholder engagement

a. Asset owners and asset managers

From the perspective of the asset owner and the asset manager, the chains of intermediaries between themselves and the issuer company in which they ultimately invest operate as a complex barrier to any kind of meaningful engagement. The costs that intermediation poses for asset owners and managers may provide them with the explanation necessary in order to avoid full compliance with Article 3g, say. As described in Chapter 2, regulators such as the FRC and EC expect that asset owners will engage with their asset managers and monitor the engagement of these asset managers with investee companies and this is manifested in the provisions of the SC in its various iterations and SRD2.⁸² Asset managers, therefore, bear the ultimate responsibility for proactive engagement and interaction with the company. This, however, is not always a principle that asset owners have accepted unreservedly. The Department of Business, Innovation and Skills in the UK conducted a wide ranging survey of investment chain intermediaries in 2016, which included interviews with asset owners such as pension funds and insurance firms and asset managers.⁸³ The Department found that asset managers generally feel that voting was a practice that ought to be delegated to them as part of the asset management function.⁸⁴ They also found that the largest asset owners had the ability to have shareholder rights passed back to them by ensuring that their mandate specified that this occurred.⁸⁵ According to their survey,

⁷⁹ Higher chain custodian refers to the custodian closer to either the CSD or issuer company.

⁸⁰ Luca Enriques, Matteo Gargantini and Valerio Novembre, 'Mandatory and Contract-Based Shareholding Disclosure' (2010) 15 Uniform Law Review 713 at 714.

⁸¹ Gullifer calls this the "identification problem" in Gullifer and Payne (n 78) at 22.

⁸² See generally, Chapter 2.

⁸³ See BIS, 'Exploring' at 22-23. Other intermediaries interviewed included investment consultants, registrars, custodians and proxy advisory services, as well as academics and lawyers specialising in this area.

⁸⁴ Ibid at 115.

⁸⁵ Ibid at 113.

approximately nine-tenths of mandates between asset owners and managers in the UK contain no reference to voting rights.⁸⁶

There have been instances of conflict between asset owners and asset managers with regard to the function of voting. A group of pension funds in the UK launched an initiative called “red line voting” whereby the asset owners could direct the voting of pooled accounts in relation to environmental, social and governance (“ESG”) issues.⁸⁷ Many pension schemes in the UK expressed a desire to adopt the red line voting principles but experienced resistance from their asset managers who refused to be bound by such voting instructions.⁸⁸ In pooled accounts with asset managers, splitting votes between different asset owner clients can be logistically very difficult, if not practically impossible and some asset managers have refused to attempt to do so.⁸⁹ For pooled mutual funds, asset managers will prefer to vote one way for each portfolio company. As will be described, the pooling of asset manager accounts by custodians may render this equally difficult.⁹⁰

The survey conducted for this thesis revealed a variation in experiences of asset managers who responded with regard to interactions with their asset owner clients. The survey asked the respondents to state what the proportion of their individual or institutional clients had sought to influence their engagement in the 12 previous months and this resulted in three different levels of response. One respondent said “approximately half” of their clients sought to influence engagement, one said “very few” and one said no clients had sought to influence engagement in the previous 12 months. In line with this, the survey asked about the details of the investment mandate and whether it included provisions on how the respondent asset manager ought to engage. The respondent with whom approximately half

⁸⁶ Ibid at 114. This is according to Principles for Responsible Investment, who are a “United Nations sponsored initiative comprising of an international network of investors working together to put the six Principles for Responsible Investment into practice.” (reference omitted). The six Principles for Responsible Investment is an investor led initiative, sponsored and promoted by the United Nations, whereby by signatory investors publicly commit to the six identified principles. See <https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment> for principles. See BIS ‘Exploring’ at 10.

⁸⁷ The group of pension funds is called the Association of Member Nominated Trustees (AMNT). See AMNT, “Red Line Voting: A new approach to asset owner voting in the UK stock market by the Association of Member Nominated Trustees”, available at http://redlinevoting.org/wp-content/uploads/2015/11/Red_Line_Voting_Red_Lines.pdf.

⁸⁸ Attracta Mooney, “Asset managers push back against activist pension funds”, *Financial Times*, 31 July 2016.

⁸⁹ Ibid, quoting Laurent Ramsay, chief executive of Pictet Asset Management as asserting “[v]oting is an act of management and it is, therefore, done uniformly for all clients invested in pooled vehicles so far — so, no split votes on pooled funds.”

⁹⁰ See below, at p 103.

of clients had sought to influence engagement responded that their mandate contained a provision on how they were to engage, whereas the two other respondents had no such provision in their investment mandate. This suggests that the mandate is centrally important for asset owners that want to influence asset manager engagement. In the two responses that reported asset owner clients seek to influence engagement, both stated that asset owners feel that sustainability and social issues are particularly appropriate for engagement. The response that indicated that approximately half of asset owner clients seek to influence engagement also reported that these clients felt that executive/director remuneration, governance structure and shareholder distributions were appropriate for engagement. It is worth noting that this latter respondent, who reported they had an engagement provision in their mandate clarified that these clients sought to influence the engagement policy and not seek to influence any specific engagement. Finally, all three respondents asserted that the engagement role was within the discretion of their organisation as part of the portfolio management function and not subject to the direction and views of clients.

From the perspective of an important asset owner, pension funds, the responsibility for engagement will fall upon the pension fund trustee. Whether or not or to what extent trustees engage substantively with either investee companies or with asset managers they have hired in relation to their investment activities will be guided by fiduciary duties that the trustee owes to the pension fund investors. Reisberg and Tilba conducted a recent study of pension fund trustees and their views on how their fiduciary duties guide their engagement.⁹¹ These authors undertook interviews with 35 pension fund trustees in the UK, seeking to determine their views on the meaning of their fiduciary duties and how it guided their engagement and stewardship. In line with the description of engagement given in Chapter 1, the authors identify an “analytical spectrum of engagement”.⁹² At one end of this spectrum is a “disengaged” approach, which is associated with the view of the trustee being that the purpose of the pension fund is simply to pay pensions and must act according to the narrow financial interests of the investors. At the other end is what the authors call “corporate engagement”, which involves a much more expansive interpretation of the trustees’ fiduciary duties, to include stewardship and ESG issues that may affect the value of the pension fund assets over the long term. Of the 35 interviews Reisberg and Tilba

⁹¹ Anna Tilba and Arad Reisberg, 'Fiduciary Duty under the Microscope: Stewardship and the Spectrum of Pension Fund Engagement' (2019) 82 *Modern Law Review* 456.

⁹² *Ibid* at 470.

conducted, they found that 22 trustees could be categorised as “disengaged.”⁹³ As they say, their findings suggest that “the majority of pension funds do not have direct relationships with their investee companies, nor do they seek to influence their fund managers in any way when it comes to corporate governance or ESG issues.”⁹⁴ A disengaged approach is a reasonable interpretation of the fiduciary duty of loyalty and is in line with the approach of the 2020 SC. This is because protecting the financial interests of the pension fund investors and being a steward of the assets in the pension fund can guide a trustee to being focused on the portfolio performance rather than the performance of any individual investee company. As well as this, expending resources on engagement depletes the value of the assets in the pension fund in the immediate term with uncertain benefits in the longer term. This interpretation of a trustee’s fiduciary duties does, however, present a barrier to the engagement that the SRD2 seeks to encourage, listed as the various elements of the engagement policy that must be disclosed under Article 3g.

The relationship between asset owners and their asset manager clients presents another possible barrier to asset manager engagement in a way that will be returned to repeatedly in this thesis: short termism. As was described by the EC in their proposal for the SRD2, short termism “appears to be rooted in a misalignment of interests between asset owners and asset managers.”⁹⁵ This is because, according to the EC, asset owners select and evaluate asset managers on the basis of short term performance benchmarks. Asset managers respond by prioritising short term performance, relative to the relevant index in their mandate. Competition among asset managers exacerbates this effect. As Jaap Winter has argued, deviations by asset managers from “the mainstream” becomes costly where they do not produce immediate returns.⁹⁶ This results in herding behaviour, where asset managers are more interested in the behaviour of other asset managers than with the underlying investee companies.⁹⁷ Enhancing the performance of their portfolio returns on a longer term basis becomes less of a priority.⁹⁸ Engagement, again according to the EC, is

⁹³ Ibid at 471.

⁹⁴ Ibid.

⁹⁵ Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 4 April 2014 [hereafter “EC 2014 proposal”] at 4.

⁹⁶ Jaap Winter, 'Shareholder Engagement and Stewardship: The Realities and Illusions of Institutional Share ownership', (2011) available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1867564 at 6.

⁹⁷ Ibid; See European Commission, Green Paper, “the EU corporate governance framework,” 5 April 2011 [hereafter “EC 2011 Green Paper”] at 11; Kay Review at 40.

⁹⁸ See Simon CY Wong, 'Why Stewardship is Proving Elusive for Institutional Investors' (2010) Butterworths Journal of International Banking and Financial Law 406.

a means of achieving better performance in the long term.⁹⁹ In circumstances where asset managers are concerned only with short term benchmarks, it is more likely that they will sell shares of an underperforming company than take the time to engage with and try and help to improve its performance, which could take far longer. In this way, by evaluating and selecting asset managers on a short term time scale, asset owners provide a disincentive to intermediaries to engage, despite most asset owners having long term liabilities.¹⁰⁰

There is a great deal of research and commentary on shareholder short termism, on why shareholders have or do not have a tendency to prefer the short term and what the effect of shareholder short termism may have on company management.¹⁰¹ Much of this work explicitly links short term strategies of shareholders with an absence of engagement. For example, Black argued in 1992 that “short-sighted institutions won't do much monitoring, because the payoff from oversight is long-term.”¹⁰² While the EC identifies the root of short termism as being in the incentives created by asset owners, it does not explore why asset owners create these incentives. After all, asset owners, as the EC acknowledge, “tend to have long-term interests” because of their long term liabilities.¹⁰³ There is an apparent contradiction therefore, as those shareholders with apparently the most interest in the long term create the conditions of short termism. It is possible that this apparent contradiction can be explained by a cognitive bias in favour of the short term. Kay describes “the natural human tendency to make decisions in search of immediate gratification at the expense of future returns: decisions which we subsequently regret.”¹⁰⁴ Concepts from behavioural economics explain the systematic preference among individuals for the short term, including discounting events in the future.¹⁰⁵ Added to this is the possibility of underestimation of low frequency events or “disaster myopia” such as was widespread

⁹⁹ See EC 2011 Green Paper at 11.

¹⁰⁰ EC 2014 Proposal at 4.

¹⁰¹ A small sample of this research and commentary is Lynne L Dallas, 'Short-Termism, the Financial Crisis, and Corporate Governance' (2011) 37 *The Journal of Corporation Law* 264; Therese Strand, 'Short-Termism in the European Union' (2015) 22 *Columbia Journal of European Law* 15; Kent Greenfield, 'The Puzzle of Short-termism' (2011) 46 *Wake Forest Law Review* 627; George W Dent, 'The Essential Unity of Shareholders and the Myth of Investor Short-Termism' (2010) 35 *Delaware Journal of Corporate Law* 97; Emeka Duruigbo, 'Tackling Shareholder Short-Termism and Managerial Myopia' (2011-2012) 100 *Kentucky Law Journal* 531; Mark J Roe, 'Corporate Short-Termism - In the Boardroom and in the Courtroom' (2013) 68 *The Business Lawyer* 977.

¹⁰² Black (n 4) at 863.

¹⁰³ EC 2014 Proposal at 4. See also Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (“Pension funds should be especially long-term oriented. That's where their liabilities are.”)

¹⁰⁴ Kay Review at par 1.1.

¹⁰⁵ Michelle Baddeley, *Behavioural Economics and Finance*, (Routledge, 2013) at Chapter 9.

during the global banking collapse.¹⁰⁶ A bias can be called “systematic” where a sufficient number of individuals display it.¹⁰⁷

Other commentators have pushed back against the idea that shareholder short termism is a serious problem.¹⁰⁸ According to these commentators, “short termism” is ambiguously defined and has little evidence to support it.¹⁰⁹ Roe argues that, while it is true that there is evidence that shareholders undervalue the long term, there is also evidence that shareholders *overvalue* the long term.¹¹⁰ He gives the example of technology companies that seek investment from the market with little immediate prospect of profit. He cites the dotcom bubble as an example of shareholder over exuberance, which he calls “excessive long termism”.¹¹¹ The point he is making by pointing to “excessive long termism” is that one cannot just look at the evidence of short termism when evaluating the time horizons of the stock market. It is submitted that the very existence of one temporal problem does not negate the need to intervene to prevent another. There is plenty of evidence that individual companies have been guided by short term pressures from the market.¹¹² The problem of excessive short termism may contribute to bad decision making of companies and is not diminished by the presence of excessive long termism.

Many critics of the argument that markets exert short term pressures point to the efficient capital markets hypothesis by way of rebuttal.¹¹³ The efficient capital markets hypothesis (ECMH) asserts that stock prices reflect all available information in the market.¹¹⁴ The

¹⁰⁶ Dallas (n 101) at 314-315.

¹⁰⁷ Marc T. Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (2014) 41 *Journal of Law and Society* 416 at 421.

¹⁰⁸ Strand (n 101); Bebhuk, Brav and Jiang, 'The Long-Term Effects of Hedge Fund Activism' ; Roe (n 98); Robert Anderson IV, 'The Long and Short of Corporate Governance' (2015) 23 *George Mason Law Review* 19; Dent (n 101).

¹⁰⁹ Strand (n 101) at 28-29; Dent (n 101) at 122; Anderson (n 108) at 39-40.

¹¹⁰ Roe (n 101) at 993-996; Mark J Roe, “Stock Market Short Termism’s Impact,” Law Working Paper N° 426/2018, November 2018 at 29.

¹¹¹ Roe (n 101) at 995.

¹¹² The Kay Review cites many examples in coming to the conclusion that “[t]here are sufficient issues about the performance of large British quoted companies over the last two decades to raise questions about the role of equity markets in encouraging high performing businesses.” See Kay Review at 1.27; John Hendry and others, 'Owners or traders? Conceptualizations of institutional investors and their relationship with corporate managers' (2006) 59 *Human Relations* 1101 which seeks the views of corporate managers and shareholders and finds at 1118 “several managers pointed to the difference between long-term shareholder value and the shorter term demands of the market.”

¹¹³ Dent (n 101) at 124; Anderson (n 101).

¹¹⁴ Eugene F Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *The Journal of Finance* 383.

claim that short termism, the undervaluing of the long term and the preference for immediate gratification, is a systematic market problem is irreconcilable with the ECMH, since information about the long term value should be reflected in the current stock price of a given company's shares. If a large chunk of the market is not paying attention to the long term, investors equipped with this information can exploit this undervaluation to the detriment of those with only a short term view. In other words, in an efficient market, the existence of arbitrage opportunities should mean that short termism self corrects. Jensen argued in 1978 that "there is no proposition in economics which has more solid empirical evidence supporting it than [the ECMH]."¹¹⁵ More recently however, the ECHM has been described as an idea that "has fallen into disrepute",¹¹⁶ is "very weak"¹¹⁷ as well as being a "zombie idea" that is neither alive nor dead.¹¹⁸ Moore and Walker-Arnott give three reasons why the possibility of market arbitrage is not an effective means of correcting short termism.¹¹⁹ First, shareholders who act as arbitrageurs are themselves subject to individual biases in favour of the short term. In other words, despite having access to information about the company's long term prospects and the market's undervaluation of those prospects, the arbitrageur may nonetheless, irrationally, themselves undervalue the long term. Second, Moore and Walker-Arnott point to momentum trading, which involves betting that a rising stock price will continue to rise. Even where an investor believes that the stock is overpriced, in the sense that the short term price is disconnected from long term value, it may be perfectly rational to buy that stock. Moore and Walker-Arnott explain:

"As long as the arbitrageur is able to exit her investment (and thereby 'lock in' her short-term gain) before the overpricing is detected by the market generally, she will stand to make a better return (at least in the short run) than would be possible from effectively 'betting against the market' (via disposal of existing holdings and/or short-selling of previously unheld shares) over the longer term."¹²⁰

¹¹⁵ Michael C Jensen, 'Some Anomalous Evidence Regarding Market Efficiency' (1978) 6 *Journal of Financial Economics* 95.

¹¹⁶ Lynn Stout, 'The Mechanisms of Market Inefficiency: An Introduction to the New Finance' (2003) 28 *The Journal of Corporation Law* 635.

¹¹⁷ James Crotty, 'Structural causes of the global financial crisis: a critical assessment of the 'new financial architecture'' (2009) 33 *Cambridge Journal of Economics* 563 at 565.

¹¹⁸ John Quiggen, *Zombie Economics: How Dead Ideas Still Walk Among Us* (2010, Princeton University Press) as cited in Lynn Stout, *The Shareholder Value Myth* (Berrett-Koehler Publishers, 2012) at 65.

¹¹⁹ Moore and Walker-Arnott (n 107) at 421-422.

¹²⁰ Moore and Walker-Arnott (n 107) at 422.

Third, Moore and Walker-Arnott suggest that financial incentives are likely to work against potential arbitrageurs. Bearing the costs of discovering the information regarding long term undervaluation and the costs of buying and holding those shares until this information is borne out will require that the undervaluation is substantial, such that the expected gains are significant. While the costs of discovering the undervaluation will usually be relatively high, the level of undervaluation will not usually be so substantial as to compensate the bearing of the costs.¹²¹ For these reasons, Moore and Walker-Arnott argue that arbitrage will never be an effective check on investors' short term biases and for this reason, they say that "short-termism is a structurally *inevitable* feature of stock markets."¹²² On the other side of the short termism debate, Anderson argues that critics of short termism have tended to exaggerate the extent to which the ECMH has been undermined.¹²³ He says that behavioural finance theories of individual bias are "indeterminate" in the sense that many behavioural theories compete to explain many different phenomena.¹²⁴ As he puts it, "there is no specific alternative to market efficiency upon which behavioral finance scholars agree."¹²⁵

Notwithstanding the question of whether present stock prices are reflective of long term value, Arsalidou argues that "there is no reason why diversified shareholders should focus on the long term."¹²⁶ This is because measuring the long term performance of a company is much more difficult and costly than simply looking at short term indicators. Where a shareholder is diversified, as most institutional investors are, the incentive to monitor any one company in an investment portfolio will be very limited.¹²⁷ In this sense, short termism and passivity are inherently linked and the economic incentives in favour of short termism represent an impediment to engagement. The mere availability of short term indicators allows shareholders to rely upon them as a more cost effective way of conducting monitoring than seeking to engage more deeply in order to discover the long term (or "fundamental") value of the company. It is interesting to note in this context that the Kay Review recommended the reduction of short term indicators such as quarterly reporting of

¹²¹ Ibid.

¹²² Ibid at 423 (emphasis in original).

¹²³ Anderson (n 108) at 35.

¹²⁴ Ibid at 36.

¹²⁵ Ibid.

¹²⁶ Demetra Arsalidou, 'Institutional Investors, Behavioural Economics and the Concept of Stewardship' (2012) 6 Law and Financial Markets Review 410 at 412.

¹²⁷ Most institutional investors diversify the risk from their portfolios based on an economic theory called "modern portfolio theory", pioneered by Harry Markowitz in 1952. See Harry Markowitz, 'Portfolio Construction' (1952) 7 Journal of Finance 77. A comprehensive discussion of modern portfolio theory is beyond the scope of the present thesis.

companies in order to address this impediment.¹²⁸ In the following years, and calls from other industry groups such as the Investment Association, many FTSE 100 and FTSE 250 companies stopped producing quarterly reports.¹²⁹

Asset managers' conflicts of interest may provide disincentives to engage with investee companies, even where their asset owner clients do not provide short term disincentives to engagement. These conflicts of interest arise where the asset manager has a financial incentive to not engage with a particular investee company due to a desire to manage assets of that company, often its pension fund.¹³⁰ The SEC has described the problem in the following way:

“... in some situations the interests of a mutual fund's shareholders may conflict with those of its investment adviser [asset manager] with respect to proxy voting. This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund. In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.”¹³¹

Where this conflict occurs, asset managers will be less likely to engage in a negative or dissenting way, even if they identify an issue or problem in the investee company. Arsalidou has criticised the manner in which the SC deals with conflicts of interest.¹³² As she notes, the Institutional Shareholders' Committee's list of principles that preceded the SC required its signatories to minimise or deal with conflicts of interest, which, as she says, was designed to reduce or avoid conflicts altogether. This is in contrast to the SC which only requires signatories to have a robust policy on “managing” conflicts of interest, which Arsalidou calls “a step backward”.¹³³ These concerns may be mitigated to a certain extent

¹²⁸ Kay Review, Recommendation 11, at 74.

¹²⁹ The Investment Association press release, “Quarterly Reporting Falls as Companies Focus on the Long-Term” 4 September 2017, available at <https://www.theia.org/media/press-releases/quarterly-reporting-falls-companies-focus-long-term>.

¹³⁰ Wong calls these “institutional conflicts”. See Simon CY Wong, 'How Conflicts of Interest Thwart Institutional Investor Stewardship' (2011) *Butterworths Journal of International Banking and Financial Law* 481.

¹³¹ Securities & Exchange Commission, “Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies”, available at <http://www.sec.gov/rules/final/33-8188.htm>. (references omitted).

¹³² Arsalidou (n 126) at 413.

¹³³ *Ibid.*

in the 2020 SC. While the latter states that signatories must “identify and manage conflicts of interest” as a principle, it also contains guidance that a conflicts of interest policy must be one that “minimises or avoids conflicts of interest when client interests diverge from each other”.¹³⁴ This might fairly be described as a “step forward” from the 2012 SC.

b. Custodians and CSDs

The fact that a typical investment chain in Europe now contains a proliferation of custodians and CSDs undermines the possibility of shareholder engagement in a number of ways. From the investor’s side (which is typically the asset manager, from the perspective of the custodian), custody chains reduce their ability to access shareholder rights. This has been acknowledged by the EC, who noted that “additional intermediaries can make the instruction chain longer and thus increase operational risks and costs. Moreover, they often preclude shareholders from directly exercising their voting rights.”¹³⁵ Passing voting rights instructions from custodian to custodian requires not only an agreement from the investor with their custodian, but an agreement from this custodian to a sub-custodian that they may use.¹³⁶ As Eva Micheler argues, “[t]aken together, the least favourable terms determine which rights investors have.”¹³⁷ Therefore voting rights may not be passed back or voting instructions may not be passed forward, depending on whether any one custodian is willing to undertake this action. Jennifer Payne has noted that the fiduciary obligations in the law of custodians are limited to the contract a custodian has with its client (which may be another custodian) and that many custodians exclude the obligation to undertake voting services.¹³⁸ Custodians therefore breach no fiduciary duty where they ignore the voting rights attached to shares.

From the issuer’s perspective, the company identifies the shareholder as whoever is listed in the company’s shareholder register.¹³⁹ The registered shareholder will typically be the

¹³⁴ Financial Reporting Council, “The Stewardship Code 2020” at 26.

¹³⁵ European Commission, “Commission Staff Working Document: Initial reflections on the obstacles to the development of deep and integrated EU capital markets” Accompanying the document Green Paper Building a Capital Markets Union COM(2015) 63 final, 18 February 2015, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015SC0013&from=EN> at 13.

¹³⁶ Dirk Zetzsche, ‘Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive’ (2008) 8 *Journal of Corporate Law Studies* 289 at 333; Micheler (n 69) at 509-510.

¹³⁷ Micheler (n 69) at 510.

¹³⁸ Gullifer (n 78) at 209.

¹³⁹ This is a corollary of the fact that shareholder rights attach on the basis of entry onto the register. See SI No. 316/2009 - Shareholders’ Rights (Directive 2007/36/ec) Regulations 2009 (transposing SRD into Irish law), Regulation 8(3): “A person shall be entered on the relevant

custodian who has an account with the CSD to which the issuer company's shares are admitted.¹⁴⁰ In certain circumstances, the company can receive more voting instructions than shares issued.¹⁴¹ These circumstances are, as Micheler again notes, where custodians outsource the processing of voting instructions to proxy advisors.¹⁴² These proxy advisors require 7-10 days to process the instructions and if a shareholder sells their shares after the processing but before the company has ceased accepting voting instructions, it can receive more votes than shares issued. If there is a doubt about the validity of a vote cast, the company will dismiss the vote.¹⁴³

Finally, the pooling of accounts by custodians, as with asset managers, presents problems for shareholder identification. In pooled accounts, the service providers who process the voting instructions must identify the proportion of each investor's shareholding in respect of each portfolio company. Even where the service provider is able to do this for one pooled account, they will have to undertake the same splitting exercise for each custodian in the custody chain.¹⁴⁴ This can be practically impossible in many cases.

Furthermore, in pooled accounts there is little ability for shareholders to identify each other, let alone for the company to identify its own shareholders.¹⁴⁵ While shareholders have a statutory right to inspect the shareholder register,¹⁴⁶ this usually requires the company itself to have undertaken a statutory process to establish which party has an interest in its shares and to update the register.¹⁴⁷ Very often, companies will not undertake this statutory process and the register will show the custodian that holds the shares on behalf of a great many investors in the CSD. In this case, shareholders will have no facility to discover the identities of other shareholders in the relevant company. The effect of this will be to

register of securities by the record date in order to exercise the right of a member to participate and vote at a general meeting and any change to an entry on the relevant register of securities after the record date shall be disregarded in determining the right of any person to attend and vote at the meeting.”

¹⁴⁰ See Micheler (n 69) at 514 (noting that in a custody chain, the custodian will be the registered shareholder); BIS ‘Exploring’ at 91 (“The identifier on the register is in the form of the name of the custodian bank nominee accounts and any codes used to identify who the investor is.”)

¹⁴¹ Eva Micheler, 'Building a Capital Markets Union: Improving the Market Infrastructure' (2016) 17 *European Business Organization Law Review* 481 at 485.

¹⁴² *Ibid* at 484.

¹⁴³ *Ibid* at 485.

¹⁴⁴ *Ibid*.

¹⁴⁵ BIS, ‘Exploring’ at 97-98.

¹⁴⁶ In Ireland, the relevant provision is section 216, Companies Act 2014. In UK, this is section 808, Companies Act 2006.

¹⁴⁷ This statutory process is found in section 1062, Companies Act 2014 and section 808, Companies Act 2006 in respect of the UK. See BIS ‘Exploring’ at 98.

significantly curtail the shareholder's ability to co-operate in its engagement, which, as described above, is often a pre-requisite to engagement for many shareholders.¹⁴⁸ Without the ability for shareholders to identify their fellow shareholders, a barrier is placed in front of the shareholder seeking to engage.

iv. Conclusion

While at each link in the chain of intermediaries there are particular obstacles to engagement with the issuer company, the growth in intermediation itself reduces the feeling of each intermediary of being an owner and thereby reduces the culture of accountability within the investment chain.¹⁴⁹ In this way, all intermediaries contribute to impede engagement, including those not mentioned above. Rather than one particular constituent of the investment chain being presented with a barrier to engaging by virtue of the practices of another constituent, all are affected by a vacuum of accountability that is a result of the widespread intermediation. As Jaap Winter argues in relation to increased intermediation:

“The ultimate investor becomes more and more removed from individual investment decisions and consequently loses sight of and interest in the individual shares held; and as a result, any sense of responsibility for the success of the individual undertakings in which money is invested.”¹⁵⁰

As well as reducing a culture of accountability and a feeling of ownership, intermediation increases the costs of engagement. It is an expensive and time consuming process to split pooled accounts up in order to give shareholders a proportional voting right, rather than vote the entire fund the same way or ignore the shareholder rights of the fund completely. In light of the cost-benefit analysis of engagement and the free rider problem discussed in the preceding section, these onerous actions increase the costs, making it less likely that shareholder will have any desire to engage. The practical realities and operation of the engagement process, in other words, may not add value to investment chain constituents, including shareholders, in the manner that is assumed by the engagement regulation.

¹⁴⁸ See above at p 84.

¹⁴⁹ Wong (n 98) at 407-408.

¹⁵⁰ Winter (n 96).

D. Control Enhancing Mechanisms

i. Introduction

The next section will address another potential barrier to shareholder engagement, control enhancing mechanisms (CEMs), which involve capital structures of companies that are designed to exclude certain classes of shareholder from corporate governance. The effect of CEMs is not always easily stated. In certain circumstances, CEMs are designed to promote shareholder engagement by the holders of certain classes of shares. However, CEMs often operate to impede shareholder engagement, whether in the process of promoting engagement by privileged classes of shareholder or not and so it is appropriate to examine CEMs in the present context.

Again, the distinction between “market” and “regulatory” impediments is not a clear one in respect of CEMs. While companies introduce a CEM as a matter of preference, they do so in the context of a particular regulatory environment. Efforts have been made by certain jurisdictions to restrict companies from adopting particular CEMs, especially in a takeover context.¹⁵¹ Depending on one’s perspective, these regulatory efforts could be interpreted as impeding or promoting shareholder engagement. This is because, as noted, CEMs can be seen as promoting engagement for holders of certain classes of shares, while simultaneously impeding engagement for other classes. For present purposes however, CEMs are broadly available across the EU¹⁵² and so the decision by a company to adopt one or more CEMs is a market based decision that is informed by market preferences. Accordingly, where shareholders are confronted with a CEM, it is a product of market based incentives, which itself creates incentives to which shareholder respond. For this reason, it is appropriate to discuss CEMs in the context of market impediments to engagement.

CEMs can be adopted in many different forms. Broadly speaking, a CEM occurs wherever a company deviates from the “one share one vote” principle, also known as the proportionality principle. “One share, one vote” has traditionally been seen as a cornerstone

¹⁵¹ See below discussion of the “breakthrough rule” at pp 115-117.

¹⁵² See European Commission, “Report on the Proportionality Principle in the European Union” 18 May 2007, available at http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf [hereafter “EC Proportionality Report”].

principle of shareholder democracy and deviations from this principle have been regarded by many as an undermining of shareholder democracy.¹⁵³ As will be argued, however, certain deviations from “one share, one vote” are designed to improve the quality of shareholder democracy. For this reason, CEMs confront common ideas of what “shareholder democracy” means and how it should operate. The EC commissioned Shearman & Sterling LLP, Institutional Shareholder Services and the European Corporate Governance Institute to conduct a research report regarding CEMs in the EU in 2007.¹⁵⁴ As this report detailed, classes of shares can have multiple voting rights or none, and can include cash-flow rights to compensate for the diminished voting right. Others involve shares that include veto rights for insiders on certain issues, depositary certificates which separate the underlying share from its voting rights, voting right ceilings and restrictions on the transferability of shares which prevent potential shareholders from acquiring a level of ownership.¹⁵⁵ Golden shares are issued to give priorities or preferences to Governmental authorities. Shareholder agreements constitute a CEM where shareholders agree to form voting blocs or alliances. However, unlike other CEMs, it is submitted that shareholder agreements are not a CEM that presents a barrier for shareholder engagement. Shareholder agreements to form alliances enhance the control of those making the agreement but do not themselves dilute the control of any other shareholder. So-called “pyramid structures” involve insider control of a company that itself is a controlling shareholder in another company, which can result in a chain or “cascade” of companies.¹⁵⁶ One company owns a majority stake in another company, which in turn owns a majority stake in a third company. The initial shareholding company can gain control of another company at the bottom of the pyramid by putting proportionally less capital in the latter company than would normally allow control.¹⁵⁷ The bigger the pyramid, the greater the deviation from the proportionality principle.¹⁵⁸ Pyramid structures are one way in which control is effectively retained by insiders. Cross shareholdings are another CEM that involve one company owning a stake in another company, which in turn owns a stake in the former company. Finally, “loyalty

¹⁵³ See European Commission, Communication from the Commission to the Council and the European Parliament, “Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward,” 21 May 2003.

¹⁵⁴ *Ibid.*

¹⁵⁵ *Ibid.* at 11-12.

¹⁵⁶ Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, 10 January 2002, [hereafter “Winter Report”] at 6.

¹⁵⁷ Federico Cenzi Venezze, ‘The costs of control-enhancing mechanisms: how regulatory dualism can create value in the privatisation of state-owned firms in Europe’ (2014) 15 *European Business Organization Law Review* 499 at 508 (“The use of different companies - in which minority shareholders also invest - allows the main shareholder to exercise very strong, or complete, control over even very large listed companies situated at the bottom of the pyramidal structure without investing an amount of money proportionate to his voting power in the same firms.”)

¹⁵⁸ EC Proportionality Report at 7 (“The higher the number of companies involved in the pyramid, the higher the degree of deviation from the proportionality between ownership and control.”)

shares” are time based CEM that are becoming an increasingly popular means of addressed short termism in PLCs.¹⁵⁹ Loyalty shares involve giving shareholders more votes per share if the shares are held for a specified period of time.¹⁶⁰ Shareholders who have not yet reached a designated ownership length are effectively disenfranchised. In a sense, loyalty shares do not impede shareholder engagement, since those “long term” who qualify for enhanced voting rights will be in a better position to engage with a greater influence in corporate governance. Shareholders who have not reached the qualified holding period will, however, conversely be disenfranchised so this CEM will impede engagement for these classes of shareholder. This will be discussed in greater detail below.¹⁶¹

ii. *The Prevalence of CEMs*

Deviations from “one share one vote”, particularly deviations are in the form of dual class share structures wherein certain classes have enhanced or diminished voting rights, are becoming increasingly popular across the world, both in companies and commentary.¹⁶² . This development was most likely driven by high profile Initial Public Offerings (IPOs) by technology companies with issued classes of shares carrying less than one vote per share. As Bebchuk and Kastiel report, “since Google went public with a dual-class structure in 2004 and was followed by well-known tech companies, such as Facebook, Groupon, LinkedIn, Snap, Trip Advisor and Zynga.”¹⁶³ This development is most likely driven by a desire to maintain the “idiosyncratic vision” of the founder.¹⁶⁴ Snap, in particular, took the

¹⁵⁹ Loyalty shares have been referred to in many different ways, including “time phased voting”, see Lynne L Dallas and Jordan M Barry, 'Long-Term Shareholders and Time-Phased Voting' (2016) 40 Delaware Journal of Corporate Law 541; “tenure voting”, see David J Berger, Steven Davidoff Solomon and Aaron J Benjamin, 'Tenure Voting and the US Public Company' (2017) 72 The Business Lawyer 295.

¹⁶⁰ Loyalty shares can also involve other means of incentivising shareholders to hold shares for longer, including enhanced dividends and reduced capital gains. See generally Jeroen Delvoie and Carl Clottens, 'Accountability and short-termism: some notes on loyalty shares' (2015) 9 Law and Financial Markets Review 19; P Alexander Quimby, 'Addressing Short-Termism Through Loyalty Shares' (2013) 40 Florida State University Law Review 389; Patrick Bolton and Frédéric Samama, 'Loyalty Shares: Rewarding Long-Term Investors' (2013) 25 Journal of Applied Corporate Finance 86.

¹⁶¹ See below at pp 109-112.

¹⁶² Steve Johnson, “Mantra of ‘one share one vote’ is under fire”, *Financial Times*, 22 February 2015.

¹⁶³ Lucian A Bebchuk and Kobi Kastiel, 'The Untenable Case for Perpetual Dual-Class Stock' (2017) 103 Virginia Law Review 585 at 594.

¹⁶⁴ Zohar Goshen and Assaf Hamdani, 'Corporate Control and Idiosyncratic Vision' (2016) 125 Yale Law Journal 560; Kishore Eechambadi, 'The Dual Class Voting Structure, Associated Agency Issues, and a Path Forward' (2017) 13 New York University Journal of Law and Business 503 at 513.

unprecedented step of offering zero voting shares at its IPO in the US.¹⁶⁵ Certainly in the US, the trend is toward greater use of dual class structures to enhance control for a select number of insiders. It has been reported that 13.5% of companies listing in the US in 2015 adopted a dual class structure, as compared to 1% of companies listing in the US in 2005.¹⁶⁶

The growth in popularity of dual class firms in Europe appears to be at a slower rate than in the US. This is likely attributable to the restrictions of European stock exchanges – most notably the London Stock Exchange – on the listing of dual class share structures.¹⁶⁷ The Kay Review noted the ongoing hostility of UK shareholders to dual class structures, resulting in their “virtual elimination” in UK companies.¹⁶⁸ The aforementioned EC commissioned study of CEMs found that deviations from the proportionality principle were “widely available” in the reviewed countries, in the sense that they were not prohibited by law.¹⁶⁹ The study found that CEMs featured in less than half of the total companies studied.¹⁷⁰ Of those companies that did feature a CEM, the pyramid structure was the most popular form, as it was found that 27% of companies that had a CEM had a pyramid structure.¹⁷¹ This finding is consistent with earlier research by La Porta, Lopez-De-Silanes and Schleifer in 1999.¹⁷² These authors reviewed 30 companies in 27 countries and found that among companies with controlling shareholders, 26% held this control through a pyramid structure.¹⁷³

¹⁶⁵ John Plender, “Snap and the 21st century governance vacuum” *Financial Times*, 22 February 2017.

¹⁶⁶ Steven Davidoff Solomon, “Shareholders Vote With Their Dollars to Have Less of a Say”, *New York Times*, 4 November 2015, as also cited in Bebchuk and Kastiel (n 159) at 594-595.

¹⁶⁷ Flora Huang cites the uptick in interest in dual class shares in the listing of Alibaba on the New York Stock Exchange because of the restrictions on dual class listings on the Hong Kong and London Stock Exchanges. See Flora Huang, 'Dual Class Shares around the Top Financial Centres' (2017) 2 *Journal of Business Law* 137. However, the Listing Rules do not prohibit dual class structures or low voting shares outright, but seek to guide issuers toward the principle of one share one vote, see Financial Conduct Authority, Listing Rules, Premium Listing Principle 4: “Where a listed company has more than one class of securities admitted to premium listing, the aggregate voting rights of the securities in each class should be broadly proportionate to the relative interests of those classes in the equity of the listed company.”

¹⁶⁸ Kay Review at 63 (par 8.34).

¹⁶⁹ EC Proportionality Report at 19-20. This study involved 464 companies across 19 countries, 16 of which were EU countries and 3 that were not. These latter 3 non-EU countries were Japan, USA and Australia.

¹⁷⁰ *Ibid* at 35 (“Of all the European companies analysed, 56% feature no CEM.”)

¹⁷¹ *Ibid* at 25 (“Out of all identified occurrences of CEMs, 27% are pyramid structures.”)

¹⁷² Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Schleifer, 'Corporate Ownership Around the World' (1999) 54 *The Journal of Finance* 471.

¹⁷³ The sample included the largest 20 companies in each country, as well as the smallest 10 companies with a capital valuation of at least \$500 million by the end of 1995. The countries reviewed were Argentina, Austria, Australia, Belgium, Canada, Denmark, Finland, France, Hong Kong, Germany, Greece, Israel, Ireland, Italy, Japan, Mexico, Netherlands, New Zealand, Norway, Portugal, Singapore, South Korea, Spain, Sweden, Switzerland, UK, USA. See *ibid* at 500.

In theory, CEMs ought to be at least as popular, if not more popular in Europe as in the US. Controlling shareholders have long been a feature of the European corporate landscape.¹⁷⁴ In theory, controlling shareholders are interested in maintaining or increasing their control of a company and so one might have expected that the use of CEMs would be observed in companies that have controlling shareholders. However, ownership concentration has been shown to be markedly different in common law versus civil law systems.¹⁷⁵ The UK and Ireland tend to have companies with more dispersed shareholders and fewer controlling shareholders than countries with a civil law system, such as France and Germany. This may create a greater appetite in these latter countries for CEMs than in Ireland and the UK. While the 2007 EC data on CEMs reveals that EU civil law countries had companies that on average had more CEMs than common law countries,¹⁷⁶ there are wide variations. In France, for example, only 28% of reviewed companies had no CEM, whereas in Germany, 77% of reviewed companies had no CEM. The variations in these cases were likely due to legislative restrictions on many CEMs in Germany, as compared to legislative encouragement of certain CEMs in France.¹⁷⁷

In 2002, Faccio and Lang found that dual class structures were used by a high proportion of companies in certain European States, such as Sweden, Switzerland and Italy.¹⁷⁸ In contrast, other European countries such as Portugal, Belgium and Spain were found in this study to have very few companies issuing dual class shares.¹⁷⁹ In the mid-2000s a trend was identified of companies in Europe abandoning dual class structures in favour of a

¹⁷⁴ See generally, Fabrizio Barca and Marco Becht (eds), *The Control of Corporate Europe*, (Oxford University Press, 2002).

¹⁷⁵ A recent study that demonstrated this was conducted by Marc Steffen Rapp and Oliver Trinchera, "Regulation an the Ownership Structure of European Listed Firms" in Kose John, Anil K Makhija and Stephen P Ferris (eds), *Global Corporate Governance, Advances in Financial Economics*, Vol 19 (Emerald Publishing, 2017) at 23-76; Mara Faccio and Larry HP Lang, 'The ultimate ownership of Western European corporations' (2002) 65 *Journal of Financial Economics* 365; Porta, Lopez-De-Silanes and Schleifer (n 172) at 505 ("common law countries have a significantly higher fraction of widely held firms than civil law countries do.")

¹⁷⁶ This data reviewed 12 civil law countries: Belgium, Denmark, Finland, France, Germany, Greece, Hungary, Italy, the Netherlands, Poland, Spain and Sweden, which had an average CEM presence of 52%, while the UK and Ireland averaged 35%.

¹⁷⁷ A Report by the OECD that was published around the same time as the EC Proportionality Report sets out the comparative restrictions, see OECD, "Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion," Issued by the OECD Steering Group on Corporate Governance, December 2007, at 16.

¹⁷⁸ The proportion of companies issuing dual class shares in these countries was found to be, respectively, 66.07%, 51.17% and 41.35%. See Faccio and Lang (n 179) at 385.

¹⁷⁹ Ibid.

unified capital structure.¹⁸⁰ It is possible that this was due to the perceived effect that unifying a dual class structure increased firm value.¹⁸¹ More recent evidence suggests that dual class listing in fact attract a higher valuation than single class offerings but that this increased valuation reduces over time.¹⁸²

While dual class listings have not gained the same prominence in Europe as in the US, other forms of CEM have gained ground, such as loyalty shares. Loyalty shares are not, strictly speaking, dual class shares, since shareholders cannot enter and exit the different classes of share where there is a time-dependent element. Dual class shares can be hoarded by controllers of companies, without offering the possibility to the wider population of shareholders to share in the control-premium. Loyalty shares, by contrast, gain the benefits of enhanced control simply where lower-voting shares are held for long enough. While it is possible to characterise shares held for the requisite time frame as a different “class” from those not held for this time period, loyalty shares are certainly distinct enough in their qualities to be treated separately from traditional “dual class” structures.

Loyalty shares have gained traction in Europe far more than in the US.¹⁸³ The popularity of loyalty shares in certain European countries has largely been driven by the preferences of companies themselves, rather than regulation. France has a legal regime in which companies as a default option have shares which gain double voting rights if held for two years.¹⁸⁴ Prior to this default option being introduced in 2014, the default option was one share one vote and, despite this, most French public companies “opted out” and adopted some form of loyalty shares as part of their capital structure.¹⁸⁵ The adoption of the loyalty shares default, therefore, merely formalised a prior preference of the majority of public companies in France. Fiat, a high profile Italian car maker migrated to the Netherlands in

¹⁸⁰ Anete Pajuste, “Determinants and Consequences of the Unification of Dual-Class Shares” European Central Bank Working Paper Series, No. 465, March 2005.

¹⁸¹ This is discussed as a hypothesis in *ibid* at 15-19.

¹⁸² Martijn Cremers, Beni Lauterbach and Anete Pajuste, “The Life-Cycle of Dual Class Firms”, ECGI Working Paper Series in Finance, Working Paper N° 550/2018, May 2018.

¹⁸³ See below at p 110.

¹⁸⁴ Loi 2014-384 du 29 mars 2014 visant à reconquérir l'économie réelle [Law 2014-384 of March 29, 2014 Aimed at Reconquering the Real Economy], as described in Yu-Hsin Lin, “Controlling Controlling-Minority Shareholders: Corporate Governance and Leveraged Corporate Control,” (2017) *Columbia Business Law Review* 453 at 469.

¹⁸⁵ Marco Becht, Yuliya Kamisarenka and Anete Pajuste, “Loyalty Shares with Tenure Voting - A Coasian Bargain? Evidence from the Loi Florange Experiment” ECGI Working Paper Series in Law, Working Paper No. 398/2018 April 2018, available at http://ecgi.global/sites/default/files/working_papers/documents/finalbechtkamisarenkapajuste.pdf at 4.

2014. The management of the company gave as a partial explanation for its migration the availability of loyalty shares there.¹⁸⁶ In response, the Italian government removed legal restrictions to loyalty shares.¹⁸⁷ The EC briefly floated the idea of introducing loyalty shares into European corporate law but did not pursue it.¹⁸⁸ During the development of the SRD2, members of the European Parliament proposed adding a requirement that Member States introduce some measure to encourage long term shareholding, which could include tax incentives, loyalty dividends or loyalty shares with enhanced voting rights.¹⁸⁹ As will be recalled from the discussion of the final text of SRD2, this requirement did not survive the legislative process.

iii. CEMs as Impediments to Shareholder Engagement

The fact that CEMs often impede shareholder engagement is a common criticism of many forms of CEM.¹⁹⁰ As noted, CEMs can be thought of as either presenting an impediment to shareholder engagement or as facilitating it. Different CEMs can be characterised more easily as impediments than others. For example, non-voting shares for all shareholders apart from certain managing executives clearly provides a formidable impediment to engagement. Facebook, for example, has a capital structure where management and directors hold 10 times the voting rights of ordinary shareholders,¹⁹¹ and Mark Zuckerberg, Facebook's CEO and Chairman, holds 1% of the shares but 60% of the voting rights of the company.¹⁹² Dual class structures have been criticised for barring shareholder influence over management. *The Economist* noted that a dual class structure in a company “makes it

¹⁸⁶ See di Augusto Santoro and others, 'Deviations from the One Share - One Vote Principle in Italy: Recent Developments - Multiple Voting Rights Shares and Loyalty Shares' (2015) 5 *Bocconi Legal Papers* 141.

¹⁸⁷ This decision was reversed however in response to pressure from institutional investors, see Rachel Sanderson, “Italy makes U-turn on loyalty shares” *Financial Times*, 5 February 2015.

¹⁸⁸ Alex Barker, “Brussels aims to reward investor loyalty”, *Financial Times*, 23 January 2013.

¹⁸⁹ Klaus J Hopt, 'Corporate Governance in Europe: A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance' (2015) 12 *NYU Journal of Law and Business* 139 at 158.

¹⁹⁰ Lucian A. Bebchuk, Reinier Kraakman, George Triantis, “Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights” in Randall K Morck (ed), *Concentrated Corporate Ownership*, (University of Chicago Press, 1998), at 301 (“Unlike in [dispersed ownership] structures, where controlling management may have little equity but can be displaced, the controllers of [controlling-minority shareholder] companies face neither proxy contests nor hostile takeovers.”); Frank H Easterbrook and Daniel R Fischel, 'Voting in Corporate Law' (1983) 26 *The Journal of Law and Economics* 395 at 409 (“Cumulative voting... produces the same costs as any other stratagem by which managers seek to insulate themselves from the displeasure of shareholder.”)

¹⁹¹ Hannah Kuchler, “Facebook investors lodge protest vote against board” *Financial Times*, 6 June 2018.

¹⁹² Andrea Tan and Benjamin Robertson, “Why investors are fretting over dual-class shares” *Bloomberg*, 10 July 2017.

hard for a majority of shareholders to remove even dismal managers.”¹⁹³ This newspaper also decried the listing of Snap in 2017 with zero voting shares as “a wider trend towards corporate autocracy.”¹⁹⁴ In the context of the market for corporate control, dual class structures are specifically designed to ensure that the wider population of shareholders in a public company does not have the voting power to accept a takeover bid that is hostile to incumbent management.¹⁹⁵ By insulating management in this way, dual class shares can have the effect of eliminating the ability for shareholders to engage, since the implicit threat of voting against management is removed. As noted, “one share, one vote” has been considered a cornerstone of shareholder democracy. Under this view of shareholder democracy, deviations in the form of CEMs undermine shareholder democracy due to their disenfranchising nature. Where certain shareholders have their ability to vote restricted, their incentive to engage in any way is further diminished. However, as observed earlier, some commentators have emphasised that what is needed in an effective corporate governance system is a greater quality of engagement, rather than a greater quantity. The Kay Review clearly made the point that “[s]hareholder engagement is neither good nor bad in itself: it is the character and quality of that engagement that matters.”¹⁹⁶ This perspective of shareholder democracy is perhaps more restricted but, it is submitted, it is nonetheless a vision of shareholder democracy. This vision might seek to enhance engagement by a smaller subsection of shareholders, encouraging their involvement at the expense of the other shareholders. This point is critical when considering shareholder engagement and the operation of shareholder democracy and will arise throughout this thesis. It should however equally be noted that shareholders who are disenfranchised by the operation of CEMs may nonetheless be subject to the provisions of the SRD2 and so will be expected to produce and carry out an engagement policy under Article 3g. It is possible that as part of a “clear and reasoned” explanation for not complying fully with Article 3g, a shareholder may rely on the CEMs of investee companies.

Certain CEMs, such as loyalty shares can, it is submitted, be considered a manifestation of this more restricted vision of shareholder democracy. Loyalty shares are less easily

¹⁹³ “More equal than others: Will Facebook pay a price for its new two-tiered share structure?” *The Economist*, 26 November 2009.

¹⁹⁴ “Corporate Democracy is Ailing: Snap’s refusal to hand out any voting shares is part of a wider trend towards corporate autocracy” *The Economist*, 9 February 2017.

¹⁹⁵ Gompers, Ishii and Metrick describe dual class shares as “the most extreme example of antitakeover protection” in Paul A Gompers, Joy Ishii and Andrew Metrick, ‘Extreme Governance: An Analysis of Dual-Class Firms in the United States’ (2010) 23 *The Review of Financial Studies* 1051 at 1052.

¹⁹⁶ Kay Review at 1.30.

characterised as unqualified impediments to engagement. Similar to dual class shares, loyalty shares will undoubtedly impede engagement for those shareholders with diminished voting rights as a result of not reaching the designated time period. Lynne Dallas and Jordan Barry conducted a study of companies in the US which had adopted some form of loyalty share system that awarded greater voting rights to “long term” shareholders.¹⁹⁷ Due to the paucity of loyalty shares in the US, they were only able to identify 12 companies that had a loyalty shares arrangement in the previous 30 years. Of these companies, the authors found that the main reasons behind adopting loyalty shares were both to decrease the influence of “short term” shareholders and to increase the influence of “long term” shareholders.¹⁹⁸ It is clear then that impeding engagement by certain shareholders is a specific and central aim of loyalty shares. However, the opposite side of the argument is that other shareholders gain an advantage in greater voting power if they simply hold the shares for the requisite time period. This does not necessarily help to overcome the “rational apathy” described above, but it does make engagement more effective if undertaken. That said, many shareholders do not have the option of holding shares for long periods. Many mutual funds, for example, are open ended, which means they must allow investors to redeem their investments on a daily basis.¹⁹⁹ Where redemptions are always a possibility, these mutual funds must always stand ready to sell assets in order to fund these redemptions, and frequently do so.

Loyalty shares have been opposed traditionally by institutional investors. For instance, it was reported that the Italian government reversed its decision to introduce a loyalty shares system similar to that in France due to pressure from institutional investors.²⁰⁰ BlackRock, the world’s largest asset manager by assets under management, released a white paper in 2015 detailing its opposition to loyalty shares.²⁰¹ This white paper makes a similar point to that made above, that loyalty shares disenfranchise minority shareholders. As it is put in the paper:

“Anecdotal evidence and research suggest that changing companies’ share structure by introducing enhanced voting rights or dividends based on the duration

¹⁹⁷ Dallas and Barry (n 159).

¹⁹⁸ Ibid at 611.

¹⁹⁹ Coffee (n 4) at 1318; Pozen (n 42) at 442.

²⁰⁰ Rachel Sanderson, “Italy makes U-turn on loyalty shares” *Financial Times*, 5 February 2015.

²⁰¹ BlackRock, “Key Considerations in the Debate on Differentiated Voting Rights” 2015, available at <https://www.blackrock.com/corporate/literature/whitepaper/blackrock-the-debate-on-differentiated-voting-rights.pdf>.

of ownership will not lead to a material change to the time-horizon of investment in companies. Rather, these measures could well be counterproductive by entrenching a core group of shareholders to the detriment of minority shareholders.”²⁰²

Pyramid structures are simply a means by which a shareholder maintains a controlling position in two or more companies. While they are the most common form of CEM in Europe, they are not present historically in either the UK or Ireland.²⁰³ Pyramid structures, as described above, involve the control of a company, which itself controls another company, which itself owns a third company, and so on. All companies in the pyramid are effectively controlled by the first shareholder at the top of the pyramid. However, all companies in the pyramid will also have minority shareholders, whose capital is used by the company to buy control in the next company in the pyramid. These minority shareholders will be blocked from engagement with any companies in the pyramid, because each is effectively controlled by the shareholder at the top of the pyramid.

A mention should also be given at this stage to controlling shareholders. Often controlling shareholders enhance their control through CEMs but often there is an alignment between share ownership and voting rights. Controlling shareholders can be thought of as an impediment to shareholder engagement, from the perspective of non-controlling or minority shareholders. Controlling shareholders are different from “blockholders”, who simply own higher than usual percentages of the company stock than the wider body of shareholders. Blockholders are usually defined as owning at least 5% of the company’s shares.²⁰⁴ Controlling shareholders are those with sufficient voting rights to determine the outcome of votes, which may not be over 50%.²⁰⁵ The presence of controlling shareholders

²⁰² Ibid (footnote omitted).

²⁰³ See EC Proportionality Report. No Irish companies in the sample were owned through a pyramid structure and only one was found to have been owned through a pyramid structure in the UK.

²⁰⁴ Alex Edmans, 'Blockholders and Corporate Governance' (2014) 6 Annual Review of Financial Economics 23 at 24; LL Eng and YT Mak, 'Corporate Governance and Voluntary Disclosure' (2003) 22 Journal of Accounting and Public Policy 325 at 330.

²⁰⁵ This is the definition adopted in Lucian A Bebchuk and Assaf Hamdani, 'The Elusive Quest for Global Governance Standards' (2009) 157 University of Pennsylvania Law Review 1263 at 1267. See also Financial Conduct Authority Handbook which defines “controlling shareholder as meaning “any person who exercises or controls on their own or together with any person with whom they are acting in concert, 30% or more of the votes able to be cast on all or substantially all matters at general meetings of the company.”

in a company renders the voting rights of minority shares effectively obsolete.²⁰⁶ The presence of controlling shareholders is therefore a considerable barrier to minority shareholder engagement. However, the engagement of a controlling shareholder is no less legitimate than the engagement of minority shareholders, despite possible agency problems that controlling shareholders create for minority shareholders.²⁰⁷ While the engagement of a controlling shareholder is far more available and less subject to impediments than engagement by dispersed shareholders, it is no less “shareholder engagement.”

Finally, it is perhaps notable that in the survey conducted for this thesis, one respondent of three mentioned that dual class structures of investee companies presented a particular barrier to their engagement. While this does not constitute evidence that dual class structures are indeed a barrier to institutional investor engagement more broadly, it is worth noting anecdotally.

iv. The Breakthrough Rule

In the context of takeovers, the effect of CEMs is to deprive those shareholders who do not benefit from the CEM of a (proportionate) voice in whether a takeover bid is successful or not.²⁰⁸ This has important implications for the operation of the market for corporate control in disciplining management and corporate decision makers. The market for corporate control is a theory that says mismanagement of a company will result in a decreased share price as discontented shareholders sell their shares and other investors do not wish to invest.²⁰⁹ A low share price will make the company attractive for a takeover, where incumbent management can be replaced. In this way, the market for corporate control involves the takeover market disciplining underperforming managers. In the context of CEMs, non-controlling shareholders cannot accept a bid that would remove incumbent management where they do not benefit from the CEM. The “non frustration rule” in the Takeover Bids Directive was designed to ensure that incumbent management themselves

²⁰⁶ George W Dent Jr, 'Dual Class Capitalization: A Reply to Professor Seligman' (1986) 54 *The George Washington Law Review* 725 at 747 (“If one shareholder owns 51% of the stock, the minority shareholders in effect have no vote, even though they are entitled to nearly half of the profits.”)

²⁰⁷ “Legitimate” for the purposes of fulfilling the requirements of Directive (EU) 2017/828.

²⁰⁸ Winter Report at 28 (“If, prior to the bid, the capital and control structures of the company deviate from [the principle of proportionality], the disproportionate control rights can be used, and are likely to be used, to authorise the board to frustrate the bid if the board or the minority shareholder controlling the board wishes to oppose it.”)

²⁰⁹ See generally, Henry G Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *The Journal of Political Economy* 110.

cannot protect themselves from hostile bids.²¹⁰ Under this rule (also known as the “board neutrality” rule), the board of a target company for whom a bid has been made cannot take any action that might frustrate that bid, other than seeking alternative bids, without the prior authorization of a general meeting of shareholders.²¹¹ The board may publicly criticize the bid and its effects on the company if successful, but it may not take an action which would impede the bid such as issuing shares.²¹²

However, in early 2002 the High Level Group of Company Law Experts (also called the “Winter Group” after its Chairperson) noted in a Report that the board neutrality rule in and of itself did not assist non-controlling shareholders where a company had adopted a CEM prior to the commencement of the takeover period.²¹³ The Winter Group stressed the importance of “one share on vote” in EU company law, saying that it was one of two “guiding principles”, the other being shareholder decision making.²¹⁴ For the Winter Group “[t]he extent to which a shareholder holds risk bearing capital should determine the extent to which he is able to determine the affairs of the company and the operation of its business.”²¹⁵ In order to incorporate the proportionality principle in the context of a takeover, the Winter Group proposed a “breakthrough rule.”²¹⁶ This rule would operate to “breakthrough” any CEM that would otherwise prevent a takeover bid being successful if not for the CEM. The rule would only operate in the context where an offer is made and succeeds in respect of the majority of those holding risk bearing capital (shares), proportional to their shareholding. If the bid is unsuccessful, the CEMs present in the company would remain unaffected and, if the bid is successful, the CEMs would be broken through only for the purposes of allowing the bid to succeed. The Winter Group proposed that this rule form a part of the Takeover Bids Directive. During the development of what would become the Takeover Bids Directive, Greece, president of the European Council at the time, presented a proposal that conformed with the Winter Group’s Report, to the effect that a breakthrough rule would be contained in Article 11 of the Takeover Bids Directive.²¹⁷ According to Skog, this legislative move was opposed by certain Scandinavian countries,

²¹⁰ See Directive 2004/25/EC, article 9; David Kershaw, “Hostile Takeovers and the Non-Frustration Rule: Time for a Re-Evaluation” (2016) LSE Law, Society and Economy Working Papers 19/2016, available at <https://ssrn.com/abstract=2875772>.

²¹¹ Directive 2004/25/EC, article 9(2).

²¹² Directive 2004/25/EC, article 9(5).

²¹³ Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, 10 January 2002, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=315322, at 28.

²¹⁴ *Ibid* at 20-22.

²¹⁵ *Ibid* at 21.

²¹⁶ *Ibid* at 29.

²¹⁷ Rolf Skog, 'The Takeover Directive, the Breakthrough Rule and the Swedish System of Dual Class Common Stock' (2004) 15 *European Business Law Review* 1439 at 1444.

on the grounds that companies should be free to determine their own financial structure, whether that includes multiple share classes or not, that the breakthrough rule actually restrains shareholder activism and therefore good corporate governance, that it lacks empirical support for its effectiveness and that it encroaches on the property rights of owners of high vote shares.²¹⁸

Due to criticisms of the breakthrough rule, similar to those expressed by Scandinavian countries, ultimately it was included in the Takeover Bids Directive on an optional basis.²¹⁹ Only three Member States ultimately transposed the breakthrough rule into their national law, which were Estonia, Latvia and Lithuania.²²⁰ It can therefore be seen that attempts at a European level to regulate multiple class share structures and other deviations from the proportionality principle in European public listed companies has been less than successful.

E. Conclusion

Ultimately, what the above shows is that a number of market structure impediments exist to deter shareholder engagement. The different impediments will operate in different ways to deter different kinds of engagement in different circumstances for different kinds of shareholders. For example, loyalty shares will reduce the ability of shareholders with certain liquidity requirements or short term investment strategies to engage, by increasing the costs of engaging. Pyramid ownership and dual class structures disenfranchise minority shareholders. The widespread use of custodians and sub-custodians will reduce the ability of asset managers to engage where one or more of these custodians in the custody chain uses pooled accounts because shareholder identification becomes a costly hurdle. Asset owners are deterred from engaging with investee companies where they use asset managers and the asset managers use pooled accounts. Article 3g requires specific elements to be included in an engagement policy, and the different impediments described above may operate to impede particular elements but not others. For example, CEMs may impede the

²¹⁸ Ibid at 1444-1445.

²¹⁹ See Directive 2004/25/EC, Article 12; Guido Ferrarini, 'One Share - One Vote: A European Rule?' (2006) 2 *European Company and Financial Law Review* 147 at 152-153; Yu-Hsin Lin, 'Controlling Controlling-Minority Shareholders: Corporate Governance and Leveraged Corporate Control' (2017) 2017 *Columbia Business Law Review* 453 at 502-503.

²²⁰ European Commission, "Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Application of Directive 2004/25/EC on Takeover Bids", 28 June 2012, available at http://ec.europa.eu/internal_market/company/docs/takeoverbids/COM2012_347_en.pdf/ at 3.

exercise of voting rights but not impede the conducting of dialogues or cooperation with other shareholders. It would not suffice, therefore, for a shareholder giving an explanation for non-compliance to reference an impediment to explain complete non-compliance, unless they can give an explanation for how the impediment blocks engagement for each element listed in Article 3g.

As noted, “market” impediment is an imperfect description of many of the above impediments. Many impediments are indirectly caused by other financial regulation or are facilitated by some regulation. The next part will describe “regulatory” impediments to shareholder engagement. The difference between those impediments that will be described in the next part and those described above is that it is not the regulation itself that presents an obstacle to engaging for those described above. Rather, some market practice that may be in response to a regulatory aim (such as certain forms of intermediation) or completely unrelated to regulation (such as the free rider problem). The best means of overcoming these “market” impediments may be regulatory.²²¹ However, the impediments described in the next chapter are caused directly by some regulatory order. It may be the case that overcoming these impediments is the simple removal of the regulation. This would require balancing of the aims of the regulation that impedes engagement and the aims of engagement itself. These regulations and this balancing exercise will be explored in the next chapter.

²²¹ The different solutions to overcoming impediments to engagement will be discussed in Chapter 5: Overcoming Impediments to Shareholder Engagement.

4. Regulatory Impediments to Shareholder Engagement

A. Introduction

In Chapter 3, market impediments to engagement were detailed and discussed. This chapter will deal with regulatory impediments, which will involve examining particular regulations and analysing how they directly act as an impediment to the engagement of shareholders in Europe. As will be seen, these regulations promote specific aims, such as the protection of minority shareholders or the prevention of market manipulation and seek to guide the behaviour of market participants. If they also act to impede engagement, the aim of engaging shareholders must be weighed against the other aim of the regulation. As with market impediments, different regulatory impediments will act to impede different kinds of engagement for different kinds of shareholder. As will be seen, regulatory impediments also operate to impede certain required elements of an engagement policy under Article 3g for certain shareholders. The first section of the chapter will address the concepts of acting in concert and the mandatory bid rule (MBR), the second section will address shareholder identification provisions, the third will address the Market Abuse Regulation¹ and the final section will address legal formalities relating to the annual general meeting (AGM).

B. Acting in Concert and the MBR

i. Introduction

The acting in concert provisions of the MBR in the Takeover Bids Directive² are among the most cited regulatory obstacles to shareholder engagement.³ In the survey conducted

¹ Regulation (EU) No 596/2014.

² Directive 2004/25/EC, article 5(1).

³ Paolo Santella and others, 'Legal Obstacles to Institutional Investor Activism in the EU and in the US' (2012) *European Business Law Review* 257 at 279-280; Riccardo Ghetti, 'Acting in Concert in EU Company Law: How Safe Harbours can Reduce Interference with the Exercise of Shareholder Rights' (2014) 11 *European Company and Financial Law Review* 594; European Commission, Green Paper, "the EU corporate governance framework," 5 April 2011 at 14 ("Many respondents to the 2010 Green Paper proposed that existing EU law on acting in concert, which may hinder effective shareholder cooperation, should be amended."); Sir David Walker, "A review of corporate governance in UK banks and other financial industry entities Final recommendations" 26 November 2009 at 162 ("It is important that there are no regulatory impediments, real or imagined, to the development of collective dialogue. Uncertainty about the rules on acting in concert can be a deterrent to such initiatives.")

for this thesis with asset managers, one of the three responses cited the possibility of acting in concert and triggering a mandatory offer as a particular barrier to engagement. While this was just one response of three, arguably it provides a mild confirmatory basis to existing evidence that institutional investors generally feel that the rule presents an impediment to engagement. As noted in Chapter 3, for certain shareholders, cooperation is the only realistic means of effectively engaging.⁴ The free rider problem may prevent rational investors from engaging with investee companies unless they have a large stake in the company.⁵ For many small institutional investors and asset managers, they will not have a sufficiently large stake in any one company to overcome the free rider problem. As well as this, even if an institutional investor wishes to engage despite the free rider problem, they will be unlikely to have a sufficient share of voting rights in the company to pose a serious challenge to the board of directors.⁶ In order to make engagement a viable option for many institutional investors and asset managers thus, they must work collectively or co-ordinate such engagement. A collective of investors engaging in relation to the same issue or issues within the same company will have far more clout than any investor acting individually and will be more likely to get the attention of the board of directors and therefore be more effective.

Recognition of the need for many institutional investors and asset managers to co-operate with one another can be found in both the Stewardship Code (“SC”) and Revised Shareholder Rights Directive (“SRD2”)⁷ and each of these corporate governance frameworks arguably expect a certain level of co-operation. Principle 5 of the 2012 SC states that “Institutional investors should be willing to act collectively with other investors where appropriate.” Even though “where appropriate” may suggest that signatories to the SC have a discretion to decide that collective action is not appropriate in most cases, the guidance in the SC makes clear that signatories should be generally be ready to act collectively to ensure investee companies are aware of shareholder concerns.⁸ This is amended in principle 10 of the 2020 SC to state “Signatories, where necessary, participate

⁴ See Chapter 3: Market Impediments to Shareholder Engagement, above at p 84.

⁵ See Chapter 3, above at p 82.

⁶ Hanne Søndergaard Birkmose, 'European Challenges for Institutional Investor Engagement – Is Mandatory Disclosure the Way Forward' (2014) 11 *European Company and Financial Law Review* 214 at 243; Lee Roach, 'The UK Stewardship Code' (2011) 11 *Journal of Corporate Law Studies* 463 at 485-486.

⁷ Directive (EU) 2017/828 [hereafter “SRD2”].

⁸ The exact wording of this guidance is: “Institutional investors should disclose their policy on collective engagement, which should indicate their readiness to work with other investors through formal and informal groups when this is necessary to achieve their objectives and ensure companies are aware of concerns.”

in collaborative engagement to influence issuers.” Examples given in the guidance to this principle are “collaborating with other investors to engage an issuer to achieve a specific change; or working as part of a coalition of wider stakeholders to engage on a thematic issue.”⁹ Similarly, in the SRD2, Article 3g requires institutional investors and asset managers to publicly disclose an engagement policy, which must contain information about how they “cooperate with other shareholders”. Clearly, this could encompass a disclosure that the relevant shareholder does not cooperate with other shareholders in their policy, but it arguably does acknowledge that cooperation among shareholders may be beneficial for engagement.

ii. The MBR

The MBR in the Takeover Bids Directive states that where a person or persons acting in concert acquire control of a public limited company,¹⁰ they must make a bid for the remaining shares of that company. The Takeover Bids Directive was implemented into Irish law by means of the European Communities (Takeover Bids (Directive 2004/25/EC)) Regulations 2006, but many of the provisions of the Directive were already in the Takeover Rules, including the MBR.¹¹ The price that must be offered is the highest price offered by the person acquiring control or those acting in concert in a time period of at least six months before the control was acquired,¹² and in Ireland this time period is specified as 12 months.¹³ Furthermore, according to the Takeover Bids Directive, Member States may provide that mandatory offers must be given in cash or contain a cash alternative.¹⁴ Ireland has adopted this requirement.¹⁵ Under the Takeover Bids Directive, the precise definition of “control” is left to Member States to define. In the Irish Takeover Panel Act, 1997 (“the 1997 Act”), “control” of a company is defined as the holding of at least 30% of the voting rights of the company.¹⁶ This definition is referred to in the Irish Takeover Rules, which implements the MBR.¹⁷

⁹ Financial Reporting Council, “The Stewardship Code 2020” at 19.

¹⁰ Directive 2004/25/EC, article 1(1) states that companies subject to the MBR must have securities admitted to trading on a regulated market within the meaning of Directive 93/22/EEC.

¹¹ SI No. 255/2006 - European Communities (Takeover Bids (Directive 2004/25/EC)) Regulations 2006. For the current iteration of the Takeover Rules, see Irish Takeover Panel Act 1997, Takeover Rules and Substantial Acquisition Rules, 2013, [hereafter “Takeover Rules”], Rule 9.

¹² Directive 2004/25/EC, article 5(4).

¹³ Takeover Rules, Rule 9.4(a).

¹⁴ Directive 2004/25/EC, article 5(5).

¹⁵ Takeover Rules, Rule 9.4(a).

¹⁶ Irish Takeover Panel Act 1997, s 1.

¹⁷ Takeover Rules, Rule 2.1 (in which “control” is given the definition in section 1 of the 1997 Act) and Rule 9.1 (in which the MBR is implemented).

The rationale for the MBR is broadly the protection of minority shareholders in public limited companies.¹⁸ A controlling shareholder has the ability to enrich themselves at the expense of the minority, non-controlling shareholders, and so giving these latter shareholders an *ex ante* ability to exit could deter this opportunism. Davies, Hopt and Ringe describe this rationale as “a pre-emptive strike against majority oppression of minority shareholders by providing minority shareholders with an exit right at the point of acquisition of control.”¹⁹ As well as this, it is thought that all shareholders ought to share in the premium paid for control of the company, rather than a select number from whom the acquirer paid to gain control.²⁰ However, the MBR is highly controversial.²¹ Critics of the MBR complain that it raises the costs of acquiring companies, both by forcing the acquisition of all shares and by mandating a cash offer as part of the mandatory bid.²² This means that the MBR may prevent value increasing transactions, despite also preventing value decreasing transactions.²³ Hansen also criticises the MBR as inappropriate for jurisdictions with a history of dominant shareholders, such as the Nordic countries.²⁴ He states that these jurisdictions have a “benevolent view” of dominant shareholders, which accepts the potential positive contribution of these investors as well as the abuses they may inflict on companies.²⁵ Viewing dominant shareholders as not negative *per se* and indeed presenting a potential force for good in corporate governance by having a bigger incentive to monitor and discipline management (in other words, to engage) means that allowing shareholders to become dominant ought not to be discouraged. It is certainly true that dominant shareholders are not necessarily a characteristic of bad corporate governance.

¹⁸ See Edmund-Philipp Schuster, 'The Mandatory Bid Rule: Efficient, After All?' (2013) 76 *Modern Law Review* 529 at 533; Nicholas Jennings, 'Mandatory Bids Revisited' (2005) 5 *Journal of Corporate Law Studies* 37 at 40-47.

¹⁹ Paul Davies, Klaus Hopt and Wolf-Georg Ringe, in Kraakman, Armour, Davies, Enriques, Hansmann, Hertig, Kopt, Kanda, Pargendler, Ringe and Rock, *Anatomy of Corporate Law*, (3rd ed, OUP, 2017) at 228.

²⁰ Paul L Davies, *Gower and Davies' Principles of Modern Company Law*, (8th ed., Sweet & Maxwell, 2008) at 1018; Jennings (n 18) at 43; Georgios Psaroudakis, 'The Mandatory Bid and Company Law in Europe' (2010) 7 *European Company and Financial Law Review* 550 at 551.

²¹ Davies, Hopt and Ringe in Kraakman et al (n 19) call the MBR “[t]he strongest, and most controversial, expression of the sharing principle...” at 227.

²² Jennings (n 18) at 53.

²³ See Lucian Ayre Bebchuk, 'Efficient and Inefficient Sales of Corporate Control' (1994) *The Quarterly Journal of Economics* 957 at 971 (in which the principles underpinning the MBR are called “the equal opportunity rule”).

²⁴ Jesper Lau Hansen, 'The Mandatory Bid Rule: Unnecessary, Unjustifiable and Inefficient' (2018) University of Copenhagen Faculty of Law Legal Paper Research Series, paper no 2018-54 at 12-14.

²⁵ *Ibid* at 12.

The power that dominant shareholders have can be used to oppress minority shareholders can equally be used to hold management accountable.

iii. Acting in Concert

The general debate regarding the MBR and its efficiency is beyond the scope of the present discussion, but its presence arguably presents a significant barrier to shareholder engagement. This is because the MBR is triggered by shareholders “acting in concert”. This concept is given the following definition in Irish law for the purposes of the Takeover Bids Directive: “persons who cooperate on the basis of an agreement, either express or tacit either oral or written, aimed at acquiring control of the offeree company or at frustrating the successful outcome of a bid.”²⁶ This definition is very similar to that found in the UK Takeover Rules²⁷ and is identical to that found in Article 2(1)(d) of the Takeover Bids Directive. The Notes to the Takeover Rules make clear that it is not the simple coming together of shareholders such that their pooled shareholding confers greater than 30% voting rights that will constitute acting in concert, but the subsequent acquisition by shareholders who have already come together in cooperation or coordination of shares that will bring the pooled shareholding to a level conferring over 30% voting rights.²⁸ Thus, if a group of shareholders with over 30% of voting rights between them coordinate engagement efforts with a view to acquiring control, they will not trigger of the MBR. If any one of these shareholders thereafter acquires any more shares in the targeted company however, this will likely trigger a mandatory offer. As Gower and Davies note, however, “one or other member of a group of institutional shareholders, who come together to exercise their right as shareholders, is quite likely in the ordinary course of its affairs to acquire shares in the company.”²⁹ It is therefore clear that institutional investors will be deterred from cooperating if they do not want or cannot afford to make a mandatory offer. In many EU Member States, unlike in the UK and Ireland, the coming together of shareholders can itself be sufficient to trigger a mandatory bid, even without subsequent acquisition of shares.³⁰ This arises where the ownership of the shareholders who have come

²⁶ Regulation 8 of Takeover Bids (Directive 2004/25/EC) Regulations 2006 (S.I. No. 255 of 2006). This Regulation substitutes the definition of “acting in concert” in Irish Takeover Panel Act 1997, s 1(3) for takeover bids. See Takeover Rules, Rule 2.1(b)(vi).

²⁷ The Panel on Takeovers and Mergers, *The Takeover Code*, 12th edition, 12 September 2016, available at <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf?v=8Jan2018>.

²⁸ Takeover Rules, Notes on Rule 9.1 – Acting in Concert.

²⁹ Gower and Davies (n 20) at 1022.

³⁰ See ESMA Public Statement, “Information on shareholder cooperation and acting in concert under the Takeover Bids Directive” 8 February 2019 at 14, available at

together exceeds the threshold set by the Member State. These Member States include France, Germany, Spain, Sweden and the Netherlands.³¹

In 2010, a Reflection Group was established by the European Commission (“EC”) to produce a report on the future on EU company law. In April 2011 this report was published and it contained a note acknowledging that shareholder involvement in companies may be discouraged by the MBR.³² The Reflection Group suggested that the MBR be clarified and have its application limited to contexts that involve genuine efforts to control the company “at board level.”³³ In their 2012 Action Plan, mentioned in Chapter 2,³⁴ the EC acknowledged this issue, saying that “the lack of legal certainty provided by the current rules contained in the Takeover Bids Directive... and [its] transposition in national law is perceived as an obstacle to effective shareholder cooperation.”³⁵ They committed to working with national authorities and the European Securities and Markets Authority ESMA to develop guidance on the meaning of “acting in concert” in respect of the MBR in order to improve legal certainty for shareholders.³⁶

In June 2014, ESMA published a guidance note that acknowledged the lack of legal certainty in this respect and aimed to enhance this clarity by providing a “White List” of activities that shareholders can conduct without in and of themselves triggering the acting in concert provisions of the MBR.³⁷ These activities include entering into discussions with each other about company matters and making representations to the board about company policies and practices. ESMA noted a particular sensitivity around the appointment of

https://www.esma.europa.eu/sites/default/files/library/esma31-65-682_public_statement_concerning_shareholder_cooperation_and_acting_in_concert.pdf

³¹ Ibid.

³² European Commission: Internal Market and Services, “Report of the Reflection Group on the Future of EU Company Law” 5 April 2011, available at http://ec.europa.eu/internal_market/company/docs/modern/reflectiongroup_report_en.pdf, at 46.

³³ Ibid at 46-47.

³⁴ Chapter 2: The Shareholder Rights Directive, its Development and its Revision, above at p 61.

³⁵ European Commission, “Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies,” 12 December 2012, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0740&from=en> [hereafter “EC 2012 Action Plan”] at 11.

³⁶ Hansen notes that the ESMA guidance note was “probably inspired” by a similar guidance statement by the UK Takeover Panel in 2009, see Hansen (n 24) at 18, referring to UK Takeover Panel, Practice Statement no.26, 2009.

³⁷ ESMA Public Statement, “Information on shareholder cooperation and acting in concert under the Takeover Bids Directive”, ESMA/2014/677, 20 June 2014, available at <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-677.pdf>.

directors to the board because “if shareholders cooperate in the appointment of board members, they may be in a position to control the operational management of the company.”³⁸ For this reason, cooperating in the exercise of voting rights is only included in the White List where it is not in the context of board appointments. An important qualification given was that each case ought to be decided on its own particular facts. This means that even where shareholders are undertaking activities on the White List, there may still be a context that leads national competent authorities to conclude that the shareholders are acting in concert such that a mandatory offer must be made to the remaining shareholders. As well as this, ESMA noted that the fact in and of itself that shareholders are engaged in activities not included on the White List should not necessarily imply that these shareholders are acting in concert.³⁹

As is clear, ESMA were seeking to balance the need to clarify the law relating to the MBR such that effective shareholder engagement is not deterred with the need to give national competent authorities flexibility to deal with unique situations involving shareholder cooperation. For this reason, some commentators have concluded that the guidance note does not adequately clarify the law for shareholders on an *ex ante* basis.⁴⁰ Other commentators have been especially critical of the exclusion of engagement in the context of board appointments. Birkmose, for example, argues that the primary aim of shareholder engagement is to change the behaviour of the investee company, which includes changing the composition of the board.⁴¹ Hansen goes further and argues that, while the guidance is helpful in limiting the chilling effect, it cannot solve “the problem that lies at the heart of the [MBR]”, which is that the MBR assumes that shareholders should not exercise control over management without making a mandatory offer to all other shareholders.⁴² As he puts it: “the White List is blank where it matters the most: the appointment of management and shareholder control over management.”⁴³ By excluding the context of board appointments, the guidance notes signal to shareholders that only engagement without the implicit threat of replacing directors on the board can be accepted without triggering a mandatory offer. This defanged engagement is arguably as ineffective as simply attempting to engage individually for many shareholders.

³⁸ Ibid at 6, par 5.1.

³⁹ Ibid at 6, par 4.2.

⁴⁰ Ghetti (n 3) at 631.

⁴¹ Birkmose (n 6) at 244-245.

⁴² Hansen (n 24) at 18.

⁴³ Ibid.

iv. Conclusion

The MBR and acting in concert provisions have a high likelihood of catching collective engagement by institutional investors, where together the shareholders own over 30% of the target company's voting rights. Guidance notes given by ESMA and others⁴⁴ provide a measure of clarity but any collective engagement that threatens the voting against a board member has the potential to trigger a mandatory offer in the future, provided shares are acquired by one of the shareholders in the collective. Where shareholders engage without at least the implicit threat of voting against board reappointment, the effectiveness of the engagement is inherently limited. Board members of investee companies have a greater ability to ignore shareholders, even where they engage collectively, if they are, in effect, legally barred from threatening to vote against their reappointment. While the MBR is a feature of EU takeover law, it would appear that a significant barrier to asset manager engagement exists for all but the largest asset managers. Shareholders may therefore point to concerns of triggering a mandatory bid by way of explanation for not complying with the requirement in Article 3g to include in an engagement policy a description of how they "cooperate with other shareholders".

C. Shareholder Identification and Ownership Disclosure

i. Introduction

Shareholder identification has been mentioned briefly in the context of intermediation in the investment chain.⁴⁵ The inability for companies to identify their shareholders and for shareholders to identify other shareholders due to account pooling by asset managers and custodians presents an impediment to shareholder engagement for the reasons given in the previous part. It may be thought therefore that regulation providing for or facilitating shareholder identification should help shareholders and companies overcome this impediment. Indeed, the EC has taken this view, attempting to facilitate shareholder identification in both the Shareholder Rights Directive ("SRD") and the SRD2. As it asserted in its 2012 Action Plan: "The Commission considers that additional information on who owns shares in a listed company can improve the corporate governance dialogue

⁴⁴ The UK Takeover Panel, Practice Statement no.26, 2009, and their earlier Public Consultation Paper, "Shareholder Activism and Acting in Concert: Revision Proposals Relating to Note 2 on Rule 9.1 of the Takeover Code", 14 March 2002.

⁴⁵ See Chapter 3, above at p 101.

between the company and its shareholders. The existing tools are either not detailed enough or lack the necessary cross-border dimension.”⁴⁶

It might seem odd therefore that shareholder identification and regulations that impose shareholder identification could themselves be characterised as an impediment to shareholder engagement. Engagement is a complex process and measures to improve engagement for many shareholders could have the effect of impeding the engagement of others.⁴⁷ Depending of the kind of engagement and the kind of shareholder, regulation can simultaneously impede and encourage engagement. In the case of shareholder identification, the kind of shareholder that may be impeded from engaging are those shareholders commonly called “activists,” who have been mentioned previously.⁴⁸

ii. Shareholder identification and ownership disclosure in EU law

The provisions of the SRD and SRD2 have been described in Chapter 2 and so will not be discussed in detail again here. It is worth noting however the trend toward shareholder identification from the SRD to SRD2. In the SRD, the emphasis, in terms of shareholder identification, was on how Member States ensured that companies could identify their shareholders. For example, Article 7(3) of the SRD requires that Member States introduce a “record date” applied to all companies, which essentially amounts to a reference date for the purposes of attaining rights against the company.⁴⁹ This record date must not be more than thirty days before the day of the general meeting and it must be at least eight days after the convocation of the general meeting.⁵⁰ Irish company law sets the record date at 48 hours prior to the day of the general meeting,⁵¹ which is designed to limit the number of those who hold shares at the record date but not the date of the general meeting.⁵² The record date system was designed as an alternative to “share blocking”, which had been used by companies to regulate access to the general meeting.⁵³ As a tool for shareholder

⁴⁶ EC 2012 Action Plan at 7.

⁴⁷ In this way, shareholder identification is not dissimilar to the issues surrounding loyalty shares and other CEMs, because they can be characterised as facilitating the engagement of particular shareholders but simultaneously disenfranchising others.

⁴⁸ See Chapter 1: Introduction at pp 20-21.

⁴⁹ Directive 2007/36/ec, article 7(2).

⁵⁰ Directive 2007/36/ec, article 7(3).

⁵¹ Companies Act 2014, s 1105(1).

⁵² Dirk Zetzsche, 'Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive' (2008) 8 Journal of Corporate Law Studies 289 at 316.

⁵³ European Commission, Internal Market Directorate General, “Fostering an appropriate Regime for Shareholder Rights in the EU: Consultation document of the Services of the Internal Market Directorate General,” September 2004, available at

identification, this system is useful for companies and shareholders to know that at the record date, the shareholder register is fixed.

The shareholder identification elements of the SRD are qualified by the principle of proportionality. Article 7(4) reads: “Proof of qualification as a shareholder may be made subject only to such requirements as are necessary to ensure the identification of shareholders and only to the extent that they are proportionate to achieving that objective.” As Dirk Zetsche notes, what is “proportionate” for the purposes of identifying shareholders is not clear.⁵⁴ Other provisions of the SRD that seek to facilitate shareholder voting are qualified in the same way, such that the use of electronic means to participate at the general meeting and voting by correspondence must be adopted subject only to such requirements and constraints as are necessary for shareholder identification.⁵⁵

As is evident, this is a limited approach to shareholder identification, designed to place the onus on companies to use the facilitative provisions to identify their shareholders. In particular, the record date provides certainty for companies and shareholders with regard to whether certain investors have shareholder rights at the general meeting and this certainty theoretically facilitates shareholder-company engagement. However, this approach is not always effective in the face of intermediation. This is specifically acknowledged in the SRD2, recital 4 of which sets out the problem:

“Shares of listed companies are often held through complex chains of intermediaries which render the exercise of shareholder rights more difficult and may act as an obstacle to shareholder engagement. Companies are often unable to identify their shareholders. The identification of shareholders is a prerequisite to direct communication between the shareholders and the company and therefore essential to facilitating the exercise of shareholder rights and shareholder engagement.”⁵⁶

http://ec.europa.eu/internal_market/company/docs/shareholders/consultation_en.pdf at 17. On “share blocking” as a practice see Chapter 2, above at pp 37-38.

⁵⁴ Zetsche (n 52) at 317 (“It is foreseeable that what precisely is proportionate to identify shareholders will be the subject of intense debate.”) It appears this “intense debate” has not materialised since the SRD.

⁵⁵ Directive 2007/36/ec, articles 8(2) and 12, respectively.

⁵⁶ SRD2, Recital 4.

This obstacle to engagement has been dealt with in detail above and the solution in the SRD2 is to give a remedy for companies who want to identify their shareholders. As described in Chapter 2, Article 3a gives companies the right to request identification of shareholders owning at least 0.5% of the company's shares or voting rights.⁵⁷ It is the 0.5% threshold that has been focused upon by critics who argue that the identification provisions in Article 3a counterproductively act as an impediment to shareholder engagement.⁵⁸ As noted, the transposition into Irish law did not include this 0.5% threshold and so there is no lower limit in Irish law for companies to be able to request identification from shareholders.

Prior to both the SRD and SRD2, the Transparency Directive set certain disclosure requirements for ownership.⁵⁹ In particular, Article 9 of the latter Directive requires disclosure to the issuer company of any acquisition or disposal of shares that attach voting rights of 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%.⁶⁰ This disclosure must be made "as soon as possible, but not later than four trading days".⁶¹ This was implemented in Irish law by the Transparency (Directive 2004/109/EC) Regulations 2007.⁶² While shareholder identification and ownership disclosure have different goals, the effect is the same from the perspective of those arguing that these transparency regulations will impede shareholder engagement.⁶³ This is much tighter than US requirement, in terms of the timeframe within which disclosure must be made. Regulation 13D requires that ownership disclosure be made to the issuer company within at least 10 days of accumulating 5% of voting shares.

iii. Shareholder identification and ownership disclosure as an impediment to engagement

As noted, shareholder identification can theoretically improve the ability of shareholders to engage, by allowing companies to identify with whom they should be engaging. There are many forms of engagement, one of the most controversial of which is shareholder

⁵⁷ SRD2, Article 3a(1). See Chapter 2, above at pp 68-69.

⁵⁸ See, for example, Alessio M Paces, 'Hedge Fund Activism and the Revision of the Shareholder Rights Directive' (2017) ECGI Law Working Paper No 353/2017 1..

⁵⁹ Directive 2004/109/EC, transposed into Irish law by SI No. 277/2007 - Transparency (Directive 2004/109/EC) Regulations 2007 as amended by S.I. No. 336/2017 - Transparency (Directive 2004/109/EC) (Amendment) Regulations 2017.

⁶⁰ Directive 2004/109/EC, Article 9(1).

⁶¹ Directive 2004/109/EC, Article 12(2).

⁶² In particular, see SI No. 277/2007 - Transparency (Directive 2004/109/EC) Regulations 2007, Regulation 21(3)(a).

⁶³ Paces (n 58) at 19.

“activism”. This form of engagement is frequently undertaken by hedge funds and so the term “hedge fund activism” is used to describe this kind of shareholder engagement.⁶⁴ Hedge funds have been described in greater detail above and, as was noted, not all hedge funds are activists, nor are all shareholder activists hedge funds.⁶⁵ It is clear however that hedge funds activism as an “offensive” form of activism falls within the conception of “engagement” within the SRD2. Hedge funds activism typically will involve intensive dialogue, for example, as a precursor to engagement with other shareholders to form “wolf packs”. Often hedge funds will seek to have a nominee placed onto the board of a target company, or at least to remove existing management. Hedge fund activism describes an investment strategy that involves intense engagement with a target company, usually on the basis of a short-term investment⁶⁶ (although there is disagreement about whether this leads to long term destruction of value in relation to the target company⁶⁷). Rational apathy can be overcome by holding a larger stake in the company, since shareholders with larger stakes will benefit proportionally from the rewards of engagement.⁶⁸ A key feature of hedge fund activism therefore involves building up a “toehold” investment in the target company

⁶⁴ Some examples include Paces, 'Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance' ; Cheffins and Armour, 'The Past, Present, and Future of Shareholder Activism by Hedge Funds' ; John Armour and Brian Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' (2012) 14 *The Journal of Alternative Investments* 17; Thomas W Briggs, 'Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis' (2007) 32 *Journal of Corporation Law* 681; Katelouzou, 'Worldwide Hedge Fund Activism: Dimensions and Legal Determinants'; Houman B Shadab, 'Hedge Fund Governance' (2013) 19 *Stanford Journal of Law, Business and Finance* 141.

⁶⁵ See Chapter 1 at pp 20-21.

⁶⁶ Shadab (n 64) at 147.

⁶⁷ See Iman Anabtawi and Lynn Stout, 'Fiduciary Duties for Activist Shareholders' (2008) 60 *Stanford Law Review* 1255 at 1292 (“it is possible that many activists are using their influence to push for corporate transactions that will provide them with a personal benefit—a higher stock price in the short term—while providing no benefit, or even harming, longer-term shareholders.”); Martijn Cremers, Erasmo Giambona, Simone M Sepe and Ye Wang 'Hedge Fund Activism and Long-Term Firm Value' (2015) SSRN at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693231 ; Lucian A. Bebchuk, Alon Brav and Wei Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 *Columbia Law Review* 1085.

⁶⁸ Shleifer and Vishny, 'Large Shareholders and Corporate Control'; Danny Miller and Isabelle Le Breton-Miller, 'Family Governance and Firm Performance: Agency, Stewardship, and Capabilities' (2006) 19 *Family Business Review* 73 at 100 (“...the returns to monitoring decrease and free-rider problems increase with the number of nonmanager shareholders”); Ang, Cole and Lin, 'Agency Costs and Ownership Structure'; John C Coffee, 'The Future as History: The prospects for global convergence in corporate governance and its implications' (1999) 93 *Northwestern University Law Review* 641 at 641-642 (“in-depth studies of individual countries show that shareholder activism increases in direct proportion to ownership concentration.”)

before the engagement.⁶⁹ Although this is not always the case,⁷⁰ the absence of an initial toehold stake in a target company will reduce the expected benefits of activism.⁷¹

The targeting of a company by an activist or activists will almost always result in a sharp rise in the share price of the target company.⁷² If a hedge fund is to accumulate a toehold before commencing its activist strategy, it generally must do so undetected. Otherwise, the price of the target's shares will rise to a level that makes the purchase of a toehold prohibitively expensive. This need for opacity is the reason that transparency provisions involving shareholder identification and ownership disclosure operate as an impediment to hedge fund activism. As Paces puts it: "Activists' business model is fundamentally based on the purchase of undervalued stock... while the market is still in the dark about the hedge fund's intentions. Thus, the obvious way to undermine activism is to reduce the size of the toehold that can be purchased profitably."⁷³

With respect to the provisions of the SRD2, it is possible that Article 3a will not have the adverse impact that might be predicted from the above discussion. Paces argues that the impact of the SRD2 on hedge fund activism "will probably not be dramatic"⁷⁴ since hedge funds may be able to get around the strict 0.5% threshold for disclosure, where requested by a company, by investing through multiple corporate vehicles.⁷⁵ This will depend on how Member States implement Article 3a and in Ireland, hedge funds will not be able to use this tactic to avoid identification. Some Member States may also choose to prohibit this tactic by requiring disclosure of dealings with related entities. As well as this, whether or not shareholders are identified will depend on whether the issuer company uses its right under Article 3a to seek identification. A hedge fund may accumulate a larger stake than 0.5% undetected, provided the company never triggers this right. Where a company does identify an activist who has accumulated a stake over 0.5%, they may not necessarily

⁶⁹ 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 at 902-903.

⁷⁰ Katelouzou (n 64) at 800-801; Thomas H Noe, 'Investor Activism and Financial Market Structure' (2002) 15 *The Review of Financial Structures* 289 at 307-308.

⁷¹ Gilson and Gordon (n 69) at 904.

⁷² Alon Brav and others, 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (2008) 63 *The Journal of Finance* 1729 at 1755-1757; April Klein and Emanuel Zur, 'Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors' (2009) 64 *The Journal of Finance* 187 at 207-211; Bebchuk, Brav and Jiang (n 67) at 1121-1122.

⁷³ Paces (n 64) at 29.

⁷⁴ Paces (n 58) at 23.

⁷⁵ *Ibid* at 20.

disclose this to the wider market (although it may be in their interests to do so where the activist threatens to replace existing managers or pursue some other hostile agenda).

Gilson and Gordon point to ownership disclosure in the UK and EU and predict that thresholds for disclosure as low as 3% in the UK⁷⁶ would lead to a situation whereby “the activist sector would shrink, fewer firms would be identified as targets for strategic initiatives, and the activists would reduce costly campaign efforts.”⁷⁷ Irish rules also specifies a disclosure obligation where a shareholder attains or disposes of a 3% ownership stake of an Irish PLC.⁷⁸ Other Member States set their disclosure threshold lower with Italy for example requiring disclosure at 2% ownership.⁷⁹ The four day limit for disclosure after the threshold has been triggered is also important. Where the activist has a longer period before disclosure is required, they can build up a more significant toehold more cheaply and thereby improve their financial position ahead of their campaign.

Irish company law also gives PLCs a right to conduct inquiries into their share ownership. Section 1062 of the Companies Act 2014 gives a PLC the power to require by notice in writing “a person whom the PLC knows or has reasonable cause to believe to be, or at any time during the 3 years immediately preceding the date on which the notice is issued, to have been, interested in shares comprised in the PLC's relevant share capital” to confirm an interest, indicate where there is no interest and provide further details on any interest the person may have in the company's shares.⁸⁰ The PLC is entitled to the particulars of the interest a person may have or have had in the company's shares.⁸¹ Particulars of interest can include the identity of persons holding an interest in the shares, which encompasses the interests of spouses, minor children and associated companies of persons.⁸² Failure to comply with such a notice from a PLC may give rise to restrictions on the transfer and voting rights of the shares, as well as a possible criminal conviction.⁸³ If members

⁷⁶ FCA Disclosure and Transparency Rules, Rule 5.1.2(1).

⁷⁷ Gilson and Gordon (n 69) at 904.

⁷⁸ Central Bank Transparency Rules, November 2015, Rule 7.1.

⁷⁹ See Luca Enriques and Matteo Gatti, 'Creeping Acquisitions in Europe: Enabling Companies to be Better Safe than Sorry' (2015) 15 *Journal of Corporate Law Studies* 55 at 74.

⁸⁰ Companies Act 2014, s 1062(1). “Relevant share capital” here means any issued shares carrying rights to vote in all circumstances at general meetings of the company, see Companies Act 2014, s 1047(1).

⁸¹ Companies Act 2014, s 1062(2).

⁸² See Thomas B Courtney, *The Law of Companies* (4th ed, Bloomsbury, 2016) at para 31.111.

⁸³ Respectively, Companies Act 2014, s 1066(1) (allowing the PLC to apply to the High Court for restrictions under s 768), s 1066(3) (providing for a category 3 offence for failure to comply with a s 1062 notice, with s 1066(4) setting out a defence that the notice was frivolous or vexatious).

representing at least 10% of the PLC's voting rights so requisition it, the PLC must conduct an investigation into its share ownership and prepare a report after the conclusion of the requisitioned investigation.⁸⁴ It is submitted that these legislative powers could be used where a company is seeking to undermine a hedge fund activist campaign of which it is the target. Though the powers under s 1062 cannot be used to gain an advantage in a takeover bid,⁸⁵ they may be used to try to establish whether a takeover bid is imminent.⁸⁶ As described, the very exercise of transparency may thwart a hedge fund activist's attempt to build up a toehold in order to make the activist campaign cost effective.

Gilson and Gordon note an apparent irony in the EU and UK's position to seek to encourage greater shareholder engagement while simultaneously creating disclosure requirements that may discourage hedge fund activism.⁸⁷ According to them, these disclosure requirements will work counterproductively and reduce overall engagement. They argue that institutional investors are not actually "rationally apathetic" in the terms outlined above, but are instead "rationally reticent."⁸⁸ What this means is that institutional investors will tend not to initiate a governance question, due to the costs of so initiating, but will respond where such a question is initiated by another shareholder.⁸⁹ Hedge fund activists are the shareholders, according to Gilson and Gordon, who are specialised in creating proposals for other shareholders to vote on. As they put it:

"Activist investors specialize in monitoring portfolio company strategy and formulating alternatives when appropriate for presentation to the institutional investors; in turn, institutional investors specialize in portfolio management and in evaluating proposals presented by activist investors."⁹⁰

In this way, hedge fund activists "potentiate institutional voice."⁹¹ This argument assumes that hedge fund activism is, by and large, the only form of engagement that is viable. Otherwise, these transparency provisions would not constitute an impediment to

⁸⁴ Companies Act 2014, ss 1064, 1065.

⁸⁵ See *Re Ricardo Group Plc (No 2)* [1989] BCLC 766, as cited in Courtney (n 81) at par 31.108.

⁸⁶ *Re TR Technology Investment PLC* [1988] BCLC 256, as cited in *ibid*.

⁸⁷ Gilson and Gordon (n 69) at 905-906.

⁸⁸ *Ibid* at 867.

⁸⁹ *Ibid* at 887-888.

⁹⁰ *Ibid* at 897.

⁹¹ *Ibid* at 867.

shareholder engagement *per se* but would only impede engagement by one particular kind of shareholder: activists. This may be perfectly reasonable from the perspective of financial regulators, as they may wish to encourage particular kinds of engagement from particular shareholders and discourage others. Specifically, it is clear that both the EC and Financial Reporting Council wish to encourage engagement for the “long term” by “long term” shareholders and discourage “short termism” in all its forms.⁹² As Madsen puts it, the EC seeks to encourage the “right” kind of activism, implying the existence of a “wrong” kind in relation to the SRD2.⁹³ Hedge fund activists have been accused widely of inculcating short termism in capital markets.⁹⁴ This criticism is based on different but interrelated accusations against hedge fund activists, including that they have short term investment horizons, that their goal is to raise the share price of a target company in the short term in order to sell and that hedge fund activists’ tactics tend to focus on short term changes to target companies, such as cutting of research and development, employees and increased wealth transfers to shareholders.⁹⁵ While the empirical evidence is decidedly mixed on whether hedge fund activists actually contribute to or cause short termism,⁹⁶ it is conceivable that both the UK and EU seek to exclude this kind of shareholder on the basis of these concerns but include shareholders with a longer term investment horizon.

Paces responds to the above argument by describing institutional investor engagement without activists as a “myth”.⁹⁷ He argues that the EU has made a “mistake” by assuming “that hedge funds activism is always detrimental for efficiency.”⁹⁸ He also notes that Gilson and Gordon explain that the institutional investors’ business model does not incentivise them to be proactive, but they can be reactive to hedge fund activism.⁹⁹ However, as noted, Paces does not think that the identification provisions in the SRD2 will have the effect of

⁹² See Chapter 2, above at p 60.

⁹³ Marina B Madsen, 'Promoting the 'Right' Kind of Ownership: The Good, the Bad, and the Passive' (2018) 29 European Business Law Review 143.

⁹⁴ William W Bratton and Michael L Wachter, 'The Case Against Shareholder Empowerment' (2010) 158 University of Pennsylvania Law Review 653 at 682 (“[Activist hedge funds] are impatient shareholders, who look for value and want it realized in the near or intermediate term.”); Anabtawi and Stout (n 66) at 1290-1292; Martin Lipton, “Further Recognition of the Adverse Effects of Activist Hedge Funds,” Harvard Law School Forum on Corporate Governance and Financial Regulation, 13 April 2015.

⁹⁵ These arguments are summarised in Grace Lee Mead, 'Two New Tools for Addressing Activist Hedge Funds: Sunlight Bylaws and Reciprocal Disclosures' (2016) 21 Fordham Journal of Corporate and Financial Law 479 at 491-492; Bebchuk, Brav and Jiang (n 67) at 1093-1095.

⁹⁶ This question is beyond the scope of this thesis, since the EC do not directly implicate hedge fund activists in the short termism they identify. See, however, on one side of the debate see Bebchuk, Brav and Jiang (n 67) and on the other, see Cremers, Giambona, Sepe and Wang (n 67).

⁹⁷ Paces (n 58) at 20-23.

⁹⁸ Ibid at 22.

⁹⁹ Ibid at 21.

stifling hedge fund activism.¹⁰⁰ What could occur is that hedge fund activism may become marginally more costly as activists seek to cloak their toehold purchase through creative means.¹⁰¹ However, it is submitted that the shareholder identification provisions in Article 3a give target companies an important weapon against hedge fund activists, where being the target of an activist campaign is unwelcome, which it often is. This weapon can be wielded to increase the costs of activism and thereby to deter it as a practice.

The position inherent within the arguments of Paces, Gilson and Gordon that institutional investors will not be proactive in engagement and will only act reactively to activists is challengeable. Other kinds of shareholders that have none of the characteristics of hedge funds have been known to generate governance proposals. These “activists” do not necessarily have a short term time horizon and do not rely on building a toehold in order to maximise their returns. One example is large pension funds, some of whom are known for intervening extensively in the affairs of investee companies. The California Public Employees' Retirement System (CalPERS) has been well known for decades for its active role in corporate governance.¹⁰² CalPERS is a large public pension fund, which would likely not be concerned with triggering shareholder identification or ownership disclosure provisions since opacity does not play a role in its activism. As Roberta Romano observed in 1993: “Public funds have, in fact, been more active than other institutional investors in corporate governance over the past few years, offering shareholder proposals and engaging in other highly publicized activities to influence management actions.”¹⁰³ This form of activism can be characterised as “defensive”, because it is designed to protect or maintain an existing position with a company, which contrasts with the “offensive” activism displayed by hedge fund activists.¹⁰⁴ Defensive activism is less visible than offensive activism but is initiated typically by long term shareholders who already have a stake in the company.¹⁰⁵ While defensive activism is reactive, it is initiated usually behind the scenes

¹⁰⁰ See above, at p 129.

¹⁰¹ See Paces (n 58) at 20.

¹⁰² Coffee noted that as of 1989, CalPERS had sponsored 28 shareholder proposals, see John C Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277 at 1294 (n 56 in his text); Bruce E Aronson, 'A Japanese Calpers or a New Model for Institutional Investor Activism - Japan's Pension Fund Association and the Emergence of Shareholder Activism in Japan' (2011) 7 NYU Journal of Law and Business 571 at 596-598.

¹⁰³ Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered' (1993) 93 Columbia Law Review 795 at 797.

¹⁰⁴ See Chapter 1, above at p 20 for a more detailed discussion of this distinction.

¹⁰⁵ See *ibid*; Andreas Jansson, 'No Exit!: The Logic of Defensive Shareholder Activism' (2014) 10 Corporate Board: role, duties and composition 16 at 20; Cheffins and Armour (n 64) at 56 (“The key feature that makes activism “defensive” is that the shareholder or shareholders taking the initiative will have held a sizeable stake before stepping forward.”)

and not necessarily in the presence of offensive shareholder activists.¹⁰⁶ The existence of defensive activism rebuts the argument that hedge fund activism is the exclusive initiator of shareholder engagement.

Shareholder identification provisions are interesting in the sense that they may operate to both facilitate and impede shareholder engagement simultaneously. Ownership disclosure can operate in the same way. Arguably, these transparency measures operate to impede one kind of engagement, that undertaken by hedge fund activists. Commentators mentioned above argue that hedge fund activism is the only viable approach to engagement, since activists specialise in producing governance proposals to which other institutional investors can react.¹⁰⁷ From their point of view, all engagement in reality begins with these activists. Therefore, attempts to engage shareholders, as in the SRD2 and SC, accompanied by ownership transparency measures is likely, according to these commentators, to have a counterproductive effect. However, for the reasons outlined above, this argument can be challenged. As well as this, it is not clear that all transparency measures will necessarily defeat hedge fund activism. They may merely increase the costs of activism and consequently decrease how much activism could occur. However, even if hedge fund activism is defeated, this will not necessarily lead to the discouragement of other forms of engagement. It is arguable that there are no circumstances that the identification provisions of the SRD2 can be relied upon to explain non-compliance with any elements of Article 3g. Article 3g does not contemplate that hedge fund activism potentiates institutional investor voice and so it is not conceivable that any institutional investor or asset manager may rely on an absence of hedge fund activism among its investee companies as an explanation for non-compliance.

D. Market Abuse Regulation

i. Introduction

The EU Market Abuse Regulation (MAR)¹⁰⁸ replaced the Market Abuse Directive¹⁰⁹ in 2014, prohibiting certain market activities. The MAR is specifically designed to prevent

¹⁰⁶ See Joseph A McCahery, Zacharias Sautner and Laura T Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' (2016) 71 *Journal of Finance* 2905.

¹⁰⁷ See above at pp 126-131.

¹⁰⁸ Regulation (EU) No 596/2014 [hereafter "MAR"].

¹⁰⁹ Directive 2003/6/EU.

insider dealing, the unlawful disclosure of inside information and market manipulation. Like other potential legal impediments to engagement, the MAR has the potential to impede very specific forms of engagement. In particular, private dialogue between shareholders and directors, which is distinct from other forms of engagement such as collective action or voting at general meetings, may be deterred or rendered less effective by certain provisions of the MAR. Such dialogue is covered by MAR on the basis that there is a possibility that “inside information” will be disclosed during a private dialogue. However, as Recital 19 of the MAR outlines, the objective of the Regulation is not to deter dialogue. It states:

“This Regulation is not intended to prohibit discussions of a general nature regarding the business and market developments between shareholders and management concerning an issuer. Such relationships are essential for the efficient functioning of markets and should not be prohibited by this Regulation.”¹¹⁰

Nonetheless, the restrictions and penalties of the MAR represent risks for both companies and shareholders that may deter the engagement of private dialogues. This is especially important because, as noted, private “behind the scenes” dialogues have been identified as being the most effective and preferred means of engagement for many shareholders.¹¹¹

Legitimate search efforts by shareholders seeking to find out “hidden” information regarding investee companies may be deterred. These search efforts can involve seeking out “tips” from those with knowledge of a company or intensive research efforts which may reveal information to which general public does not have access.¹¹² As will be seen, the provisions of the MAR are very broad and would prohibit the use of any information discovered in this way, thereby deterring such search efforts.

ii. The rules of the MAR

¹¹⁰ MAR, Recital 19.

¹¹¹ McCahery, Sautner and Starks (n 106).

¹¹² Importantly, these efforts cannot include the theft or misappropriation of information by a shareholder, since this action is illegal.

The MAR and its predecessor, the Market Abuse Directive,¹¹³ were designed to prevent trading on inside information and market manipulation. The aim of preventing both of these practices is guided by the principle of equal treatment of shareholders. This principle is located across several EU Directives, including the SRD,¹¹⁴ the 2004 Transparency Directive,¹¹⁵ the Second Company Law Directive¹¹⁶ and the Takeover Bids Directive.¹¹⁷ Each of the equal treatment provisions in these Directives emphasises not simply equal treatment but equal treatment of shareholders “who are in the same position.” What this means is that larger shareholders can take precedence over smaller shareholders in certain circumstances, including engagement. As Strampelli has argued that “it is reasonable to assume that, under European company and financial markets law, major shareholders are not be considered to be in the same position as retail investors with minimal holdings, and the directors should be allowed to engage in dialogue with selected relevant shareholders.”¹¹⁸ During an engagement by an institutional investor, there is a risk that “inside information” may be disclosed, either intentionally or accidentally and this will trigger the provisions of the MAR, which, as will be described, can have serious commercial consequences, as well as possible criminal implications.

“Inside information” is defined in the MAR in the following way:

“information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments”¹¹⁹

¹¹³ Directive 2003/6/EU.

¹¹⁴ Directive 2007/36/EC, Article 4.

¹¹⁵ Directive 2004/109/EC, Article 17(1).

¹¹⁶ Directive 2012/30/EU, Article 46.

¹¹⁷ Directive 2004/25/EC, Article 3(1)(a).

¹¹⁸ Giovanni Strampelli, 'Knocking on the Boardroom Door: A Transatlantic Overview of Director-Institutional Investor in Law and Practice' (2018) 12 Virginia Law and Business Review 187 at 223.

¹¹⁹ MAR, Article 7(1)(a).

From a practical perspective, the most important aspect of this definition is the price sensitivity of the information conveyed.¹²⁰ The MAR elaborates on the meaning of information that, if made public, would be likely to have a significant effect on prices by setting a “reasonable investor” test. Article 7(4) outlines that information will have a “significant effect” on prices if a “reasonable investor” would use the information as a basis upon which to make investment decisions.¹²¹ Both the High Court and Supreme Court in Ireland have examined the “reasonable investor” test, although under a slightly different legislative context, the Companies Act 1990 (the “1990 Act”), in *Fyffes plc v DCC plc and Others*.¹²² This was a civil case taken by Fyffes seeking damages against DCC and two of its subsidiaries for insider dealing. The relevant information were several trading reports which suggested that Fyffes’ financial results would likely fall below analyst expectations. Jim Flavin, who was CEO of DCC, which was a major shareholder of Fyffes and a non-executive director of Fyffes, had access to these trading reports by virtue of this latter role. DCC sold off its shares in Fyffes in three tranches prior to the information in the trading reports being made available to shareholders and the public. When this information became public, Fyffes’ share price dropped substantially. The main defence of DCC was that the information contained in the trading report did not constitute inside information.¹²³

¹²⁰ The meaning of “precise nature” is elaborate on in article 7(2) in the following way: “information shall be deemed to be of a precise nature if it indicates a set of circumstances which exists or which may reasonably be expected to come into existence, or an event which has occurred or which may reasonably be expected to occur, where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instruments or the related derivative financial instrument, the related spot commodity contracts, or the auctioned products based on the emission allowances.” This aspect of the MAR can provide difficulties, such as in the Greek Supreme Court case of Case 317/2014 in which the decision to delay information regarding an acquisition was considered to be insufficiently precise to have breached articles 6(2) and (3) of the Market Abuse Directive 2003/6/EU. See Panagiotis Staikouras, 'Dismantling the EU insider dealing regime: the Supreme Court of Greece's muddled interpretation of “inside information” (2015) 9 Law and Financial Markets Review 210.

¹²¹ MAR, Article 7(4).

¹²² *Fyffes plc v DCC plc and Others* [2009] 2 IR 417. The legislative context that was in force for this case was Part V of the Companies Act 1990 and the Market Abuse Directive, 2003/6/EC. While the Companies Act 2014 repeals the Companies Act 1990 in its entirety, the commencement order enacting the 2014 Act excludes Part V of the 1990 Act, which continues to be in force. See SI No. 169/2015 - Companies Act (Commencement) Order 2015. The Investment Funds, Companies and Miscellaneous Provisions Act 2005, s 31 repealed Part V of the 1990 Act “but only for the purpose of repealing the enactments specified in that section in so far as they relate to a regulated market (within the meaning of Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003) operated by a recognised stock exchange within the meaning Part V of the Companies Act 1990.” See SI No. 323/2005 - Investment Funds, Companies and Miscellaneous Provisions Act 2005 (Commencement) Order 2005. Hutchinson noted in 2016 that the full repeal of Part V was “imminent” following the implementation of the MAR, but at the time of writing this has not occurred. See G Brian Hutchinson, *Keane on Company Law* (5th ed, Bloomsbury, 2016) at 613.

¹²³ Hutchinson (n 122) at 618, par 34.17.

In the High Court, Laffoy J held that the plaintiff had failed to show that the trading reports constituted inside information. The reasoning behind this decision centred on both the “reasonable investor” test and other market information regarding Fyffes. At the time, Fyffes was exploring an internet venture called World-of-Fruit.com and the market had been responding very favourably to companies with internet ventures. In interpreting the reasonable investor test, Laffoy J made the following remarks:

“It seems to me that, if the concept of the reasonable investor is to be meaningful in assessing objectively whether the availability of the November and December Trading Reports was likely to materially affect the Fyffes share price, it must represent the type of investor who was typically found in the market at the time. If that investor, on the evidence, was one who was anxious to own internet stocks or stocks with an internet element, the likely consequences of such predilection are a relevant factor.”¹²⁴

Laffoy J weighed up the impact on the reasonable investor of the trading reports and the “dotcom mania” that she identified in the market. On this basis, she concluded that the plaintiff had not proven that the trading reports would not have materially affected the price of Fyffes’ shares, and it was therefore not inside information. This conclusion was overturned on appeal to the Supreme Court. Denham J, along with the four other judges in the Supreme Court, rejected the application of the reasonable investor test entirely, since it had no basis in either the 1990 Act or the Market Abuse Directive, both of which regulated the area of inside information at the time.¹²⁵ However, Article 7(4) of the MAR introduces the test specifically and so the further obiter elaboration on the test is worth setting out. Denham J went on to assert that Laffoy J had erred in “offsetting” the information in the trading reports with other factors (the internet venture). The Supreme Court approached the reasonable investor test more broadly than Laffoy J in the sense that the judgments that interpreted the test focused not on the profile of one reasonable investor, but on the market more generally. As Finnegan J said:

¹²⁴ [2009] 2 IR 417 at 584.

¹²⁵ [2009] 2 IR 417 at 703 (“I am satisfied that the reasonable investor test does not apply, nor is ‘the reasonable investor’ an appropriate approach in construing s.108(1) of the Act of 1990.”) and at 715 (“The ‘reasonable investor’ approach does not apply in this jurisdiction, it is not a principle to be found in Irish law.”)

“In my view the [reasonable investor] test is to be derived directly from the statute – if the information that is not generally available, if it were generally available, would it be likely materially to affect the share price. The test is directed to the market effect and not the conduct of a hypothetical reasonable investor.”¹²⁶

Again, although clearly rejecting the application of a reasonable investor test, the Supreme Court’s judgment in *Fyffes* helps guide an understanding of how the reasonable investor test under the MAR would be applied, and therefore the understanding of the meaning of “inside information.” Blanaid Clarke has argued that the Supreme Court’s formulation of the reasonable investor is consistent with Directive 2003/124, which is an implementing Directive under the Lamfalussey process, and contains a statement on the reasonable investor test¹²⁷ because “both focus on the question: would the reasonable investor be likely to use the information as part of the basis of his investment decision?”¹²⁸

Article 14 of the MAR prohibits the unlawful disclosure of inside information.¹²⁹ What “unlawful disclosure of inside information” means is specified in Article 10 which states that it arises where a person possesses inside information and discloses it to any third party other than in the normal exercise of an employment, a profession or duties.¹³⁰ The Court of Justice of the European Union has ruled that this exception must be interpreted strictly and that there must be a “close link” between the disclosure and the exercise of employment, profession or duties.¹³¹ The person who has made the disclosure must have been aware, or ought to have been aware, that the information was inside information in order for the disclosure to be unlawful.¹³²

¹²⁶ [2009] 2 IR 417 at 770.

¹²⁷ Directive 2003/124/EC.

¹²⁸ Blanaid Clarke, 'Insider dealing: getting under the skin of *Fyffes v DCC & Others*' (2009) 1 *Journal of Business Law* 68 at 77.

¹²⁹ MAR, Article 14(c).

¹³⁰ MAR, Article 10(1).

¹³¹ Case C-384/02 *Criminal proceedings against Knud Grøngaard and Allan Bang* (2005) ECR I-9939 at par 31.

¹³² Chiara Mosca in Marco Ventoruzzo and Sebastian Mock, eds, *Market Abuse Regulation: Commentary and Annotated Guide* (Oxford University Press, 2017) at 278.

Where a person possesses inside information and acquires or disposes of a financial instrument to which the information relates, they are “insider dealing.”¹³³ This will include any shareholder who has come into possession of the inside information through an engagement with a company. Article 8 of the MAR provides for a broad set of circumstances in which a person can possess inside information for the purposes of insider dealing, including having capital in an issuer company or otherwise and where the person doing the dealing knows or ought to know the information is insider information.¹³⁴ Article 10 sets out that it is unlawful to disclose inside information to any other person “except where the disclosure is made in the normal exercise of an employment, a profession or duties.”¹³⁵ Article 14 prohibits insider dealing and attempts at insider dealing, recommendations or inducements for another to engage in insider dealing.¹³⁶

Article 17 of the MAR provides for mandatory disclosure for inside information on the part of issuer companies. Issuers must disclose all inside information that directly concerns that issuer as soon as possible.¹³⁷ Allowances are made certain for certain issuers, such as a credit or financial institution, who are permitted to not disclose inside information where disclosure entails a risk of undermining the stability of the issuer and financial system, where it is in the public interest to delay the disclosure, where the confidentiality of the information cannot be ensured or where the competent regulatory authority has consented to a delayed disclosure.¹³⁸ This provision also places an onus on issuer companies who have disclosed inside information to a third party, which could include an engaging investor, in the normal course of the exercise of an employment, profession or duties as per Article 10, to promptly make a complete and effective public disclosure of the information.¹³⁹ The Article 17 obligations do not apply where the person receiving the information owes a duty of confidentiality.¹⁴⁰ However, where such a person receives inside information, they may not trade on the basis of that information.¹⁴¹ This is a significant commercial consequence for any asset manager that manages active funds.¹⁴² Many mutual funds have liquidity requirements that mean they must remain free to trade asset classes in their portfolio.

¹³³ MAR, Article 8(1).

¹³⁴ MAR, Article 8(4).

¹³⁵ MAR, Article 10(1).

¹³⁶ MAR, Article 14.

¹³⁷ MAR, Article 17(1).

¹³⁸ MAR, Article 17(5)(a)-(d).

¹³⁹ MAR, Article 17(8).

¹⁴⁰ MAR, Article 17(8).

¹⁴¹ MAR, Article 8; Strampelli (n 118) at 216.

¹⁴² As opposed to passively managed funds, which track a benchmark index.

Article 30 sets out administrative sanctions for breaches of the MAR. This provision empowers competent national authorities to take appropriate administrative sanctions in respect to infringements of certain articles, including the mandatory disclosure provision of Article 17(1).¹⁴³ While Article 30 does not cover insider dealing in Article 8, Irish national law that gives full effect to the MAR sets out extensive penalties for infringements, including of insider dealing. Regulation 10 of the European Union (Market Abuse) Regulations 2016 sets out criminal sanctions for infringements including insider dealing, unlawful disclosure of inside information, market manipulation and market abuse occurring outside the State.¹⁴⁴ These Regulations specify that the Central Bank of Ireland is the competent authority in Ireland for enforcement of the Regulations.¹⁴⁵ Under the Regulations, each of these practices constitutes an offence and the penalties set out are as follows: (a) on summary conviction to a class A fine or imprisonment for a term not exceeding 12 months or both, or (b) on conviction on indictment to a fine not exceeding €500,000 or imprisonment for a term not exceeding 3 years or both.¹⁴⁶ The Central Bank is also empowered under the Regulations to impose sanctions in respect of particular provisions of the MAR.¹⁴⁷ Regulation 41(1) empowers the Central Bank to impose different sanctions for certain contraventions, depending on whether the person guilty of the contravention is a natural or legal person. In order to be found “guilty” of the contravention, the Central Bank is empowered to appoint an assessor where they have reason to believe a specified contravention has occurred.¹⁴⁸ In order to avoid duplication, these fines cannot be imposed by the Central Bank where the assessee has been found guilty of committing an offence under the Regulations or an offence under section 1368 of the Companies Act 2014, which creates a penalty for conviction under Irish market abuse law of a fine not exceeding €10,000,000 or imprisonment of not more than 10 years.¹⁴⁹ The sanctions the Central Bank is empowered to impose include:

¹⁴³ MAR, Article 30(1) specifies 14 and 15, Article 16(1) and (2), Article 17(1), (2), (4) and (5), and (8), Article 18(1) to (6), Article 19(1), (2), (3), (5), (6), (7) and (11), Article 20(1) and Article 23(2).

¹⁴⁴ SI No. 349/2016 - European Union (Market Abuse) Regulations 2016, Regulation 10.

¹⁴⁵ SI No. 349/2016, Regulation 3.

¹⁴⁶ SI No. 349/2016, Regulation 10.

¹⁴⁷ SI No. 349/2016, Regulation 41. These provisions correspond with those specified in MAR, Article 30(1).

¹⁴⁸ See SI No. 349/2016, Regulation 35.

¹⁴⁹ SI No. 349/2016, Regulation 47(2).

- a) a direction ordering the assessee to cease the prescribed contravention and to take such measures as are necessary to prevent a repeat of the prescribed contravention;
- (b) the disgorgement of the profits gained or losses avoided due to the prescribed contravention insofar as they can be determined;
- (c) a private caution or reprimand;
- (d) a public warning that identifies the assessee and the nature of the prescribed contravention;
- (e) withdrawal and suspension of the authorisation of any regulated financial service provider;
- (f) a direction disqualifying the assessee from being concerned in the management of, or having a qualifying holding in, any regulated financial service provider for such time as is specified in the order.¹⁵⁰

In respect of the unlawful disclosure of inside information, which is prohibited by Article 14 of the MAR, the Central Bank can order a natural person to pay up to €5,000,000 and a legal person up to €15,000,000 or 15% of their annual turnover.¹⁵¹ Where there are repeated contraventions of Article 14, the Central Bank can permanently disqualify an assessee from managing or having a qualified holding in any regulated financial service provider.¹⁵² Regarding a breach of the mandatory disclosure of inside information requirement under article 17, the Central Bank can impose a fine of €1,000,000 in respect of a natural person and, in respect of a legal person, €2,500,000 or 2% of annual turnover.¹⁵³

iii. The MAR as an impediment to engagement

The extent to which the provisions of the MAR can be considered a realistic impediment to shareholder engagement with regard to shareholder director dialogue can be broken up into three questions: 1) what is the risk that inside information is disclosed during a private dialogue between shareholders and directors, 2) what are the consequences for shareholders and directors if inside information is disclosed and 3) how effectively are the market abuse provisions enforced? If there is a low risk that inside information is passed along to

¹⁵⁰ SI No. 349/2016, Regulation 41(1).

¹⁵¹ SI No. 349/2016, Regulation 41(1)(k)(i) and 41(1)(l)(i) respectively.

¹⁵² SI No. 349/2016, Regulation 41(1)(f).

¹⁵³ These are also the possible sanctions for breaches of Article 16 of MAR.

shareholders during a private engagement, then the provisions of the MAR are unlikely to be triggered and would not present a realistic impediment. If there is a high risk of inside information being passed along, but the consequences of this occurring are not restrictive, costly or punitive in some manner, then the provisions of the MAR may not present a realistic impediment. If there is a high risk of inside information being passed along and the consequences are potentially very serious, but the chances of being caught through the enforcement of the MAR are low, this too will reduce the extent to which the MAR operates as an impediment.

Dealing with the first question, the possibility of inside information being passed from directors to shareholders during the course of an engagement will vary from engagement to engagement. It will depend on the nature of the information, which will not always obviously be “inside information” to either the director or shareholder in dialogue. Hansen uses the example of two CEOs at a business conference having a polite conversation.¹⁵⁴ If this initial conversation leads to a merger or takeover, at what point does the conversation become sufficiently “price sensitive” to require disclosure? This illustrates the fact that very often information may indeed be inside information when viewed in hindsight but it is not always clear contemporaneously when the information becomes sufficiently price sensitive to require disclosure. This possible lack of clarity may inhibit a dialogue, as directors will not wish to inadvertently disclose inside information. Alternatively, the broadness of the definition may increase the chances that inside information is disclosed and trigger the provisions of the MAR. This relates to the second question.

If inside information is disclosed, it will only be considered unlawful disclosure if the director disclosing the information was aware or ought to have been aware that the information was inside information.¹⁵⁵ In light of the penalties for unlawful disclosure of inside information,¹⁵⁶ a director will likely not wish to disclose information that they believe is sufficiently price sensitive. The “ought to have known” aspect of the unlawful disclosure arguably removes a *mens rea* requirement, leading to a possibility that the director is unaware of the quality of the information but negligent in making the

¹⁵⁴Jesper Lau Hansen, 'Say when: When must an issuer disclose inside information?' (2016) University of Copenhagen Faculty of Law Legal Studies Research Paper Series, paper no 2016-28 at 6.

¹⁵⁵ See above p 139.

¹⁵⁶ See above at pp 138-139.

disclosure.¹⁵⁷ This may encourage directors in a dialogue to err on the side of not giving meaningful information. It may be thought that an inadvertent disclosure of inside information may be corrected by an immediate public disclosure under Article 17, but unless the director who has disclosed the information is aware of its price sensitivity or believes it may be price sensitive, they will not know to correct the selective disclosure.

In relation to the third question, it is impossible to compare the number of cases of market abuse that are prosecuted and in which the market abuse regulations are enforced with the cases of market abuse that are not prosecuted because the latter are necessarily not known. Researchers have identified a wide disparity across Europe in how the MAR is enforced.¹⁵⁸ Cumming et al found that detection rates across Europe were noticeably enhanced in countries that had a higher number of supervisors, with more formalized cooperation between legal and supervisory authorities and imprisonment as a deterrent.¹⁵⁹ As noted, imprisonment is an available sanction for breaches of the Irish market abuse law. To date there have been few prosecutions for market abuse in Ireland.¹⁶⁰ The *Fyffes* case is one instance of civil enforcement of the insider dealing provisions. More recently, The Director of Corporate Enforcement alleged that evidence of market abuse had been uncovered in relation to Independent News and Media PLC as part of a wider application to have inspectors appointed to that company.¹⁶¹ The market abuse alleged to have been uncovered in this case was the passing of inside information by company officers to a major shareholder of the company. Inspectors were appointed by the High Court on foot of this application and at the time of writing it remains to be seen if a prosecution will be undertaken.

From the perspective of a shareholder who has received the disclosure, Article 8 prohibits them trading on the information. This restriction may deter shareholders from engaging in a dialogue for fear that some information may be disclosed to them that is price sensitive

¹⁵⁷ See David Moalem and Jesper Lau Hansen, 'Insider Dealing and Parity of Information - Is *Georgakis* Still Valid?' (2008) 19 *European Business Law Review* 949 at 968.

¹⁵⁸ Douglas Cumming, Alexander Peter Groh and Sofia Johan, 'Same rules, different enforcement: Market abuse in Europe' (2018) 54 *Journal of International Financial Markets, Institutions and Money* 130.

¹⁵⁹ *Ibid.*

¹⁶⁰ An example is *DPP v Byrne*, Unreported January 24, 2002 Dublin Circuit Court, in which a director who possessed inside information was acquitted of the charges of insider dealing on the basis that the DPP had been unable to prove the requisite *mens rea* of knowledge that the information was price sensitive. See Clarke (n 128) at 68.

¹⁶¹ See *Director of Corporate Enforcement v Independent News and Media Plc* [2018] IEHC 488.

where their business model requires them to be able to continue to trade. Giovanni Strampelli describes the potential problem that the MAR poses for shareholder engagement as a “double risk.” As he says:

“First, the prohibition in Article 8 of the MAR on trading usually represents an unacceptable burden for active institutional investors, whose business model is based on the ability to trade. Second, under the European market abuse regime, shareholders that engage with directors face the risk of being fined even if they asked not to receive inside information, or if they are not actually aware of having received inside information. Engaging in dialogue with directors could (at least at first glance) turn out to be a dangerous practice for shareholders in Europe.”¹⁶²

However, Strampelli goes on to argue that concerns related to the MAR and shareholder engagement “should not be overstated” because, despite the general nature of the provisions of the MAR, it appears to leave sufficient room for shareholder-director dialogue.¹⁶³ He suggests that directors and shareholders could voluntarily adopt the safeguards that apply to the “market soundings” provisions in order to create a “safer context” for dialogue.¹⁶⁴ Market soundings involve seeking interest in investment in a transaction of some kind and are regulated by Article 11 of the MAR, in order to facilitate them without triggering the provisions that involve inside information and insider dealing. Article 11 contains very particular safeguards. First, those making the market sounding must specifically consider whether the market sounding contains inside information, make a written note of the conclusion of this consideration and make this note available to competent authorities upon request.¹⁶⁵ Second, the person making the market sounding must obtain the consent of the receiver of the information to receive inside information and inform them that they are prohibited from the using the information to trade in any way and must keep the information confidential.¹⁶⁶ Applying the safeguards to shareholder-director dialogues, as Strampelli suggests, prior to the dialogue taking place, the director would have to make a written note of the possibility of inside information being disclosed and inform the shareholder that they must not trade in any way on any such information and

¹⁶² Strampelli (n 118) at 214.

¹⁶³ *Ibid.*

¹⁶⁴ *Ibid* at 219.

¹⁶⁵ MAR, Article 11(3).

¹⁶⁶ MAR, Article 11(5).

keep any such information confidential. There are a number of reasons to doubt that these safeguards facilitate dialogue in the context of the provisions of the MAR.

First of all, the safeguards relating to market soundings do not apply easily to private dialogue between shareholders and directors. Market soundings require very specific information regarding a transaction and so it is easier for directors to analyse whether inside information must be disclosed in order to seek interest in the transaction by investors. With regard to private dialogues, the information that will be discussed may be less specific as it could concern any number of issues that the shareholder wants to address. Second, even if the information in a private dialogue is very specific in nature, shareholders may not wish to be bound to not trade on any information they receive that may constitute inside information, since trading is an important aspect of the business of many institutional investors and asset managers. Simply applying the safeguard may not provide a sufficient protection for a shareholder who may have a greater desire to retain their ability to trade. Third, the application of these safeguards necessarily formalises what would otherwise be an informal discussion about how the company is being managed. It limits the possible direction of a conversation by restricting the shareholder to particular issues that are pre-agreed for the purposes of the initial note taken by the director. It is likely that the attempt to impose the Article 11 safeguards would be ineffective in properly facilitating a dialogue and may deter such dialogue. ESMA are, at the time of writing carrying out a consultation on the MAR and have noted a lack of clarity regarding market soundings.¹⁶⁷ They note a broad definition for a market sounding and that 2an increased number of persons that expressed their wish not to receive the market soundings (included in the relevant list set out in Article 4(2) of CDR 2016/960) may be an indicator of an excessive burden of the regime for those persons receiving the market soundings.”¹⁶⁸

Beyond dialogue, shareholders who seek out information about investee companies through search efforts or “tips” are at risk of being prevented on trading on that information.¹⁶⁹ Since an ability to trade is a necessary element of many institutional investors’ business, the provisions of the MAR may deter or inhibit the ability of such institutional investors seeking out new information about an investee company. Search

¹⁶⁷ ESMA, “Consultation Paper: MAR Review Report”, 3 October 2019, ESMA70-156-1459 at 44-48.

¹⁶⁸ Ibid at 48.

¹⁶⁹ Sergio Gilotta, 'The Regulation of Outsider Trading in EU and the US' (2016) 13 European Company and Financial Law Review 631.

efforts, arguably, should be encouraged, since the more shareholders seeking out information about investee companies, the greater the level of discipline and monitoring that is undertaken. These search efforts, carried out for the purposes of profit making on the part of the shareholder, are thought to have the effect of reducing agency costs of management by revealing wrongdoing.¹⁷⁰ Where a shareholder discovers inside information through legitimate searching, they are prohibited from trading under the MAR. For instance, if a shareholder is tipped off by an ex-official of a company about accounting fraud in the company, the shareholder would be prohibited from using that information as the basis of trading.¹⁷¹ This means there is little incentive for shareholders to seek out “hidden” inside information in order to profit from it. Since these search efforts constitute a form of engagement, the effect of the MAR clearly has a deterrent effect in terms of this kind of engagement.

It is difficult to know to what extent the provisions of the MAR constitute an impediment to engagement. The nature of a private dialogue is such that it is difficult to know to what extent the MAR affects such dialogue. As well as this, shareholders seeking to search for “hidden” information in respect of an investee company may be deterred but there is little evidence that the MAR has had a material impact on search efforts of shareholders. What the above section shows is that there are good reasons to believe that these provisions could, in theory, provide an impediment to particular kinds of engagement. It is possible that shareholders subject to the SRD2 may rely on the provisions of the MAR to explain non-compliance with the “dialogue” element of Article 3g. For example, an asset manager that declares a need to be free to trade may also declare a fear of the MAR in preventing this, were it to conduct a dialogue.

E. Formalities of the AGM

i. Introduction

¹⁷⁰ Ibid (“An unconditional ban on informed trading prevents outsiders from profiting from the discovery of fraud, unfair self-dealing and other misbehavior on the part of corporate agents.”)

¹⁷¹ This example echoes the facts of the US case of *Dirks v SEC* 463 U.S. 646 (1983), in which the US Supreme Court held that such a tip off was a permissible basis to trade, under US securities law. Gilotta makes the point that EU law is much more strict and such a factual scenario would trigger the provisions of the MAR, see *ibid* (“there is... low legal uncertainty surrounding *Dirks*-like cases: they almost certainly fall within the scope of Art. 8(4) last sentence, as any other more ordinary case of tippee trading.”)

The importance of the AGM for shareholder engagement is revealed by the reforms of the SRD, which, as noted, strongly target facilitating shareholder voting and engagement at the AGM.¹⁷² The exercise of voting rights is perhaps the strongest form of shareholder engagement, because the implicit threat of voting against management underpins other forms of engagement, such as dialogue, as well as being engagement in and of itself. Voting is conducted at the AGM and therefore the ability to attend the AGM or send a proxy and exercise voting rights is extremely important. Where shareholders are deprived of this ability, a significant barrier to shareholder engagement exists.

The practice of holding AGMs by companies can be traced back to local governance that developed as joint stock companies emerged in England.¹⁷³ Despite the organic origins of the general meeting, the AGM should be considered as a regulatory event, rather than being merely a market phenomenon. The holding of an AGM is a legal requirement for all companies except single member companies.¹⁷⁴ As well as this, many formalities of the AGM are prescribed by law.¹⁷⁵ It is for this reason that the AGM is considered a regulatory event and if the AGM presents an impediment to shareholder engagement, it is categorized as a regulatory one.

The AGM as an impediment to shareholder engagement is a counterintuitive proposition, considering that it is specifically designed to provide a forum for shareholder engagement. As the EC stated in 2004: “Shareholders’ influence over the company rests primarily on their access to relevant company information and the ability to exercise shareholders’ rights in the company’s General Meetings.”¹⁷⁶ Indeed, it is arguable that all shareholder engagement is underpinned by the implicit threat to take disagreements and grievances from a private “behind the scenes” setting to the public forum of the general meeting.¹⁷⁷ This informed the SRD and was the reason that so many of its provisions were focused on facilitating the shareholders’ access to the AGM and their ability to direct the AGM.¹⁷⁸

¹⁷² See Chapter 2, above at pp 38-39.

¹⁷³ See Carolyn J Cordery, 'The Annual General Meeting as an accountability mechanism' (2005) Working Paper Series Working Paper no 23 .

¹⁷⁴ Companies Act 2014, s 175 (requirement to hold AGM), s 196 (absence of requirement for single member companies).

¹⁷⁵ See Companies Act, 2014, ss 175-199.

¹⁷⁶ European Commission, Internal Market Directorate General, “Fostering an appropriate Regime for Shareholder Rights in the EU: Consultation document of the Services of the Internal Market Directorate General,” September 2004 at 6.

¹⁷⁷ Paul L Davies, *Gower and Davies' Principles of Modern Company Law* (7th edn., Sweet& Maxwell, London 2003), at 338.

¹⁷⁸ For general discussion of the development of the SRD, see Chapter 2 at pp 36-40.

However, some commentators have argued that the AGM in its current form in many developed economies is not fit for purpose.¹⁷⁹ The AGM can be thought of in essentially two ways; it is either the “the focal point for directors’ accountability”¹⁸⁰ or “simply an expensive showpiece to satisfy legal requirement, but toothless in so far as concrete attainment, with no monitoring of the event other than that it simply took place.”¹⁸¹ If the legal requirements of the AGM cloak the absence of a proper forum for shareholder engagement, these requirements can be characterised as a serious impediment to engagement. These requirements will be set out first, before examining how engagement may be impeded.

ii. Legal Formalities of the general meeting

In EU law, many of the legal provisions surrounding AGMs are contained in the SRD, which has been dealt with extensively in Chapter 2.¹⁸² In March 2016, the Informal Company Law Expert Group (ICLEG) published its Report on digitalisation in company law.¹⁸³ They included a discussion on general meetings and shareholder engagement and noted that “there is no reason why the two-way communication between shareholders and management and among shareholders themselves that is traditionally considered the main purpose of the AGM should be limited to the time - limited episode that constitutes the AGM.”¹⁸⁴ They also note that there is no need for the general meeting to be an annual event and rather could be “simply part of the ongoing communication between a company and its constituencies.”¹⁸⁵ To this end, ICLEG recommend that “unnecessary differences” between annual and extraordinary general meetings in law be removed and to allow PLCs to dispense with a physical general meeting with the approval of shareholders.¹⁸⁶ At an EU level, a Directive on the use of digital tools and processes in company law was finalised in 2019, which allows for, *inter alia*, the online formation of companies, the online filing of company documents and the online registration of company branches.¹⁸⁷ This Directive did

¹⁷⁹ See below, pp 150-154.

¹⁸⁰ Thomas B Courtney, *The Law of Companies* (3rd ed, Bloomsbury Professional, 2012) at 799.

¹⁸¹ Nicholas Apostolides, 'Exercising corporate governance at the annual general meeting' (2010) 10 *The International Journal of Business in Society* 140.

¹⁸² Chapter 2 at pp 36-40.

¹⁸³ John Armour, Gintautas Bartkus, Blanaid J Clarke, Pierre-Henri Conac, HJ de Kluiver, Holger Fleischer, Mónica Fuentes, Jesper Lau Hansen, Vanessa Knapp, Marco Lamandini, Arkadiusz Radwan, Christoph Teichmann, RH van het Kaar and Martin Winner, “Report on digitalisation in company law,” 24 March 2016, Available at SSRN: <https://ssrn.com/abstract=2893701>.

¹⁸⁴ *Ibid* at 35.

¹⁸⁵ *Ibid*.

¹⁸⁶ *Ibid* at 36.

¹⁸⁷ Directive (EU) 2019/1151, Articles 13g, 13j and 28a respectively.

not, however, address the recommendations in respect of digitalisation of general meetings. “Virtual” AGMs will be addressed further below.

The specific legal requirements of a general meeting can vary from country to country. For example, certain jurisdictions allow companies to hold general meetings in a “virtual only” manner, whereas in others this exclusive means of holding the general meeting is precluded.¹⁸⁸ In some jurisdictions, including Ireland, shareholders have a statutory right to call general meetings in particular circumstances,¹⁸⁹ and in others, no such statutory right exists.¹⁹⁰ Irish law is the primary focus of this thesis and so the formalities relating to general meetings in Ireland will be set out in detail, as well as comparisons to UK law, where appropriate. As will be clear, shareholders of Irish PLCs have certain enhanced rights over shareholders in private companies in the Companies Act 2014, by virtue of the SRD.

An AGM must be held by a company at least every 15 months unless all members of the company entitled to vote essentially consent to it not being held.¹⁹¹ This does not apply to PLCs, which must hold an AGM if there are more than 1 member, regardless of the consent of members.¹⁹² The notice period for an AGM is statutorily required to be a minimum of 21 days in both Irish and UK law.¹⁹³ This is the minimum requirement set by the SRD, which applies to PLCs.¹⁹⁴ Where a general meeting is not an AGM, Irish law designates it an extraordinary general meeting (EGM).¹⁹⁵ The minimum notice period for an EGM is 14 days for a PLC, unless a special resolution is being put forward at the EGM, in which case

¹⁸⁸ The issue of “virtual only” general meetings is a recent one in the USA, since Delaware has permitted companies incorporated in the state to hold general meeting exclusively this way, see Delaware General Corporate Law (DGCL), s 211. Other states in the US, including New York, New Jersey, Massachusetts, Wisconsin and Georgia preclude virtual only general meetings, Elizabeth Mozley and Janice Amey, “Online Shareholder Participation in Annual Meetings” Harvard Law School Forum on Corporate Governance and Financial Regulation, 19 July 2012. It is likely that Irish company law would permit virtual only meetings under section 176, Companies Act, 2014, although it is not common.

¹⁸⁹ Companies Act 2014, section 178(3), 1101.

¹⁹⁰ In Delaware, for example, shareholders are deprived of the ability to call a general meeting unless the certificate of incorporation states otherwise, see DGCL, s 211(d).

¹⁹¹ Companies Act 2014, s 175(1) (15 month requirement), s 175(3) (dispensation for consenting members). There is also a dispensation from holding an AGM where the company is a single member company, Companies Act 2014, s 196.

¹⁹² Companies Act 2014, s 1089.

¹⁹³ Companies Act 2014, ss 181(1), 1098 (for PLCs); UK Companies Act 2006, s 307(2)(a).

¹⁹⁴ Directive 2007/36/EC, article 5(1).

¹⁹⁵ Companies Act 2014, s 177(1).

the minimum notice period is 21 days.¹⁹⁶ In the UK, the minimum notice period for all general meetings that are not an AGM is 14 days.¹⁹⁷ A PLC must also disclose within 21 days of the general meeting (inclusive of the general meeting) documents to be submitted to the meeting, a copy of any draft resolution, comments from the board on each item on the agenda of the meeting, as well as any draft resolutions tabled by shareholders, where received.¹⁹⁸

Shareholders can call a general meeting themselves, provided they hold at least 10% of the paid up share capital of the company,¹⁹⁹ or in the case of PLCs, 5% of the paid up share capital.²⁰⁰ At the general meeting itself, shareholders in a PLC have a right to put an item on the agenda of the meeting, provided the shareholder or shareholders in question hold at least 3% of the voting rights of the company.²⁰¹ PLCs are permitted to provide electronic participation but this is subject to the qualification that where electronic participation is provided it is done so subject to proportionate restrictions and requirements necessary to ensure identification of those shareholders participating electronically.²⁰² As well as this, shareholders of PLCs have a statutory right to ask questions at a general meeting and to have such questions answered unless answering the question would interfere with the preparation for the meeting, the confidentiality or business interests of the company, an answer has already been given or “it appears to the chairperson of the meeting that it is undesirable in the interests of good order of the meeting that the question be answered.”²⁰³ Shareholders of private companies, while not having the aforementioned statutory rights to ask questions and have them answered, do have the right to demand a poll on any matter, provided they are at least three in number or they represent at least 10% of the voting rights or total paid up capital of the company.²⁰⁴

In order to facilitate the voting process, shareholders have the right to appoint a proxy to attend the general meeting and vote their shares on their behalf.²⁰⁵ In respect of PLCs, shareholders as a default are not permitted to appoint more than one proxy but the PLC’s

¹⁹⁶ Companies Act 2014, s 1102(2).

¹⁹⁷ UK Companies Act 2006, s 307(2)(b).

¹⁹⁸ Companies Act 2014, s 1103(3).

¹⁹⁹ Companies Act 2014, s 178(3)

²⁰⁰ Companies Act 2014, s 1101.

²⁰¹ Companies Act 2013, s 1104(1).

²⁰² Companies Act 2014, s 1106(1)-(2).

²⁰³ See Companies Act 2014, s 1107.

²⁰⁴ Companies Act 2014, s 189(1)-(2).

²⁰⁵ Companies Act 2014, s 183(1).

constitution may give such permission to their shareholders.²⁰⁶ As well as this, shareholders have a statutory right to appoint a proxy per securities account that they may hold, which facilitates intermediaries providing multiple proxies for different clients.²⁰⁷ PLCs can permit voting by correspondence in advance of the general meeting on a poll that is to be taken at the general meeting, subject only to requirements and restriction necessary to identifying the shareholder.²⁰⁸ Permitting companies to vote by correspondence is a requirement of the SRD.²⁰⁹

The quorum necessary for an AGM to be held is two members, unless the company's constitution provides otherwise.²¹⁰ This is a statutory default and companies may choose in their own constitution the number of members necessary for a quorum.²¹¹ Having a quorum of greater than two members is common among Irish PLCs.²¹²

iii. Formalities of the general meeting as an impediment to engagement

All the legal rules surrounding general meetings described above are designed specifically to ensure the AGM works effectively as an accountability mechanism for the benefit of shareholders. Christoph Van Der Elst and Anne Lafarre have identified three functions of the AGM: the information function, the forum function and the decision-making function and they argue that that all three functions are fundamentally flawed in a modern context.²¹³ These will be dealt with in turn.

²⁰⁶ Companies Act 2014, s 1108(2).

²⁰⁷ Companies Act 2014, s 1108(3); Courtney (n 82) at par 31.198.

²⁰⁸ Companies Act 2014, s 1109.

²⁰⁹ Directive 2007/36/EC, Article 12.

²¹⁰ Companies Act 2014, s 182(2). An exception is single member companies, for which a quorum is one member. See Companies Act 2014, s 182(3).

²¹¹ See Companies Act 2014, s 182(2) ("Save to the extent that its constitution provides otherwise..."); *BML Group Ltd v Harman* [1994] WLR 893.

²¹² Two prominent examples are CRH Plc, which requires 5 members for a quorum, see CRH Plc Memorandum and Articles of Association, available at <http://crh.com/docs/corporate-governance/2018-memorandum-articles-of-association.pdf?sfvrsn=2> at par 62 and Ryanair Plc, which requires 3 members for a quorum, see Ryanair Plc Memorandum and Articles of Association, available at https://www.ryanair.com/doc/investor/2010/Current_Memorandum_and_Articles_of_Association.pdf at par 54.

²¹³ Christoph Van der Elst and Anne Lafarre, 'Bringing the AGM to the 21st Century: Blockchain and Smart Contracting Tech for Shareholder Involvement' (2017) ECGI Working Paper Series in Law: Working Paper No 358/2017

According to Van der Elst and Lafarre, the information function of the modern AGM is flawed because of the length of notice period and timing by which information is disclosed to shareholders.²¹⁴ Since the information is often disclosed many weeks prior to the AGM itself, the function of the AGM to provide information is flawed.²¹⁵ Considering the fact that most information discussed at the AGM must legally be disclosed 21 days prior to the AGM,²¹⁶ the function of the AGM as a source of information is undermined. However, these mandatory disclosures are specifically tied to the AGM and so are disclosed in advance in order to facilitate the effectiveness of the AGM. In a sense, the information function of the AGM is better characterised as a sub-function of the decision-making function,²¹⁷ since the information provided outside the AGM informs the decisions to be taken inside the AGM. This is therefore not truly a criticism of the aspect of the AGM that concerns us presently, whether or not it impedes engagement, which the mandatory provision of information prior to the AGM plainly does not.

The forum function concerns the ability of shareholders to be heard, to air grievances and to get answers from the controllers of the company. While, shareholders have specific legal rights to ask questions and receive answers, as well as participate electronically at the physical AGM for a PLC,²¹⁸ there is no doubt that there are limitations on these abilities for practical reasons. As Van der Elst and Lafarre note, speaking time is often limited for individual shareholders and for all shareholders collectively.²¹⁹ The authors focus on German law to make this point, case law of which specifies certain limits on what is reasonable speaking time for shareholders.²²⁰ There are no specifications as to what is or is not reasonable in terms of shareholder speaking time in Irish law. The chairperson has the role at the general meeting of being the “guardian of the governance” of the meeting.²²¹ In other words, the chairperson runs the meeting, calling it to order when necessary, allowing questions and answers,²²² taking a vote and counting votes,²²³ directing a poll,²²⁴

²¹⁴ See *ibid* at 4-6.

²¹⁵ *Ibid* at 4 (“the relevant information for shareholders and investors is not disclosed in the general meeting of shareholders, but ad hoc, at certain intervals throughout the year, and often long before the AGM takes place.”)

²¹⁶ Companies Act 2014, ss 181(1), 1098 (for PLCs), s 1103(3).

²¹⁷ Van der Elst and Lafarre note that the decision making function is often considered the “core” function of the AGM, see Van der Elst and Lafarre (n 213) at 3.

²¹⁸ Companies Act 2014, ss 1107 and 1106 respectively.

²¹⁹ Van der Elst and Lafarre (n 213) at 6-7.

²²⁰ Van der Elst and Lafarre refer to the case of BGH (2010) Karl-Walter Freitag/Biotest AG-case, 8 February 2010, II ZR. 94/08.

²²¹ Courtney (n 82) par 14.073.

²²² Companies Act 2014, s 1107(2)(c).

²²³ Companies Act 2014, s 188(8)

²²⁴ Companies Act 2014, s 189(2)(a).

adjourning the meeting,²²⁵ signing the minutes.²²⁶ The chairperson therefore has it within their discretion as to how long a shareholder may speak and the chairperson has a statutory power to determine that a question may not be answered.²²⁷ This does not necessarily imply that shareholders will have an insufficient speaking time or that the chairperson will use their statutory power in a manner that undermines the forum function. However, there is little relief mechanism for shareholders unhappy with the performance of a chairperson in allowing them to speak or have their questions answered. The courts have repeatedly affirmed that where shareholders are unhappy with how the chairperson conducted a meeting, it is the company that is the rightful plaintiff in any consequent lawsuit, barring the aggrieved shareholders from taking such suit.²²⁸ According to the courts, the better alternative remedy is to convene another general meeting.²²⁹ This will not always be feasible however and smaller shareholders who may have been given insufficient speaking time will not by themselves have the power to convene a remedial general meeting.²³⁰

Finally, the AGM has a decision-making function, which is arguably its most important function and certainly the most relevant function for present purposes since decision making by shareholders at the AGM is in and of itself an act of engagement. In this context, the decision-making function will almost always concern the exercise of voting rights. Van der Elst and Lafarre identify a flaw with this function and it is a familiar one, as they focus on the “rational apathy” of shareholders and the free rider problem.²³¹ It is true that attendance rates at general meetings tend to not be high. Van der Elst, in another study of the AGM across Europe, found that attendance rates during the 2010 proxy season were around 49% to 66% across 5 countries, with an average of 59.50%.²³² It is likely that much of the non-attendance at general meetings can be explained by rational apathy. Attending a general meeting and deciding which way to vote on resolutions entails research and personnel costs that a shareholder may decide is better allocated elsewhere. Having said this, the legal rules for making decisions at the AGM likely reduce the costs, including allowing proxies to go in the shareholders’ place and permitting voting by

²²⁵ Companies Act 2014, s 187(4).

²²⁶ Companies Act 2014, s 199(2).

²²⁷ Companies Act, s 1107(2)(c).

²²⁸ *MacDougall v Gardiner* (1875) 1 Ch D 13; *O’Sullivan v Conroy Gold and Natural Resources* [2017] IEHC 543.

²²⁹ *O’Sullivan v Conroy Gold and Natural Resources* [2017] IEHC 543 at par 12.

²³⁰ In order to call an EGM, the shareholder or shareholders will have to hold at least 10% of the paid up shareholder capital or 5% in the case of PLCs, see respectively ss 178(3) and 1101, Companies Act 2014.

²³¹ Van der Elst and Lafarre (n 213) at 7-11.

²³² Christoph Van der Elst, 'Shareholder Rights and Shareholder Activism: The Role of the General Meeting of Shareholders' (2012) 60 *Annals FLB - Belgrade Law Review* 39 at 60.

correspondence.²³³ It should also be noted that the limitations inherent in the AGM process as an engagement and decision making forum are potentially consistent with the promotion of engagement outside of the AGM. The very fact that the AGM is an imperfect avenue for engagement may be complemented by the provisions of the SRD2 or Stewardship Code, for example, which seek to encourage engagement on an ongoing basis. For this reason, even if the formalities of the AGM were an impediment to engagement at the AGM, these formalities would not be an impediment to engagement *per se* and, indeed, could be considered as an encouragement to engagement more informally and more often.

All of the above illustrates the difference between regulation as an impediment in the context of general meetings and the other contexts discussed above. In the other contexts, the legal rules served as an impediment to shareholder engagement in and of themselves and removing the legal rules would remove the impediment (though this would have to be balanced against the aims of the legal rules). In the context of legal rules surrounding the general meeting, almost all are designed to facilitate shareholder engagement. Even rules that may be considered as barriers to engagement in and of themselves, such as the empowerment of chairpersons to refuse to have questions answered can be characterised as facilitating shareholder engagement in another sense. While the shareholder who has not had their question answered may feel aggrieved and this may encourage them to no longer engage with the company (and other shareholders who observe the failure to have questions answered may conclude that engagement is futile and do the same), the basis for this refusal will likely be “that it is undesirable in the interests of good order of the meeting that the question be answered.”²³⁴ Maintaining the “good order” of the meeting may be necessary to ensure that all shareholders who wish to speak are heard. In this sense, the failure to answer a question or questions may be the means by which other questions are heard and other points are raised at the meeting. However, there is little evidence to suggest that any of the rules concerning the AGM cloak the inability of shareholders to be heard and to use their voting rights.

F. Conclusion

Both market and regulatory impediments to shareholder engagement pose existential problems for the aims of the SRD2. While certain market impediments pose problems for

²³³ See above p 150.

²³⁴ Companies Act 2014, s 1107(2)(c). This provision provides the most explicit power to refuse to have questions answered.

engagement in a general sense, regulatory impediments present an impediment to specific forms of engagement. This will have consequences for shareholders who seek to explain non-compliance with Article 3g. The MBR is a potential impediment to engagement collectively, disclosure requirements are potentially an impediment to hedge fund activism and the MAR is potentially an impediment to private dialogues and intensive shareholder monitoring. Each of these, bar hedge fund activism, is a required element of the engagement policy under Article 3g and reliance could be placed on regulatory impediments as a “clear and reasoned” explanation for non-compliance. The formalities surrounding the AGM are an impediment only in the sense that they may not be as effective as desired in order to facilitate engagement at the AGM. The next chapter will deal with how these impediments may be overcome. Most importantly, how the SRD2 seeks to overcome the most important impediments to engagement will be analysed in detail.

5. Overcoming the Impediments to Shareholder Engagement

A. Introduction

Chapter 4 described in detail the market and regulatory impediments to shareholder engagement. This chapter is dedicated to addressing the proposed means of encouraging engagement, analysing the various proposed solutions to the problems posed by the impediments in terms of increasing the “levels and quality”¹ of engagement. Again, the distinction between market and regulatory impediments ought to be maintained. As noted, in order to overcome several of the regulatory impediments, the obvious solution is simply to remove the regulation in question.² However, since these regulations have separate goals in mind, the goals of the regulation need to be balanced against the goals of facilitating engagement. Market impediments, on the other hand, may require regulatory intervention in order to be overcome. Indeed, the provisions of the SRD2 are part of a regulatory regime that is designed to encourage higher levels of engagement for the “long term”. The means by which these provisions are enforced are mandatory disclosures, which, in this case, involve a disclosure of compliance or a disclosure of an explanation as to non-compliance. This enforcement mechanism is called “comply or explain” and is borrowed from UK corporate governance law. This transparency-based intervention will be examined first. After this, two other proposed solutions will be outlined, which are technological development and the outsourcing of engagement functions to others.

B. Comply or Explain

i. The origin and development of “comply or explain”

¹ This is a “specific objective of the Directive (EU) 2017/828 [hereafter “SRD2”], see Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 4 April 2014 [hereafter “EC 2014 proposal”].

² For example, in order to encourage collective engagement, the Mandatory Bid Rule could simply be removed. In order to encourage hedge fund activism, the various disclosure requirements could be withdrawn.

The concept of “comply or explain” first appeared in the previously discussed Cadbury Report.³ As argued in the Cadbury Report, “compliance with a voluntary code coupled with disclosure” would be more effective than “statutory measures” in achieving the desired aim of the code.⁴ This was explained on the basis that “[s]tatutory measures would impose a minimum standard and there would be a greater risk of boards complying with the letter, rather than with the spirit, of their requirements.”⁵ According to the Cadbury Report, a comply or explain approach contains sufficient flexibility to strike a balance “between meeting the standards of corporate governance now expected of them and retaining the essential spirit of enterprise.”⁶ In order to achieve this, it advised:

“The Code is to be followed by individuals and companies in the light of their own particular circumstances. They are responsible for ensuring that their actions meet the spirit of the Code and in interpreting it they should give precedence to substance over form.”⁷

The various principles of good corporate governance that the “Cadbury Code” set out were soon after applied to all companies listed on the London Stock Exchange on a comply or explain basis.⁸ The Hampel Committee subsequently endorsed the reasoning behind the comply or explain approach and developed it slightly by asserting that:

“...this committee certainly envisages that the current requirement for companies to confirm or otherwise compliance with Cadbury will be superseded by a requirement to make a statement to show how they (i) apply the principles and (ii) comply with the combined code⁹ and, in the latter case, to justify any significant variances.”¹⁰

³ “Report of the Committee on the Financial Aspects of Corporate Governance” 1 December 1992, chaired by Sir Adrian Cadbury at par 1.3. See Chapter 1: Introduction, above at pp 24-25.

⁴ Ibid at par 1.10.

⁵ Ibid.

⁶ Ibid at par 1.5.

⁷ Ibid at par 3.10.

⁸ See Chapter 1, above at p 24.

⁹ Here “combined code” refers to the principles in the Cadbury report and the Listing Rules of the London Stock Exchange.

¹⁰ “Committee on Corporate Governance: Final Report,” January 1998 Chaired by Ronnie Hampel, (Hampel Report) [hereafter “Hampel Report”] at par 1.23. On background to Hampel Committee, see Chapter 1, above at p 25.

The Combined Code set out that companies listed on the London Stock Exchange must state how they have applied the principles of the Code and must also state either that it complies with the provisions of the Code or explain why it has not complied with a particular provision.¹¹ Following this in 2003, the Higgs Report on non-executive directors was published and again affirmed the benefits of the comply or explain approach.¹² He noted:

“The Combined Code and its philosophy of ‘comply or explain’ is being increasingly emulated outside the UK. It offers flexibility and intelligent discretion and allows for the valid exception to the sound rule. The brittleness and rigidity of legislation cannot dictate the behaviour, or foster the trust, I believe is fundamental to the effective unitary board and to superior corporate performance.”¹³

Certainly, around this time, European regulators were considering introducing comply or explain into their corporate governance frameworks. During the period in the mid-1990s, many Member States adopted corporate governance codes, though most did so without the element of “comply or explain.”¹⁴ The EC commissioned a study of corporate governance codes across Europe in 2002 from Weil, Gotshal and Manges LLP.¹⁵ This study found that “[t]he greatest distinctions between corporate governance practices in EU Member States appear to result from differences in law and not from differences in recommendations that emanate from the types of codes analysed in this Study.”¹⁶ These legal differences included employee representation, the manner in which corporate purpose is articulated and the particulars of shareholder rights - all of which were found to diverge across European

¹¹ See FRC “The Combined Code on Corporate Governance,” 2003, available at <https://www.frc.org.uk/getattachment/edce667b-16ea-41f4-a6c7-9c30db75bb0c/Combined-Code-2003.pdf> [hereafter “Combined Code”], Preamble, paras 4-5.

¹² Derek Higgs, “Review of the role and effectiveness of non-executive directors Higgs Review,” January 2003. On the background to Higgs, see Chapter 2: The Shareholder Rights Directive, its Development and its Revision, above at p 47.

¹³ *Ibid* at 3.

¹⁴ EU “Study on monitoring and enforcement practices in corporate governance in the Member States” conducted by RiskMetrics Group for the EU (23 September 2009) [hereafter “RiskMetrics Study”] at 22.

¹⁵ Weil, Gotshal and Manges, “Comparative Study of Corporate Governance Codes Relevant to the European Union And Its Member States On behalf of the European Commission, Internal Market Directorate General: Final Report and Annexes I-III” January 2002 [hereafter “Weil, Gotshal and Manges study”].

¹⁶ *Ibid* at 74.

codes.¹⁷ The EC responded to this study by concluding that convergence on the content of corporate governance codes across Europe was not desirable, but that the enforcement mechanism – comply or explain – should be introduced EU-wide.¹⁸ As was argued in the Weil, Gotshal and Manges study, “Achieving broad agreement on a more detailed set of best practices that fit the varying legal frameworks of the Member States will be difficult and may succeed only in expressing the ‘lowest common denominator.’”¹⁹

On the point of divergence among corporate governance codes, the EU in its 2003 Action Plan notes that the “comply or explain” principle “offers a satisfactory solution” where issuer companies operate in multiple markets with different codes.²⁰ This endorsement of comply or explain would eventually lead to the EU inserting Article 46a into the Fourth Company Law Directive.²¹ Article 46a essentially stated that issuer companies must include a corporate governance statement in their annual report. This statement must include a reference to the corporate governance code to which the issuer is subject, applies voluntarily and/or the practices which go beyond such a code.²² More notably for present purposes, the corporate governance statement in the annual report must also provide an explanation as to why the issuer has departed from the code or any parts of the code which applies to the issuer.²³ This was the first time “comply or explain” had been introduced as a legal requirement for all issuers on a regulated EU market. Article 46a was later transformed into Article 20 of Directive 2013/34/EU in a “simplification” process in respect of the Fourth Company Law Directive, but the content in this respect is largely the same.²⁴

As noted in Chapter 2, shortly after the financial crisis, the Walker Review recommended the formalisation of the Stewardship Code (“SC”).²⁵ Walker envisioned that the SC would be enforced through comply or explain in a similar fashion to the Combined Code (now the UK Corporate Governance Code).²⁶ While the latter relies on shareholders examining the

¹⁷ Ibid at 75-76.

¹⁸ RiskMetrics Study at 27.

¹⁹ Weil, Gotshal and Manges study at 81.

²⁰ Ibid at 11.

²¹ Council Directive 78/660/EEC as amended by Directive 2006/46/EC, article 7.

²² Council Directive 78/660/EEC, Article 46a(1)(a).

²³ Council Directive 78/660/EEC, Article 46a(1)(b).

²⁴ Directive 2013/34/EU

²⁵ Chapter 2, above at p 47.

²⁶ Sir David Walker, “A review of corporate governance in UK banks and other financial industry entities: Final recommendations” 26 November 2009 [hereafter “Walker Review”], recommendations 16 and 17, at par 5.40

compliance statements or explanations and holding issuers accountable for such disclosures, the SC involves shareholders themselves making the disclosures. As noted in Chapter 2,²⁷ asset managers are the focus of the acts of stewardship and engagement and asset owners have the role of monitoring and examining the compliance statements or explanations for deviance from the Code. Walker made this recommendation because, in his view, “comply or explain” offered a flexibility to institutional investors “continues to be preferable to a more specifically rule-based approach to corporate governance.”²⁸ Walker lamented a “stigma” that seemed to him to be attached to non-compliance, which is a general criticism of comply or explain, since comply or explain by definition is flexible enough to encompass non-compliance.²⁹

ii. In the SRD2

In its 2001 Green Paper, the EC asserted that comply or explain “underpins the EU corporate governance framework.”³⁰ However, it criticised the quality of explanations for deviance from the various codes, an issue which will be returned to in more detail below.³¹ Despite this, the EC noted that survey evidence suggested that most companies and institutional investors believe that comply or explain is the appropriate means of enforcing corporate governance codes.³²

The EC 2012 Action Plan also dealt with comply or explain in some detail.³³ Again, the EC focused on the quality of explanations for non-compliance, saying that they were “often insufficient”.³⁴ It noted that individual Member States had “initiated discussions” in relation to improving disclosures under comply or explain.³⁵ The EC welcomed these discussions and stated an intention to encourage further cooperation between Member States, in particular an “exchange of best practices”.³⁶ It is notable that in response to the corporate governance failures that the EC believed contributed to the Financial Crisis, it

²⁷ Chapter 2 at p 48.

²⁸ Walker Review, at 38.

²⁹ Walker Review, at 39.

³⁰ European Commission, Green Paper, “the EU corporate governance framework,” 5 April 2011 [hereafter “EC 2011 Green Paper”] at 3.

³¹ Below at pp 162-167.

³² EC 2011 Green Paper at 18.

³³ European Commission, “Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies,” 12 December 2012 [hereafter EC 2012 Action Plan”].

³⁴ *Ibid* at 6.

³⁵ *Ibid*.

³⁶ *Ibid* at 7.

repeatedly presented comply or explain as its preferred enforcement mechanism even though it acknowledged its apparent defects. It did not appear to consider in any meaningful way alternative means of enforcement, such as making the contents of codes mandatory, a path which was chosen by US lawmakers, in the form of Sarbanes-Oxley in 2002.³⁷ Earlier that year, the European Parliament adopted a resolution in which they stated they believe “that the ‘comply-or-explain’ system is a useful tool in corporate governance” and “that codes of practice can deliver behavioural change.”³⁸

The same day the EC published its 2014 proposal for a revised SRD, it also published a Recommendation with regard to the quality of corporate governance reporting.³⁹ This recommendation reiterates the reasoning why the EC prefers the comply or explain approach as a “key feature” of European corporate governance regulation.⁴⁰ It notes that comply or explain is widely supported by market participants and that the ability to pick and choose aspects of a corporate governance code “could in some cases allow a company to govern itself more effectively.”⁴¹ As well as this:

“The ‘comply or explain’ approach provides companies with flexibility by allowing them to adapt their corporate governance to their size, shareholding structure or sectoral specificities. At the same time, it promotes a culture of accountability, encouraging companies to reflect more on corporate governance arrangements.”⁴²

³⁷ The idea of making corporate governance codes mandatory is not without precedent in Ireland either. Eamon Gilmore TD introduced a private members’ bill before the Dáil called the Corporate Governance (Codes of Practice) Bill 2009, available at <https://data.oireachtas.ie/ie/oireachtas/bill/2009/22/eng/initiated/b2209d.pdf>, in which the Central Bank would draw up a code of practice (s 3 of the Bill) containing certain mandatory provisions (s 6 of the Bill) which would be enforced by the Irish Stock Exchange (s 7). In the explanatory memorandum, it is stated that “...it has become clear that voluntary codes are no longer adequate in order to provide assurance to investors and others as to the maintenance of the necessary high standards of good corporate practice.” This Bill was not subsequently passed or discussed in the Dáil or Seanad.

³⁸ European Parliament resolution of 29 March 2012 on a corporate governance framework for European companies, 2011/2181(INI).

³⁹ European Commission, “Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting (‘comply or explain’),” 9 April 2014, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014H0208&from=en>.

⁴⁰ Ibid at 1.

⁴¹ Ibid at 2.

⁴² Ibid.

The provisions of the recommendations state that, in giving explanations, European companies should:

- “(a) explain in what manner the company has departed from a recommendation;
- (b) describe the reasons for the departure;
- (c) describe how the decision to depart from the recommendation was taken within the company;
- (d) where the departure is limited in time, explain when the company envisages complying with a particular recommendation;
- (e) where applicable, describe the measure taken instead of compliance and explain how that measure achieves the underlying objective of the specific recommendation or of the code as a whole, or clarify how it contributes to good corporate governance of the company.”⁴³

This guidance applies to the approach in the 2014 proposal for a revision to the SRD. It is clear that the recommendation was produced in order to respond to issues that the EC itself raised regarding comply or explain in the Green Papers and the Action Plan that led to the 2014 proposal. In the latter proposal, the EC stated that “[t]he EU corporate governance framework is above all based on the comply or explain approach which allows Member States and companies to create a framework that is in line with their culture, traditions and needs.”⁴⁴ For this reason, the provisions of what would become the SRD2 ought, according to the EC, retain a sufficient degree of flexibility. If an institutional investor or asset manager does not wish to create and disclose an engagement policy as required under article 3g of the SRD2, they are entitled to decline, provided that give a “clear and reasoned” explanation why they have chosen non-compliance.⁴⁵

Given the fact that the goal of the SRD2 is to raise the “level and quality” of shareholder engagement,⁴⁶ vast numbers of institutional investors and asset managers declining to comply and choosing to explain their passivity would essentially defeat the major aim of the SRD2. It is possible that the “levels” of engagement will not be affected of by the

⁴³ Ibid at 4, para 8.

⁴⁴ EC 2014 Proposal at 3.

⁴⁵ SRD2, Article 3g(1).

⁴⁶ EC 2014 Proposal at 2.

provisions of the SRD2 but the “quality” of engagement will improve. Indeed, comply or explain is specifically designed to avoid a “one size fits all” approach to compliance, allowing those subject to the disclosure requirement of comply or explain to adapt the underlying provision (in this case, the engagement provision of Article 3g) to their own circumstances. The Recitals of the SRD2 reveal that both “level” and “quality” are concerns and the latter relates largely to the temporal aspect of the engagement, whether it is “long term” or “short term”.⁴⁷ The “comply or explain” mechanism, as the enforcement tool of the SRD2 engagement provisions, must therefore both increase the levels of engagement, which necessarily involves having shareholders engage more when they otherwise would not, and ensure that the engagement is of a “long term” quality. Given the evidence that cost is the biggest impediment to engagement,⁴⁸ and the persistence of the free rider problem, the rational choice for a large number of shareholders may be to explain their non-compliance. Comply or explain may, from one perspective, give too much flexibility to institutional investors to successfully guide their behaviour towards effective engagement. In other words, too much explaining and not enough compliance would not resolve the problem that motivated the creation of the SRD2. Despite this, a common criticism of comply or explain is the pressure that market participants feel to comply, rather than explain. This criticism will be dealt with in the next section.

iii. Criticisms

a. “Comply or else”

It may seem odd that too much compliance would constitute a criticism of comply or explain. This misrepresents the nature of the criticism, however. As noted, Walker expressed a concern that a stigma attached to non-compliance and that too many shareholders interpreted comply or explain as “comply or else”.⁴⁹ This criticism essentially holds that those enforcing the codes in question, who are inevitably shareholders in some form or another,⁵⁰ do not sufficiently look at the nuance and complexity of deviations from the code but expect statements of compliance. This has been called a “box-ticking”

⁴⁷ SRD2, Recital 2 (“there is clear evidence that the current level of ‘monitoring’ of investee companies and engagement by institutional investors and asset managers is often inadequate and focuses too much on short term returns, which may lead to suboptimal corporate governance and performance.”)

⁴⁸ See Chapter 3: Market Impediments to Shareholder Engagement, above at pp 83-84.

⁴⁹ Walker Review at 38.

⁵⁰ In other words, where the code in question is the UK Corporate Governance Code, all shareholders are supposed to monitor corporate governance statements. Where the code in question is the Stewardship Code, it is asset owners who monitor the disclosures of asset managers.

approach.⁵¹ The underlying assumption of this criticism is that there are no universally correct answers as to the achievement of “good corporate governance.”⁵² Where a company can function more effectively with one person acting as both CEO and chairman of the board, for example, they should be free to do so, the argument goes, provided it can provide a reasoned explanation as to why this is so. The Hampel Report in 1998 identified another issue with box-ticking, that “lazy or unscrupulous directors - or shareholders – [could] arrange matters so that the letter of every governance rule was complied with but not the substance.”⁵³ In this sense, the problem with a box ticking approach on the part of the shareholders’ is that it encourages superficial compliance. Therefore, the criticism is not that there is “too much” compliance, but that the box ticking attitude of shareholders leads to less actual compliance with the principles and provisions of the relevant code.

The reasons why shareholders might take this box ticking approach to monitoring corporate governance statements could be related to “rational apathy”, described in Chapter 3.⁵⁴ Shareholders may not wish to evaluate detailed and nuanced explanations for non-compliance, since this will likely occupy a great deal of time and resources.⁵⁵ For shareholders it may be more simple and cost effective to simply establish whether an investee company has complied or not. As Arcot and Bruno stated:

“the institutional shareholders attitude to corporate governance encourages a box-ticking approach to corporate governance, which is biased towards unconditional compliance with all the Code provisions: if all the boxes are ticked, in the sense that the company does comply with respect to all provisions of the Code, then the conclusion is that the company is well governed.”⁵⁶

⁵¹ Marc Moore, “Whispering sweet nothings”: The limitations of informal conformance in UK corporate governance’ (2009) 9 *Journal of Corporate Law Studies* 95 at 117-125; Sridhar Arcot, Valentina Bruno and Antoine Faure-Grimaud, ‘Corporate governance in the UK: Is the comply or explain approach working?’ (2010) 30 *International Review of Law and Economics* 193 at 194; Andrew Keay, ‘Comply or explain in corporate governance codes: in need of greater regulatory oversight?’ (2014) 34 *Legal Studies* 279 at 289; Hampel Report at 10-11.

⁵² Hampel Report at 10 (“We do not think that there are universally valid answers on such points [as combining the roles of chairman and CEO and the ideal minimum of non-executive directors]”)

⁵³ Hampel Report at 11.

⁵⁴ See Chapter 3, above at pp 81-86.

⁵⁵ For evidence of shareholders aversion to expending resources on engagement, see Chapter 3, above at pp 83-84.

⁵⁶ Sridhar A Arcot and Valentina G Bruno, ‘In Letter but not in Spirit: An Analysis of Corporate Governance in the UK’ (2006) Available at SSRN: <https://ssrncom/abstract=819784> at 34.

Furthermore, companies themselves may be inclined to comply superficially, rather than give full explanations for deviance from a provision of the code. Explanations that are reasoned out may attract scrutiny from more than just the company's shareholders, as the media may analyse their statements.⁵⁷ Of course, companies may also wish to signal compliance with all aspects of the code, without seriously integrating the principles of the code into its practice. A good example is the provision of the UK Corporate Governance Code that states that at least half of the board should be composed of non-executive directors who the board considers "independent."⁵⁸ A company could declare that over half the members of the board are independent, non-executive directors and thus disclose their compliance with the code. The Code lays out a non-exhaustive list of factors that will affect the independence of directors, including whether the director: has been an employee of the company for the previous five years; has had a material business relationship with the company in the previous three years; has close family ties with the company's senior employees, advisors or directors; or has served on the board for the previous nine years or more.⁵⁹ However, where a director does not meet these standards, for example where a non-executive director has served on the board for over nine years, the company can still declare the director to be independent, in their judgment. This would appear to be compliance with the relevant provision of the Code in letter but not in substance.

An inflexible insistence on compliance with the Code would have the effect of a "one size fits all" corporate governance framework, despite "comply or explain" being designed to avoid this outcome. Even if compliance is not simply superficial and particular provisions are carried out fully in the spirit of the Code, such full spirited compliance may be inappropriate for particular companies. For example, the separation of the roles of CEO and Chairman can be complied with superficially, with two individuals holding the roles. However, the CEO might in practice be carrying out the functions of both roles and the other individual might act in a completely subservient manner.

There is evidence that shareholders will tolerate non-compliance with the Corporate Governance Code, provided that the company's underlying share price performance is

⁵⁷ Paul Coombes and Simon Chiu-Yin Wong, "Why Codes of Governance Work" (2004) 2 *McKinsey Quarterly* 48 at 51; Moore (n 51) at 119.

⁵⁸ FRC "The Corporate Governance Code" July 2018, Provision 11 at 7.

⁵⁹ FRC "The Corporate Governance Code" July 2018, Provision 10 at 6.

positive.⁶⁰ MacNeil and Li argue that “it does seem to be the case that investors do not value reasoned arguments for non-compliance and prefer to use financial performance as a proxy to determine when non-compliance can be excused.”⁶¹ This suggests that once financial performance is positive, there is less concern among shareholders regarding the use of a “tick the box” approach by the companies. Conversely, it suggests that an explanation in lieu of compliance, even if detailed and reasoned, can be used as a tool to discipline management. This can be compared to voting on director remuneration, which has been used to discipline directors rather than set appropriate remuneration.⁶² Management that wish to inoculate themselves against these disciplinary mechanisms may be inclined therefore to “play it safe” and disclose compliance. This logic may have implications for the engagement provisions of the SRD2 in respect of the asset owner-manager relationship, discussed further below.

b. Quality of Explanations

The second criticism of comply or explain dealt with here is the claim that the quality of explanations for non-compliance is frequently inadequate, in the sense that the explanation does not impart sufficient information regarding why the company deviated from the code. Several studies have examined the quality of explanations for non-compliance and regulators have picked up on these studies in order to try and improve the comply or explain regime.⁶³ In particular, the EC raised this criticism in multiple papers in the course of the development of the SRD2 and the Financial Reporting Council (“FRC”) have consistently sought to improve the quality of explanation in respect of both the Corporate Governance Code and the SC.⁶⁴

The SRD2 requires that deviations from particular provisions, such as the creation and disclosure of an engagement policy under Article 3g, must be given a “clear and reasoned”

⁶⁰ Iain MacNeil and Xiao Li, “Comply or Explain”: market discipline and non-compliance with the Combined Code’ (2006) 14 *Corporate Governance: An International Review* 486; Caspar Rose, ‘Firm performance and comply or explain disclosure in corporate governance’ (2016) 34 *European Management Journal* 202 at 219 (“The article finds some evidence of increased comply or explain disclosure within the Danish recommendations as well as regarding board composition and managerial remuneration and its association with positive firm performance.”)

⁶¹ MacNeil and Li (n 60) at 494.

⁶² See Chapter 2, above at p 59.

⁶³ See below, at pp 165-166.

⁶⁴ EC 2011 Green Paper at 3; FRC, “Developments in Corporate Governance and Stewardship 2016” January 2017 at 24.

explanation.⁶⁵ The 2012 SC provided that a signatory, when giving an explanation for non-compliance, should “aim to illustrate how its actual practices contribute to good stewardship and promote the delivery of the institution’s or its clients’ investment objectives. They should provide a clear rationale for their approach.”⁶⁶ In the UK Corporate Governance Code, explanations for non-compliance must “set out the background, provide a clear rationale for the action the company is taking, and explain the impact that the action has had.”⁶⁷ The Combined Code had previously set out a less prescriptive approach, leaving the form and content to the discretion of the company and reiterating that it was the responsibility of shareholder to evaluate explanations.⁶⁸ It went on to assert that companies should be ready to explain their governance policies and the circumstances that justify any deviation from best practice. It was in this context that this first studies of the quality of explanations were undertaken.

In 2006, Arcot and Bruno examined the corporate governance statements of 245 non-financial companies within the FTSE 350 index.⁶⁹ This study found evidence of increasing levels of compliance disclosures with the Combined Code, from 86% in 1998/99 to 92% in 2003/04.⁷⁰ However, the study went on to show that a majority of explanations for non-compliance were uninformative and that 17% of statements of non-compliance contained no explanation at all.⁷¹ A 2009 study by Seidl, Sanderson and Roberts found that among the disclosures of the 130 largest companies on the London Stock Exchange, 15% gave no explanations for non-compliance with the Combined Code.⁷² Also in 2009, the EU commissioned a study from RiskMetrics to examine monitoring and enforcement of corporate governance practices in the EU.⁷³ This study contained a sample of 270 companies listed on a public exchange in 18 EU Member States and also included a survey of 100 institutional investors in EU companies. In this latter survey, approximately a quarter of investors considered the quality of disclosures by companies to be, in their perception, above average, 47% considered disclosures to be “average” and 20%

⁶⁵ SRD2, Article 3g(1).

⁶⁶ Financial Reporting Council, “The UK Stewardship Code” September 2012 at 3.

⁶⁷ FRC “The Corporate Governance Code” July 2018 at 2.

⁶⁸ Combined Code, 2000, at Preamble, point 4.

⁶⁹ Arcot and Bruno (n 56)

⁷⁰ Ibid at 29.

⁷¹ *ibid.*

⁷² David Seidl, Paul Sanderson and John Roberts, “Applying ‘Comply or Explain’: Conformance with Codes of Corporate Governance Codes in the UK and Germany” (2009) Centre for Business Research, University of Cambridge Working Paper No. 389. This study also found that 40% of German non-compliance in respect of their “Cromme Code” (also a 130 country sample) contained no explanation. However, this Code did not formally require explanations for deviation.

⁷³ RiskMetrics Study (n 14).

considered disclosures to be either “poor” or “very poor”.⁷⁴ This study also found that, of all explanations provided in the sample, only 39% were deemed sufficiently informative, according to the methodology used.⁷⁵ In 2010, Arcot, Bruno and Faure-Grimaud studied 245 non-financial companies belonging to the FTSE 350 index and found that approximately 20% of companies studied gave no explanation for non-compliance in respect of the Combined Code.⁷⁶

The practice of using general or vague statements which provide no specific information to explain non-compliance, has been termed “boiler-plate”.⁷⁷ As noted, this criticism of the comply or explain model has captured the attention of regulators in Europe and they have deployed several means to improve the quality of explanations. A common means of seeking to improve explanations for non-compliance is clarification of what is expected of those making explanations. This is what the EC did in its 2014 Recommendation on the quality of corporate governance reporting.⁷⁸ In its review of the Combined Code in 2009, the FRC acknowledged the existence of “many boiler-plate and uninformative reports” from companies.⁷⁹ However, it expressed reluctance to be prescriptive regarding what an explanation should constitute, “as prescription can rapidly lead to boiler-plate.”⁸⁰ It did note that disclosures might be improved through encouragement in the Preface of the Code,

⁷⁴ Ibid at 155.

⁷⁵ Ibid at 126. The methodology employed here involved five categories: Invalid, General, Limited, Specific, and Transitional. As RiskMetrics explain: “Explanations for deviations which only indicate a deviation without further explanation were classified as ‘invalid’. Explanations of a general nature in which the company mostly indicates disagreement with the code provision without identifying a company specific situation, were classified as ‘general’. Explanations in which companies do not explain the reasons for deviating from the code, but where additional information was given such as an alternative procedure, were classified as ‘limited’. Explanations relating to a specific company situation were classified as ‘specific’. Finally, if companies indicated that the code provision from which they currently deviate will be applied at a later stage, these explanations were classified as ‘transitional’.

⁷⁶ Arcot, Bruno and Faure-Grimaud (n 51).

⁷⁷ See Moore (n 51) at 125-129; Keay (n 51) at 290.

⁷⁸ European Commission, “Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting (‘comply or explain’),” 9 April 2014). See also, FRC, “What constitutes an explanation under ‘comply or explain’? Report of discussion between companies and investors” February 2012.

⁷⁹ FRC, “2009 Review of the Combined Code: Final Report”, December 2009, at 31 (para 3.64).

⁸⁰ Ibid at para 3.67.

which was implemented in the subsequent 2010 Corporate Governance Code, in which it stated, “the personal reporting on governance by chairmen as the leaders of boards might be a turning point in attacking the fungus of ‘boiler-plate’ which is so often the preferred and easy option in sensitive areas but which is dead communication.”⁸¹

In the aforementioned review, the FRC also noted the lack of support for regulatory monitoring and intervention with regard to insufficient explanations.⁸² It outlined the fear that FRC intervention, for example, to improve corporate governance statements, would risk reducing the flexibility of comply or explain and may get in the way of shareholder engagement. This is because, arguably, where the FRC took on the role of enforcing comply or explain, this would remove the onus from shareholders and may begin to be viewed as an alternative to shareholders engaging to enforce the expectations surrounding explanations for non-compliance. As a result, the FRC declined to extend its role with regard to enforcing comply or explain.⁸³ However, this intention was apparently reversed in 2016 in the context of the SC. In its annual “Developments in Corporate Governance and Stewardship” in 2016, the FRC noted an improvement in quality of statements of signatories of the SC but stated that these improvements “were not sufficient to demonstrate that all signatories were following through on their commitment to the Code.”⁸⁴ As a result, the FRC undertook the “tiering” exercise, described in Chapter 2.⁸⁵ Evaluating signatory statements, tiering asset managers on this basis and threatening the lowest tiered asset managers with removal from the signatory list undoubtedly constitutes a significant enforcement intervention from the FRC.

It may obviously be argued that the FRC’s expressed intention of not involving itself in enforcement was in relation only to the Corporate Governance Code and not the SC. After all, the stated reasons for not intervening to enforce the Code were that it may get in the way of engagement between shareholders and companies. The SC’s primary aim is to encourage this engagement on the side of institutional investors. However, the SC is designed similarly to the Corporate Governance Code, in the sense that shareholders are the designated enforcers of the SC. Asset owners (or “institutional investors” in the terms of the SRD2), at least under the 2012 SC, are specifically expected to monitor the actions

⁸¹ FRC, UK Corporate Governance Code, 2010, Preface, para 7.

⁸² FRC, “2009 Review of the Combined Code: Final Report”, December 2009, at 31 (para 3.66).

⁸³ Ibid.

⁸⁴ FRC, “Developments in Corporate Governance and Stewardship 2016”, January 2017 at 24.

⁸⁵ Chapter 2, above at pp 50-51.

and stewardship disclosures of their asset managers, setting their stewardship priorities in a mandate for asset managers to execute.⁸⁶ The same concerns regarding regulatory enforcement of the Corporate Governance Code apply to the SC. Where the FRC steps in to assess the quality of asset managers' disclosures, they might arguably be fulfilling the responsibilities of asset owners and this may undermine the expectation that asset owners' ought to take these responsibilities seriously. Although the FRC did assess the statements of asset owners, they did not accompany these assessments with the threat of removal from the list of signatories.⁸⁷ Equally, regulatory intervention to comply or explain in the context of the SC could be said to reduce the flexibility afforded to asset managers regarding their statements by creating prescriptive expectations of explanations. As well as this, "engagement" by asset owners expressly can include engagement with asset managers exclusively,⁸⁸ and the FRC's involvement here may be seen as taking the place of, or getting in the way of, engagement between asset owners and asset managers. Conversely, the FRC may be highlighting the problems of asset manager statements to which asset owners can then respond. In this sense, the tiering exercise by the FRC can be seen as facilitating and reducing the costs of asset owner engagement.

The point should be made here that increasing the quality of explanations does not directly encourage the desired behaviour. Although corporate governance codes such as the UK Corporate Governance Code and the SC are designed to be flexible, which is a central purpose of comply or explain, the primary purpose of the codes are to increase the levels of compliance with the particular provisions of the codes. The SRD2 and the SC were specifically put in place in order to respond to institutional investors' perceived passivity identified in the wake of the Global Financial Crisis. Increasing the quality of explanations may serve the aim of transparency and understanding as to why engagement is not being conducted but it does not transform passive shareholders into engaged shareholders, which is the fundamental purpose of both the SRD2 and SC. Neither does transparency in and of itself transform the quality of engagement, from "short term" to "long term". The

⁸⁶ Financial Reporting Council, "The UK Stewardship Code" September 2012, Application of the Code, para 4: "Disclosures under the Code should improve the functioning of the market for investment mandates. Asset owners should be better equipped to evaluate asset managers, and asset managers should be better informed, enabling them to tailor their services to meet asset owners' requirements."; para 7: "Asset owners' commitment to the Code may include engaging directly with companies or indirectly through the mandates given to asset managers."

⁸⁷ See FRC, "Developments in Corporate Governance and Stewardship 2016" January 2017 at 24-27; FRC, "Tiering of Stewardship Code Signatories" available at <https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements>.

⁸⁸ See above (n 86); Chapter 2, above at p 51.

effectiveness of a comply or explain approach as a guide to behaviour will be dealt with in the next section.

c. Effectiveness in changing behaviour

As seen in the preceding section, much of the criticisms with regard to comply or explain do not deal with the guiding of behaviour toward the desired practice of the relevant code. The flexibility of comply or explain implies that those subject to the code ought to be free to deviate from the desired practice. Similarly, improving the quality of explanations, simply serves the purpose of transparency. So, the question must be asked: will a comply or explain approach serve the purpose of overcoming the formidable impediments to shareholder engagement? How effective is such an approach in guiding behaviour toward the practices in corporate governance codes?

As noted in Chapter 3, the cost of engaging with investee companies is consistently ranked by shareholders as the biggest impediment they face when deciding whether or not to engage.⁸⁹ A rational institutional investor will not engage where the expected costs exceed the expected benefits. For this reason, many commentators have concluded that disclosure-based regulation cannot, by itself, increase the level of engagement, since disclosures do not reduce the costs of engagement or increase its benefits.⁹⁰ Disclosures under other corporate governance codes, such as the UK Corporate Governance Code, provide shareholders with company specific information, which could conceivably form the basis for shareholder engagement. The disclosure requirements that are imposed upon shareholders by the SRD2 could provide a basis for engagement as between asset owners and asset managers, the former of whom may be dissatisfied with the engagement disclosed by the latter.⁹¹ Beyond this, the disclosure requirements for engagement under the SRD2 do not provide a basis for engagement as between shareholders and investee companies. Introducing disclosure requirements regarding engagement is likely to increase the costs for institutional investors, as they dedicate resources to the production of corporate governance statements. The increased costs that accompany disclosure obligations may be

⁸⁹ See Chapter 3, above at pp 83-84.

⁹⁰ Hanne Søndergaard Birkmose, 'European Challenges for Institutional Investor Engagement – Is Mandatory Disclosure the Way Forward' (2014) 11 *European Company and Financial Law Review* 214 at 236 (“A mandatory disclosure requirement cannot be expected to increase the low levels of engagement because it neither creates financial incentives nor lowers the costs of engagement.”); Therese Strand, 'Short-Termism in the European Union' (2015) 22 *Columbia Journal of European Law* 15 at 32.

⁹¹ For further discussion of this point, see below at pp 168-172.

more likely to push more institutional investors to “explain” rather than “comply”, since an explanation for a deviation from the desired practice will entail the same resources as disclosure of compliance with the desired practice. Unlike an explanation, disclosing compliance entails the additional cost of undertaking the desired practice, which is engagement.

There is some evidence to the effect that comply or explain has succeeded in guiding behaviour towards the desired practices of the relevant code. In a previously noted 2010 study by Arcot, Bruno and Faure-Grimaud, it was found that compliance with the UK Corporate Governance Code rose from 76.7% in 1998 to 91.4% in 2004.⁹² The FRC also noted a Grant Thornton survey in a 2012 report on “comply or explain” that shows that the FTSE 350 comply with 96% of the aggregate provisions of the Corporate Governance Code.⁹³ The 2017 Grant Thornton Corporate Governance Review reports a continued upward trend of compliance, finding that a “new high” of 66% of FTSE 350 companies declaring full compliance with the UK Corporate Governance Code and 95% of companies complying with all but one or two of the 55 provisions of the Code.⁹⁴ However, the UK Corporate Governance Code is an imperfect comparator for codes seeking to increase shareholder engagement, such as the SC and Article 3g of the SRD2. Although all three of these codes adopt a comply or explain approach, companies subject to the UK Corporate Governance Code do not have the same financial disincentives to choose to explain rather than comply. While particular boards of directors may wish to deviate from certain provisions of the UK Corporate Governance Code, there are no systemic barriers to compliance that pervade all companies in the same way that “rational apathy” can be said to pervade all shareholders, to varying extents. With regard to codes that seek to increase engagement, the market impediments to engagement, including costs and the free rider problem, are systemic and do pervade every institutional investor subject to the SRD2 or SC. For this reason, examining the trends in compliance for the UK Corporate Governance Code and its comply or explain approach is not necessarily a useful predictor of the effectiveness of a comply or explain approach might be in relation to either the SRD2 or SC.

⁹² Arcot, Bruno and Faure-Grimaud (n 51) at 195.

⁹³ FRC, “What constitutes an explanation under ‘comply or explain’? Report of discussion between companies and investors” February 2012 at 1.

⁹⁴ Grant Thornton, “Corporate Governance Review” 2017.

iv. Asset owners and the Asset Management Mandate

The above analysis does not consider the possible costs of *not* complying and engaging. It should not be assumed that providing an explanation in lieu of directing resources to some form of engagement will not itself lead to costs. This is similar to the “tick the box” criticism of the comply or explain system, described above. Asset managers who wish to avoid creating and adhering to an “engagement policy” required by Article 3g of the SRD2 may find that their asset owner clients are less willing to invest their assets with them, resulting in losses. Similar to what was previously extrapolated regarding the UK Corporate Governance Code, asset owners may rely on a lack of compliance with the SRD2 engagement provisions in order to discipline asset managers’ underperformance but they may tolerate a lack of compliance where performance is positive.⁹⁵ It may be argued that asset owners could simply dismiss asset managers for underperformance without needing to rely on an absence of compliance with Article 3g of the SRD2, making such non-compliance largely irrelevant. It should not be forgotten that asset owners are themselves under pressure not to dismiss asset managers purely on the basis of short term underperformance.⁹⁶ It would therefore be helpful for an asset owner who wishes to dismiss an asset manager for underperformance to latch on to non-compliance with Article 3g. A possible result of this could be that asset managers signal compliance by creating and disclosing an engagement policy that is generic and vague and then disclose implementation in a manner that lacks specific information regarding any actual engagement undertaken by them. In this case, the compliance box will have been ticked but there will be no meaningful engagement.

It might be contended that asset owners will accept the norms that underlie the engagement provisions of the SRD2 due to asset owners, by and large, having their interests and liabilities aligned with the long term interests of the companies.⁹⁷ Arguably then, asset owners will thus seek to probe asset managers’ disclosures more closely to ensure meaningful engagement has occurred. This will require asset owner engagement with asset managers in order to trigger asset manager engagement with investee companies. Asset owners, however, are subject to their own financial disincentives for engagement with asset managers. Rather than improving the engagement of a given asset manager, they may prefer to simply dismiss asset managers who are not complying with engagement codes

⁹⁵ See above, at p 164.

⁹⁶ For a discussion of the asset owner-manager relationship and how it relates to short termism, see Chapter 3, above at pp 95-99.

⁹⁷ See above at p 96.

and hire those declaring compliance, provided there is corresponding good financial performance. Asset manager turnover by asset owners is a well noted phenomenon, demonstrating that many asset owners have an unwillingness to tolerate anything other than positive short term financial performance.⁹⁸ Short termism, a problem described as an impediment to shareholder engagement in Chapter 3,⁹⁹ is targeted specifically by the disclosure requirements in the SRD2.

The SRD2 contains provisions specifically designed to deal with this problem. Article 3h states that asset owners must disclose certain elements of their contractual relationship with asset managers, including: how the arrangement incentivises the asset manager to invest in the medium to long term; how it encourages asset managers to engage with investee companies; how the evaluation of the performance of the asset managers takes into account and is consistent with the long term performance of the assets; how the asset owner monitors the portfolio turnover; and the duration of the relationship.¹⁰⁰ These disclosures are designed to force asset owners to consider more carefully the investment management agreement (or “mandate”) that forms the basis of their relationships with asset managers. There is a comply or explain aspect to these disclosures; asset owners can leave out the above elements of an arrangement but, where they do so, they must give a clear and reasoned explanation why they have left out each particular element.¹⁰¹ It is possible that the act of disclosing the elements of the arrangement between asset owners and managers will have the effect of introducing changes into mandates that better direct the incentives of asset managers toward the “long term” and encourage them to engage more with investee companies. Existing mandates of asset owners have been blamed for causing short termism in financial markets, by creating short term incentives for asset managers.¹⁰² In practice, there has been an increasing standardisation of asset management mandates, due to the

⁹⁸ Jane Ambachtsheer, Richard Fuller and Divyesh Hindocha, 'Behaving like an Owner: Plugging Investment Chain Leakages' (2013) 6 *Rotman International Journal of Pension Management* 18; John Kay, “The Kay Review of UK equity markets and long-term decision making” 2012 [hereafter “Kay Review”], Chapter 5; Simon CY Wong, 'Why Stewardship is Proving Elusive for Institutional Investors' (2010) *Butterworths Journal of International Banking and Financial Law* 406..

⁹⁹ Chapter 3 at pp 97-101.

¹⁰⁰ SRD2, Article 3h(2)(a)-(e).

¹⁰¹ SRD2, Article 3h(2): “Where the arrangement with the asset manager does not contain one or more of such elements, the institutional investor shall give a clear and reasoned explanation why this is the case.”

¹⁰² EC 2014 proposal at 4 (“Short-termism appears to be rooted in a misalignment of interests between asset owners and asset managers.”); Paul Woolley and Dimitri Vayanos, 'Taming the Finance Monster' (2012) *December Central Banking Journal* 57; Kay Review, 2012 at 40.

desire to avoid “protracted negotiation.”¹⁰³ The standard terms in an investment will usually include:

- provisions regarding the extent of investment discretion granted to the manager,
- the investment objectives and restrictions of the asset owner,
- duties of the manager, including preparation of information for periodic reporting to the asset owner client, the exercise of rights attached to investments,
- authority to make investment decisions on behalf of the owner,
- warranty of the manager to comply with all laws, rules and regulation that are applicable,
- Periodic reporting statements,
- provisions dealing with custody of assets,
- provisions committing the manager to avoid business that would lead to tax liability for the owner,
- limitations or exclusion of liability of the manager,
- derivative and set-off provisions,
- indemnification of the manager in respect of losses incurred during the performance of duties,
- provisions relating to third party delegation by the manager.¹⁰⁴

Absent from these typical mandates are provisions relating to engagement expectations or particular areas that the owner deems especially important. A typical time horizon for an asset management mandate tends not to exceed three years,¹⁰⁵ and asset owners will usually receive monthly performance reports from the asset manager.¹⁰⁶ Article 3h, as noted, is designed to alter aspects of the typical mandate by including engagement provisions and requiring asset owners to disclose the duration of the arrangement (or explain why they have chosen not to disclose this). There have been other initiatives to change mandates in this way. The United Nations (UN) established an initiative in 2006 called the Principles for Responsible Investment (PRI), which involves an investor led development of six main principles concerned with mainly Environmental, Social and Governance issues and

¹⁰³ Lodewijk Van Setten and Tim Plews in Danny Busch and Deborah A DeMott (eds), *Liability of Asset Managers* (Oxford University Press, 2012) at 351 (para 11.63).

¹⁰⁴ This list is a condensed version of terms noted as a usual example of those contained in investment mandates in Ireland by Andrew Bates and Blanaid Clarke in *ibid* at 389-390.

¹⁰⁵ Raffaele Della Croce, Fiona Stewart and Juan Yermo, 'Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies' (2011) *OECD Journal: Financial Market Trends* 145 at 152.

¹⁰⁶ *Kay Review* at 40 (para 5.19).

eligible investors sign up to the PRI voluntarily.¹⁰⁷ The PRI has long mentioned the inclusion of “responsible investment” criteria in asset owner mandates.¹⁰⁸ The 2018 Annual Report for the PRI noted that “[a]sset owners set the direction of markets: the mandates they award to managers determine the objectives that the world’s biggest pools of money are put to.”¹⁰⁹ As well as this, the ICGN created a Model Mandate Initiative in order to “assist... asset owners in considering the expectations which they can have of their fund managers and in how they can formulate their contracts, or mandates, with those managers such that they deliver on client expectations.”¹¹⁰ It is not clear whether either of these developments has led to sufficient alterations of mandates to the extent that engagement will be enhanced and short termism will be reduced. Certainly, Article 3h is consistent with these initiatives but is distinguished by the fact that Article 3h has a mandatory disclosure aspect. Institutional investors can choose to ignore the PRI and the ICGN Model Mandate, whereas institutional investors must at least disclose why they have not disclosed specific elements of asset management mandates.

With regard to targeting the asset owner-manager mandate, the question remains whether such a step will succeed in inculcating long term engagement in practice. The 2018 PRI Annual Report reported that 68% of asset owner signatories encourage responsible investment practices but only 19% have or would move assets to asset managers who have better integrated responsible investment practices.¹¹¹ This might suggest that asset owners are not interested in inculcating long term engagement practices in anything other than a superficial manner. It echoes trends in other voluntary engagement codes that seem to show an interest on the part of institutional investors in being seen to be interested in engagement but not carrying this out in reality. For example, the FRC’s tiering exercise, noted in Chapter 2,¹¹² revealed that many asset managers had voluntarily signed up to the SC without carrying out the necessary disclosure requirements that being a signatory entailed. As well as this, recent declines in the numbers of signatories to the PRI suggests certain signatories signed up to the codes without a long term commitment to the principles the codes enshrined. The 2018 PRI Annual Report revealed a drop in the number of asset owner

¹⁰⁷ Principles for Responsible Investment: An investor initiative in partnership with UNEP Finance initiative and the UN Global Compact, 2016.

¹⁰⁸ See PRI: 5 Years of PRI Annual Report of the PRI Initiative, 2011, in which it is noted that in the 2007 First Report on Progress that 23% of asset owners (who are signatories to the PRI) include responsible investment criteria in mandates and in 2009 this had risen to 63%.

¹⁰⁹ PRI: Annual Report 2018 at 6.

¹¹⁰ ICGN Model Mandate Initiative: Model contract terms between asset owners and their fund managers, 2012 at 4.

¹¹¹ PRI: Annual Report 2018 at 28.

¹¹² Chapter 2, above at pp 50-51.

and manager signatories from the previous year, from approximately 1,700 to just under 1,500 and identified most of those leaving the PRI signatory list as asset managers.¹¹³ This decline was preceded by several years of increasing numbers of signatories.¹¹⁴ This pattern is also seen in the UK, as a recent decline in the number of signatories of the SC was preceded by growth in years previous, though as noted a contributing factor to this reduction was likely to be the tiering exercise undertaken by the FRC.¹¹⁵

Neither Article 3h, nor the initiatives described above designed to change the behaviour of asset owners, create financial incentives to change behaviour or remove disincentives. Unlike asset managers, there is an absence of enforcement to force changes in behaviour, with regulators simply hoping that disclosure statements will have this effect.¹¹⁶ While asset owners may push their asset managers toward compliance, their own practices that create short term incentives and engagement disincentives for asset managers may not change at all. This outcome would place asset managers in a very difficult position.

C. Outsourcing Engagement

i. Introduction

Whether or not asset owners or asset managers themselves have the incentive to engage with investee companies, the level of engagement may nonetheless rise from the perspective of those investee companies. This is because, while shareholders may not be willing to bear the costs of engaging themselves, they may be willing to bear a smaller cost in outsourcing their engagement to external parties who represent them. Shareholders outsourcing engagement could reap the same benefits of engagement, be in compliance with the provisions of the SRD2 and the cost could be far less than taking on engagement themselves. Therefore, the SRD2 engagement provisions (as well as other codes that seek to engage shareholders) may result in a large growth of organisations and companies that

¹¹³ PRI: Annual Report 2018 at 28.

¹¹⁴ See PRI: Annual Reports 2017, 2016.

¹¹⁵ See FRC, “Developments in Corporate Governance and Stewardship” 2015, 2014 and, for recent numbers for signatories, see Tiering of signatories of the Stewardship Code, 14 November 2016, available at <https://www.frc.org.uk/news/november-2016/tiering-of-signatories-to-the-stewardship-code>.

¹¹⁶ The FRC in its tiering exercise did sort asset owners into two tiers, based on the quality of disclosures, but there were no consequences attached to which tier the asset owner was sorted into, unlike asset managers, who faced the threat of being removed from the signatory list, see above, (n 87).

provide engagement services. These organisations and companies comprise primarily of proxy advisory companies and institutional investor representative organisations. These organisations will be examined in turn.

ii. Proxy Advisors

The costs of engagement will include monitoring investee companies in order to discover what issues shareholders have a right to vote on and determining how each vote will be cast by examining the issue and company in question and often creating a general policy to guide the voting process. These activities can be outsourced to companies called “proxy advisors” who offer voting advice to shareholders.¹¹⁷ This involves on their parts research and analysis on all resolutions that will be put to a vote at a company’s general meeting. Proxy advisors offer this information to investors or potential investors for a fee. The use of proxy advisors by shareholders has increased steadily since the first proxy advisors were set up in the 1980s.¹¹⁸ The US market has seen a number of spikes in the use of proxy advisory, usually after specific regulatory developments. In 1988, the Department of Labor took a position that pension plans had a fiduciary duty to vote the shares of the plans asset, leading many pension fund managers to seek out the services of proxy advisors, shortly after the proxy advisory industry was set up.¹¹⁹ In 2003, the SEC created a rule whereby mutual funds must disclose their voting reports annually and adopt certain procedures to ensure that they exercised their voting rights.¹²⁰ Belinfanti described this rule as a “watershed moment for the proxy advisory industry” in the USA as mutual funds responded by seeking out proxy advisors to assist them with their proxy votes.¹²¹ It is reasonable then to predict that the proxy advisory industry will benefit across the EU as Member States transpose the SRD2. This seems to have been predicted by the EC, as they included a discussion of proxy advisors in their 2012 Action Plan, noting their influence on voting practices.¹²² Ultimately, the SRD2 contains provisions with regard to proxy advisors and,

¹¹⁷ “Proxy advisor” is defined in the SRD2 as “a legal person that analyses, on a professional and commercial basis, the corporate disclosure and, where relevant, other information of listed companies with a view to informing investors’ voting decisions by providing research, advice or voting recommendations that relate to the exercise of voting right”, see Article 1(2)(g).

¹¹⁸ ESMA, “Discussion Paper: An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options”, 22 March 2012 at 10.

¹¹⁹ Tamara C Belinfanti, 'The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control' (2009) 14 *Stanford Journal of Law, Business and Finance* 1 at 8-9.

¹²⁰ Disclosure of Proxy Voting Policies Voting Records By Registered Management Investment Companies, Investment Company Act Release No. 25922, 17 C.F.R. 239, 249, 270, 274 (Jan. 31, 2003), see *ibid*.

¹²¹ Belinfanti (n 119) at 9.

¹²² EC 2012 Action Plan at 10.

similar to the approach of other provisions, the main tool the EU rely on to guide behaviour is transparency and disclosure requirements.

Article 3j of the SRD2 requires that proxy advisors publicly disclose a code of conduct that they apply to their practice and report on the continuing application of that code. This, however, is voluntary to the extent that proxy advisors may explain their non-compliance with this provision in a “clear and reasoned” manner.¹²³ This article also requires public disclosures of elements of proxy advisors’ practice, including: “(a) the essential features of the methodologies and models they apply; (b) the main information sources they use; (c) the procedures put in place to ensure quality of the research, advice and voting recommendations and qualifications of the staff involved; (d) whether and, if so, how they take national market, legal, regulatory and company-specific conditions into account; (e) the essential features of the voting policies they apply for each market; (f) whether they have dialogues with the companies which are the object of their research, advice or voting recommendations and with the stakeholders of the company, and, if so, the extent and nature thereof; and (g) the policy regarding the prevention and management of potential conflicts of interests.”¹²⁴ Any actual conflicts of interest that have arisen or may arise must also be disclosed to clients.¹²⁵ The latter disclosures must be disclosed, without the option of explaining non-compliance. In relation to the Irish transposition of the SRD2, the disclosure requirements of proxy advisors from Article 3j are contained in section 1110K of the Companies Act 2014, as inserted. Proxy advisors covered by this section are those which have their registered office in Ireland, or alternatively their head office or an establishment in Ireland.¹²⁶ Of the two major proxy advisors, GL has a subsidiary, Glass Lewis Europe Limited, which advises in relation to European companies and this subsidiary is headquartered in Limerick. It will therefore be subject to section 1110K.

With regard to the disclosure of a code of conduct, the largest proxy advisors who control most of the market, Institutional Shareholder Services (ISS) and Glass Lewis (GL), have disclosed the code or codes of conduct they apply. In 2014, GL reported that it is a charter signatory to the three “Best Practice Principles for Shareholder Voting Research and

¹²³ SRD2, Article 3j(1).

¹²⁴ SRD2, Article 3j(2).

¹²⁵ SRD2, Article 3j(3).

¹²⁶ Section 1110K refers to SRD2, Article 1(2)(b), which states these jurisdictional rules.

Analysis” (“the Best Practice Principles”) and listed ISS as another charter signatory.¹²⁷ The Best Practice Principles were created by the Best Practice Principles Group, which is an industry group consisting of Glass, Lewis & Co, ISS, IVOX, Manifest, PIRC and Proxinvest, that came together in 2013 in order to draft a conduct of conduct.¹²⁸ These principles were developed expressly in response to an ESMA statement on the role of proxy advisors.¹²⁹ The principles that constitute the Best Practice Principles are explicitly designed to guide the behaviour of signatories, rather than act as prescriptive rules.¹³⁰ Principle one relates to service quality and states that signatories provide services to clients to agreed specifications and disclose research methodologies.¹³¹ Principle two is directed at conflicts of interest, stating that signatories must disclose a conflicts of interest policy.¹³² Principle three states that signatories ought to create and disclose a communications policy, which deals with the proxy advisor’s communication with issuers, shareholder proponents, other stakeholders, the media and the public.¹³³ ISS, while complying with the Best Practice Principles,¹³⁴ have produced their own Code of Conduct, the principles of which relate to six areas: personal conduct of employees, anti-corruption and bribery, compliance with competition laws, business partner relations, workplace standards and corporate responsibility.¹³⁵ ISS have further produced a Code of Ethics, which they say complements their Code of Conduct and probably goes beyond what is required by Article 3j.¹³⁶

¹²⁷ GL Press Release: Launch of Best Practice Principles for Voting Research & Analysis, 5 March 2014, available at <http://www.glasslewis.com/launch-best-practice-principles-voting-research-analysis/>.

¹²⁸ ESMA, “Report: Follow-up on the development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis,” 18 December 2015 at 6.

¹²⁹ Ibid; The Best Practice Principles Group, Best Practice Principles for Providers of Shareholder Voting Research & Analysis, March 2014; [hereafter “2014 BPPG, Best Practice Principles”]; ESMA, “Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry”, 19 February 2013. These principles were reviewed and an updated version was published in July 2019. See The Best Practice Principles Group, Best Practice Principles for Providers of Shareholder Voting Research & Analysis 2019, July 2019 [hereafter “2019 BPPG, Best Practice Principles”]

¹³⁰ 2019 BPPG, Best Practice Principles at 6 (“The Principles are not a rigid set of prescriptive rules; rather they consist of a set of Principles and accompanying Guidance.”)

¹³¹ Ibid at 12-15.

¹³² Ibid at 16-17.

¹³³ Ibid at 18-19.

¹³⁴ Best Practice Principles for Providers of Shareholder Voting Research & Analysis: ISS Compliance Statement 19 April 2017, available at <https://www.issgovernance.com/file/duediligence/best-practices-principles-iss-compliance-statement-april-2017-update.pdf>

¹³⁵ ISS Code of Conduct: Standards for the global operation of ISS, Adopted by the ISS Board of Directors, 16 June 2003, Revised November 2013.

¹³⁶ ISS, Regulatory Code of Ethics, June 2017.

All of these developments have taken place as a result of concerns relating to the proxy advisory industry, which can be summarised under four headings: the concentration of the industry (with the related problem of the quality of advice given), the possible blind following of proxy advice by shareholders, the conflicts of interest of proxy advisors and “one size fits all” recommendations. These will be addressed in turn.

a. Market Concentration and the Quality of Advice

The proxy advisory industry has been much slower to develop in Europe than it has in the US.¹³⁷ They have attracted the attention of regulatory authorities in Europe, however, including the new provisions directed at them within the SRD2. In 2012, ESMA published a consultation paper on the proxy advisory industry, which preceded its 2013 statement, mentioned above.¹³⁸ In this paper, it noted that the market share of the proxy advisory industry had not been measured and so the concentration of the industry was unknown.¹³⁹ It did state that in its survey, respondents considered ISS to be the leading proxy advisor in Europe.¹⁴⁰ In the US, the market concentration has been measured and in 2010 two firms were shown to occupy most of the market - ISS controlling 61% of the market and GL controlling 36%.¹⁴¹ After 2011, it appears that GL managed to increase this share to over 40%.¹⁴² ESMA did find in their survey that the majority of respondents expressed the belief that competition in the proxy advisory industry was “relatively healthy”, at least in the UK.¹⁴³ However, in response to questions posed to European investors in the 2012 consultation paper, ESMA’s subsequent 2013 final statement noted opinions of investors that the proxy advisor market was concentrated, with respect to the European market.¹⁴⁴ These opinions were in the context of asserting that no regulatory intervention should be

¹³⁷ See Gaia Balp, 'Regulating Proxy Advisors Through Transparency: Pros and Cons of the EU Approach' (2017) 14 European Company and Financial Law Review 1.

¹³⁸ ESMA, “Discussion Paper: An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options”, 22 March 2012 at 10.

¹³⁹ *Ibid* at 11.

¹⁴⁰ *Ibid*.

¹⁴¹ Belinfanti (n 119) at 14 and 12, respectively. See also ESMA, “Discussion Paper: An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options”, 22 March 2012 at 11. This concentration breakdown has been reported more recently by James R Copland, David F Larcker and Brian Tayan, 'The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry' (2018) Rock Center for Corporate Governance: Stanford Closer Look Series CGRP72 at 2.

¹⁴² Tao Li, 'Outsourcing Corporate Governance: Conflicts of Interest and Competition in the Proxy Advisory Industry' (2013) ECGI Finance Working Paper no 389/2013 at 35.

¹⁴³ ESMA, “Discussion Paper: An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options”, 22 March 2012 at 32.

¹⁴⁴ ESMA, “Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry”, 19 February 2013 at 22-23.

pursued due to the possible result of creating barriers to entry in an already concentrated market.

The dominance of ISS can be seen in the apparent influence it has over voting in companies across the world. The *New York Times* reported in 2006 that ISS’s “opinions affect the governance decisions of professional investors controlling \$25 trillion in assets – half the value of the world’s common stock.”¹⁴⁵ Where the market for voting advice is highly concentrated, concerns arise about the quality of advice given, as well as the costs of the service to investors.¹⁴⁶ Where a market for proxy advice is concentrated, there is little incentive to improve the quality of that advice, especially where shareholder clients are hiring proxy advisors not perhaps in order to receive the best possible proxy advice but in order to satisfy a regulatory requirement, such as in the SRD2. The issue of advice quality strikes at the heart of the engagement question examined in this thesis: does the SRD2 have as its aim raising the level of engagement or raising its quality? The OECD has hinted recently at the distinction, saying “in order to minimise the cost of compliance with voting requirements, many large institutions primarily rely on consultants that provide standardised advice on how to vote.”¹⁴⁷ It is not clear that this distinction has been effectively captured in the SRD2, which, as noted, looks for more “long term” engagement, as well as more engagement generally.¹⁴⁸ Blanket voting policies that apply regardless of the nuanced circumstances of individual companies may be the most cost effective way of ensuring voting rights are exercised, but it does not necessarily make for high quality engagement, at least from a voting perspective.¹⁴⁹

The quality of proxy advice has been pointed to by regulators as a reason to intervene in the business of proxy advisors. In November 2019, the SEC formally proposed new regulations on proxy advisors that would require them to give companies who are the subject of voting advice the opportunity to review such advice before it is sent to

¹⁴⁵ Robert D Hershey Jr, “A Little Industry With a Lot of Sway on Proxy Votes”, *New York Times*, 18 June 2006.

¹⁴⁶ Center on Executive Compensation, “A Call for Change in the Proxy Advisory Status Quo: The Case for Greater Accountability and Oversight”, January 2011 [hereafter “CEC, ‘Call for Change’ 2011”] at 76.

¹⁴⁷ Adriana De La Cruz, Alejandra Medina and Yung Tang, “Owners of the World’s Listed Companies”, (2019) OECD Capital Market Series, Paris, available at <http://www.oecd.org/corporate/ca/Owners-of-the-Worlds-Listed-Companies.pdf/> at 22.

¹⁴⁸ See above at p 159.

¹⁴⁹ For greater discussion on this point in the context of passive investors, see Chapter 6: Passive Investors and Engagement at pp 218-223.

shareholders.¹⁵⁰ This was expressly undertaken due to concerns about the quality of advice. As it said, “we are concerned about the risk of proxy voting advice businesses providing inaccurate or incomplete voting advice (including the failure to disclose material conflicts of interest) that could be relied upon to the detriment of investors.”¹⁵¹ This move prompted ISS to initiate litigation against the SEC, claiming that it lacks the jurisdiction to introduce such regulation.¹⁵² In April 2020, key elements of the proposal, including the requirement to submit advice to companies subject of the advice, were abandoned by the SEC.¹⁵³ However, a proposal to require the inclusion of a set time period during which the proxy advisor would have to disable any automatic submission of votes of clients.¹⁵⁴ This is more relevant to the supposed alleged blind following of proxy advice, which is discussed in greater detail in the next section.

With regard to costs, Belinfanti makes the argument that the absence of adequate competition among proxy advisors provides proxy advisors (and specifically ISS) with an opportunity to create agency costs for investors.¹⁵⁵ She cites ISS’ “first mover advantage” as insulating them from competitive pressures.¹⁵⁶ This involves the network effects favouring an early participant in a market who sets a standard in the market, the high costs of moving from one proxy advisor to another, the early acquisition of a position and resources and early technology and knowledge development.¹⁵⁷ Dent makes the point that the ability of ISS and GL to extract such agency costs from investors is constrained by investors’ ability “to perform proxy analysis in-house and of smaller institutions to follow the Wall Street Rule or some other simple formula for voting.”¹⁵⁸ In other words, if proxy advisors raise costs above an acceptable level, institutional investors will simply choose not to use proxy advisors. After all, the main reason investors use proxy advisors is because

¹⁵⁰ Securities and Exchange Commission, “Proposed Rule: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice,” 5 November 2019, available at <https://www.sec.gov/rules/proposed/2019/34-87457.pdf>.

¹⁵¹ Ibid at 11.

¹⁵² Frank M. Placenti, “The SEC’s Evolving Views Regarding Proxy Advisors,” Harvard Law School Forum on Corporate Governance, 23 November 2019.

¹⁵³ Partick Temple-West, “SEC abandons key plank of proposal to curb proxy advisers,” *Financial Times*, 29 April 2020.

¹⁵⁴ See Speech of Commissioner Elad L Roisman, “Speech at the Council of Institutional Investors’ (‘CII’) Conference”, 10 March 2020, available at https://www.sec.gov/news/speech/speech-roisman-cii-2020-03-10#_ftn10.

¹⁵⁵ Belinfanti (n 119) at 28 (“The anemic level of competition currently present in the proxy advisory and corporate governance industry is not sufficient to serve as an adequate check on ISS agency costs.”)

¹⁵⁶ Ibid at 28-32.

¹⁵⁷ Ibid.

¹⁵⁸ George W Dent Jr, ‘A Defense of Proxy Advisors’ (2014) Michigan State Law Review 1287 at 1308.

it is a more cost-effective means of fulfilling engagement responsibilities. While this may limit the costs that ISS and GL can impose on clients, there are other issues that result from a highly concentrated market. Where two companies effectively control the market, this will increase the influence and power of these two companies. Since ISS dominates the market, it theoretically has an outsized influence on companies. Whether or not it has such an influence will depend on whether institutional investors follow the advice their proxy advisor automatically, which investors claim they do not do.¹⁵⁹

b. Blind Following of Advice

The power and influence of proxy advisors would be significantly diluted if institutional investors were not so reliant on them and regularly rejected their advice. As noted, institutional investors will claim that they consider the advice thoughtfully and make up their own minds with regard to how they will vote.¹⁶⁰ However, there appears to be a high correlation between proxy advice and voting outcomes. Investors have pointed out to regulators that correlation does not imply causality since the correlation may be linked to other external factors.¹⁶¹ Regardless, studies have shown that when ISS recommends voting against management with respect to a large sample of US companies, this is associated with 13.6-20.6% fewer votes cast in favour of management.¹⁶² As well as this, where ISS recommends voting against a director, that director can expect 14-19% fewer votes.¹⁶³ It has also been reported that where ISS advises against compensation packages in respect of US companies, 24% fewer shareholders vote in its favour.¹⁶⁴ Schouten has investigated the question of whether institutional investors follow proxy advice blindly and found that they are more likely to vote against a proxy recommendation where they have a larger stake in the investee company.¹⁶⁵ However, it has been reported that large institutional investors rarely follow proxy advice on certain issues, such as directors' remuneration in the US.¹⁶⁶

¹⁵⁹ Michael C Schouten, "Do Institutional Investors Follow Proxy Advice Blindly?" (January 2, 2012). Available at SSRN: <https://ssrn.com/abstract=1978343> at 4.

¹⁶⁰ *Ibid.*

¹⁶¹ ESMA, "Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry", 19 February 2013 at 12.

¹⁶² Jennifer E Bethel and Stuart L Gillan, 'The Impact of the Institutional and Regulatory Environment on Shareholder Voting' (2002) 31 *Financial Management* 29 (with a sample of 1,500 companies from a Standard and Poor's Super Composite, containing companies from the S+P 500, S+P MidCap 400 and the S+P SmallCap 600 for the proxy voting year of 1998).

¹⁶³ Jie Cai, Jacqueline L Garner and Ralph A Walkling, 'Electing Directors' (2009) 64 *The Journal of Finance* 2389.

¹⁶⁴ James K Glassman and Hester Peirce, "How Proxy Advisory Services Became so Powerful", Mercatus Center at George Mason University, June 2014.

¹⁶⁵ Schouten (n 159).

¹⁶⁶ Attracta Mooney, "Voting advice on CEO pay is usually ignored by big asset managers", *Financial Times*, 18 November 2018, citing evidence from Proxy Insight.

PWC published a study in 2018 in relation to ISS advice for the remuneration vote of 40 FTSE 100 companies in 2017, in which they found that a recommendation by ISS to vote against the remuneration report correlated with between 10-15% increase in negative voting among the company's shareholders.

The high correlation between proxy advice and voting outcomes gives companies the strong impression of influence, especially so in the case of ISS. The fact that proxy advisors appear to have such influence has led to concerns being expressed about potential conflicts of interest with regard to the advice that they provide.

c. Conflicts of Interest

ESMA, in its 2013 report on the proxy advisory industry noted that, during its market consultation, two main sources of conflicts of interest concerned investors.¹⁶⁷ These occurred where (1) a proxy advisor advises institutional investors on to how to vote the shares of public listed companies and also provides consulting advice and services to the same public listed companies and (2) where a proxy advisor is owned by an institutional investor or public listed company to whom or about whom the same proxy advisor gives advice. With regard to ISS and GL, the former provides both advisory services to shareholders and governance services to issuers and the latter is owned in part by the Ontario Teachers' Pension Plan and by Alberta Investment Management, both large institutional investors.¹⁶⁸ Providing both proxy advice to shareholders and governance consulting to issuers is a potential conflict to which ISS has repeatedly been accused of being subject.¹⁶⁹ The reason this amounts to a conflict of interest is because ISS could give favourable proxy advice to the investors of a company, provided that same company retains ISS' consulting services.¹⁷⁰ In 2008, ISS, in response to this concern, created separate divisions for each service and a firewall between the division that provides proxy advice to shareholders and the division providing consulting services to issuers.¹⁷¹ It is submitted that creating separate divisions for services does not eliminate the conflict of interest for the

¹⁶⁷ ESMA, "Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry", 19 February 2013 at 9.

¹⁶⁸ Belinfanti (n 119) at 16, 13; Glass Lewis, Conflict of Interest Statement, 1 January 2018, available at <http://www.glasslewis.com/conflict-of-interest/>

¹⁶⁹ See United States Government Accountability Office, Report to Congressional Requesters, Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting, June 2007 [hereafter "GAO Report 2007"] at 4; CEC, "Call for Change" 2011, at 43-46; Belinfanti (n 119) at 16-17; James K Glassman and JW Verret, "How to Fix our Broken Proxy Advisory System", Mercatus Center at George Mason University, 16 April 2013 at 22.

¹⁷⁰ Dent acknowledges "slight evidence" that this occurs in Dent (n 158) at 1308. See also GAO Report 2007 at 4.

¹⁷¹ See Belinfanti (n 119) at 17; Dent (n 158) at 1323; CEC, "Call for Change" 2011 at 45.

organisation as a whole. This is perhaps reflected in the persistence of the concern as, despite the separation, the issue was raised again by investors with ESMA in 2013.¹⁷²

In relation to the conflict of interest of GL, the ownership of a proxy advisor by a shareholder that may seek out proxy advice imperils the objectivity of the advice. The owners of the proxy advisor may seek to influence its voting advice in a manner that suits their own interests, rather than the interests of the market as a whole. GL acknowledges that both of its owners are clients but goes on to assert that it “excludes [its owners] from any involvement in the formulation and implementation of its proxy voting policies and guidelines, and in the determination of voting recommendations for specific shareholder meetings.”¹⁷³ This is not dissimilar to ISS’ firewall position, whereby different parties are separated in the corporate group in order to insulate those giving proxy advice from those who have interests that diverge from those of their institutional investor clients. It is submitted that if many in the market are unconvinced by ISS’ assurances, they will be no less assuaged by the assurances of GL. Both ISS and GL argue that they already disclose any conflicts of interest when they arise.¹⁷⁴ The nature of these disclosures has been criticised for being overbroad, with the Center on Executive Compensation calling them “blanket disclosure[s]”.¹⁷⁵

More recently, Nasdaq and the US Chamber of Commerce’s Center for Capital Markets Competitiveness conducted an annual survey for the 2018 proxy season, which involved responses from representatives of 165 US public companies.¹⁷⁶ This survey revealed the low confidence companies have in the advice of proxy advisors, as only 39% of respondents reported that they believe proxy advisors “carefully researched and took into account all relevant aspects of the particular issue on which it provided advice.”¹⁷⁷ Despite

¹⁷² See ESMA, “Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry”, 19 February 2013; Belinfanti (n 119) at 17.

¹⁷³ Glass Lewis, Conflict of Interest Statement, 1 January 2018, available at <http://www.glasslewis.com/conflict-of-interest/>

¹⁷⁴ Ibid; ISS, Regulatory Code of Ethics, June 2017, at 13 and ISS, Policy Regarding Disclosure of Significant Relationships, 27 October, 2017, available at <https://www.issgovernance.com/file/duediligence/Disclosure-of-Significant-Relationships.pdf>.

¹⁷⁵ CEC, “Call for Change” 2011 at 69 (“At present, some proxy advisors, including ISS, utilize a blanket disclosure in their reports to alert investors that they may have done business with the corporation that is the subject of the report and direct readers to an email address where they can ask for more information.”); Dent (n 158) at 1324.

¹⁷⁶ Center for Capital Markets Competitiveness, Proxy Season 2018: Examining Developments and Looking Forward, 2018.

¹⁷⁷ Ibid at 5.

this, 92% of respondents retained a proxy advisor to make a recommendation on an issue in their proxy statements.¹⁷⁸ This loyalty could be due to shareholder clients of proxy advisors using proxy advice services for strategic and cost saving reasons, such as being required to exercise voting rights as a part of their fiduciary duty,¹⁷⁹ rather than for the quality of the advice they receive. Of the 165 respondents, 10% identified significant conflicts of interest with a proxy advisor.¹⁸⁰

On the other hand, in 2007, the US Government Accountability Office (GAO) found that “[a]ll of the institutional investors – both large and small – we spoke with that subscribe to ISS’s services said that they are satisfied with the steps that ISS has taken to mitigate its potential conflicts.”¹⁸¹ The GAO found no “major violations” with regard to any proxy advisors in the US.¹⁸² ESMA’s findings in 2013 are consistent with the Nasdaq/Center for Capital Markets Competitiveness survey, insofar as representatives of issuers had greater concerns than investors. As it said, “The investors’ community seems relatively comfortable with the advice and/or recommendations given by proxy advisors. Stronger concerns, together with the request for some form of regulation, come from the issuers.”¹⁸³ Similarly to the GAO’s findings, ESMA could not identify a “market failure” that would justify introducing binding measures in the proxy advisory market and it ultimately recommended that proxy advisors self-regulate by developing a code of conduct.¹⁸⁴ A possible reason for the disparity in opinion of proxy advisors between investors and issuers according to Dent is that corporate managers of issuers once had greater power in the decision making of companies but now, thanks in part to proxy advisors, their dominance has been ceded to shareholders. Dent goes on to say, “[c]orporate managers resent being dethroned and have sought to hobble proxy advisors with various regulations.”¹⁸⁵ Certainly, the ESMA 2013 report revealed a concern among European issuers that the use of proxy advisors can create a risk of shifting the responsibility from shareholders and weaken their prerogatives.¹⁸⁶

¹⁷⁸ Ibid at 4.

¹⁷⁹ As is the case with US pension plans since 1988, see above at p 173.

¹⁸⁰ Center for Capital Markets Competitiveness, Proxy Season 2018: Examining Developments and Looking Forward, 2018 at 7.

¹⁸¹ GAO Report 2007 at 11.

¹⁸² Ibid at 4.

¹⁸³ ESMA, “Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry”, 19 February 2013 at 5.

¹⁸⁴ Ibid at 27.

¹⁸⁵ Dent (n 158) at 1329.

¹⁸⁶ ESMA, “Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry”, 19 February 2013 at 14.

Ultimately, it is difficult to say whether increased use by shareholders of proxy advisors will be harmful to companies in the long run. As argued above, it is a safe assumption that the SRD2 will increase the reliance of institutional investors on proxy advisors to meet regulatory engagement expectations and, thus, increase their influence in European corporate governance.¹⁸⁷ Perhaps anticipating this, the provisions in the SRD2 targeting proxy advisors seek to increase their transparency and reduce the effect of any conflicts of interest. However, it is difficult to see how these provisions will make any difference, since the provisions largely require proxy advisors to publicly adhere to a code of conduct and disclose potential or actual conflicts of interest, which the two major proxy advisors already do. Article 3j(2), which requires the disclosure of many elements of proxy advisors' research and preparation of voting advice, is a step further but the language used in this provision allows for very general disclosures. For example, this provision requires disclosure of "essential features" of proxy advisors' methodologies and voting policies, the "main" information sources used in research and procedures put in place to ensure the quality of research. Very little of Article 3j(2) requires specific information on proxy advisors' produced methodologies and the content of their advice. For this reason, it is predicted that Article 3j will not change the practices of proxy advisors and will not assuage the concerns that exist with regard to the proxy advisory industry. Furthermore, the increased reliance on proxy advisors gives rise to concerns that engagement will be undertaken on a generalised basis, involving a blanket policy for voting that does not take into account the nuanced circumstances of each company. This is addressed in the next section.

d. One Size Fits All

With regard to engagement, there is a danger that an increased reliance on proxy advisors will lead to a greater "one size fits all" approach to engagement. This is a common complaint about proxy advisors, that they use inflexible, rules based analytics that are applied to all companies to produce standard recommendations that do not reflect the nuances of individual companies.¹⁸⁸ Proxy advisors have established "best" practices with

¹⁸⁷ See above, p 176.

¹⁸⁸ Latham & Watkins LLP, "Corporate Governance Commentary: Proxy Advisory Business: Apotheosis or Apogee?" March 2011, available at <https://www.lw.com/thoughtLeadership/corporate-governance-commentary-march-2011> (There are, however, a number of countervailing factors that might make apogee a more accurate description of the proxy advisory industry's role and influence on corporate governance. These include... Growing discontent on the part of companies and company advisers with the one-size-

respect to certain areas of corporate governance, such as the separation of the roles of CEO and Chairman and the declassification of boards.¹⁸⁹ While it may generally be preferable that the Chairman and CEO roles are held by separate people, inflexibly recommending voting against any such arrangement may not be efficient in every case. Gordon makes the point that proxy advisors themselves may seek to economize on research costs and therefore adopt these “one size fits all” approaches to recommendations.¹⁹⁰ This could lead to “inflexible governance checklists that could stifle beneficial corporate governance innovations.”¹⁹¹ These concerns likely motivated the inclusion of transparency with regard to methodologies of proxy advisors in Article 3j. Ideally, the transparency that Article 3j seeks to produce will reveal whether a proxy advisor is adopting an inflexible approach. However, as noted above, institutional investors may turn to proxy advisors for recommendations in order to reduce costs of engagement, especially where engagement is a duty rather than a right. As Ormazabal notes, proxy advisors in these circumstances will not have a financial incentive to invest in research, “since any such effort would decrease the profitability of advisory firms while having no substantive impact on their ability to attract new institutional customers or generate additional revenue.”¹⁹² Reddy notes that ISS objects to the combination of the roles of CEO and Chair as a rule and argues: “By treating this aspect as a bright-line rule, clearly the proxy advisor is not considering whether a relevant company is able to adhere to the main principle that there is a clear division of responsibilities at the head of the company without separating the roles of CEO and chair.”¹⁹³

fits-all analytics used by proxy advisory firms...”); Albert H Choi, Andrew Lund, and Robert J Schonlau, “Golden Parachutes and the Limits of Shareholder Voting,” (August 23, 2019), Vanderbilt Law Review (Forthcoming), available at SSRN: <https://ssrn.com/abstract=3229962> at 22 (“Proxy advisors might economize by using simple, one-size-fits-all criteria when making their recommendations if their clients were expected to care less about the vote.”); Jeffrey N Gordon, “Say on Pay”: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In’ (2009) 46 Harvard Journal on Legislation 323 at 353 (“...the very effort to avoid criticism over its multiple roles may lead a multi-service proxy advisor towards ‘one size fits all’ rather than firm-specific compensation tailoring.”)

¹⁸⁹ Yaron Nili, “Proxy Advisory Firms and Corporate Governance Practices: One Size Does Not Fit All” Harvard Law School Forum on Corporate Governance and Financial Regulation, 18 June 2014.

¹⁹⁰ Gordon (n 188) at 325.

¹⁹¹ Holger Fleischer, 'Proxy Advisors in Europe: Reform Proposals and Regulatory Strategies' (2012) 9 European Company Law 12 at 14.

¹⁹² Gaizka Ormazabal, “The Role of Stakeholders in Corporate Governance: A View from Accounting Research” November 2017, available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3086875 at 61.

¹⁹³ Bobby V Reddy, 'Thinking Outside the Box – Eliminating the Perniciousness of Box-Ticking in the New Corporate Governance Code' (2019) 82 Modern Law Review 692 at 700.

The notion that proxy advisors apply a “one size fits all approach has been challenged. Dent has said “[t]he charge of a one-size-fits-all approach is at best grossly exaggerated.”¹⁹⁴ He describes the approach of ISS in particular as “sophisticated” and argues that they offer “custom voting policies” which undermines the argument that they are inflexible. At the same time, he acknowledges that the sheer number of companies for which proxy advisors offer recommendations means that they cannot offer an “individualised review” for reasons of cost. Even if proxy advisors were able to customise their recommendations, they could be subject to a criticism of inconsistency,¹⁹⁵ placing them in an invidious position. Other academics have rebutted the notion that proxy advisors follow a “one size fits all” approach in discrete contexts. Ertimur et al studied proxy advisors’ recommendations with respect to the executive pay votes of ISS and GL in 1,275 companies in 2011 in the US.¹⁹⁶ They found “limited” evidence of a “one size fits all” approach, in the form of an ISS policy to recommend a vote against remuneration where a company includes excise tax gross-ups and modified single triggers in severance agreements in the remuneration package in the year prior to the vote on the package.¹⁹⁷ Otherwise, the authors did not find evidence that either proxy advisor adopts a mechanical or rules based approach to recommendations. The question of “one size fits all” engagement is not limited to proxy advice and will be returned to in the context of passive investors in the next chapter.

ii. Representative Groups

Another, less publicised, means of outsourcing engagement is to establish representative groups of institutional investors and asset managers. This does not always involve “outsourcing”, in the sense that the group will engage on behalf of the shareholders, but it can involve communication and the discussion of issues in investee companies among shareholders as a group. The former, whereby the group engages on behalf of the shareholders in the group, is beginning to occur more frequently and groups are being set up for this purpose. One reason for this is that representative groups may be used to

¹⁹⁴ Dent (n 158) at 1316.

¹⁹⁵ CEC, ‘Call for Change’ 2011 at 60 (“At the same time, there are concerns that proxy advisors utilizing a “case-by-case” or individualized approach to their recommendations can be inconsistent in how they treat companies or can be opaque with respect to their decision process on any particular issue.”)

¹⁹⁶ Yonca Ertimur, Fabrizio Ferri and David Oesch, 'Shareholder Votes and Proxy Advisors: Evidence from Say on Pay' (2013) 51 *Journal of Accounting Research* 951.

¹⁹⁷ *Ibid* at 967.

facilitate engagement without triggering the “acting in concert” rules and insider trading laws, described in Chapter 4.¹⁹⁸

Perhaps the most prominent of these groups is the Investor Forum, established in the UK in 2014.¹⁹⁹ This group was set up as a response to a recommendation of the Kay Review.²⁰⁰ Kay viewed the solution to the high diversification of asset managers’ portfolios and consequent lack of incentive to engage with any one of those companies as involving greater encouragement of collective action among asset managers.²⁰¹ Kay went on to say: “We believe the need for collective action should be addressed by the establishment of an investors’ forum, the objectives of which are to facilitate both supportive and critical action on issues of concern to investors, in general and in relation to particular companies.”²⁰² Kay’s vision for such a forum involved an independent, flexible body, without Government involvement, in which asset managers would be “critical participants”.²⁰³ Kay addressed the concern that such collaboration might trigger a mandatory bid by arguing that this would be “highly unlikely” and noting that this outcome would require the investors in the forum seeking to not only replace board members but also to replace them with connected persons.²⁰⁴ According to its website, as of December 2019, there were 50 members of the Investor Forum, which represented 33% of the FTSE All Share capitalisation.²⁰⁵

Membership of the Investor Forum also appears to be an effective way for investors who are signatories to the SC to signal to the FRC that they are in compliance with its principles. In its annual report representing 2015/2016, the Investor Forum mentioned that, during the FRC’s tiering exercise, described above,²⁰⁶ “[a] number of investors cited membership of the Investor Forum as important evidence of their commitment to stewardship.”²⁰⁷ Certainly, it is clear that membership of the Investor Forum potentially demonstrates compliance with two principles of the SC: collaborative engagement and the means by

¹⁹⁸ Chapter 4: Regulatory Impediments to Shareholder Engagement, above at pp 119-122; pp 133-139; The Investor Forum, “Collective Engagement Framework: Summary”, 18 October 2018; “Asset managers get involved in the companies they own” *The Economist*, 30 August 2018.

¹⁹⁹ See the Investor Forum, “Our History,” at <https://www.investorforum.org.uk/about/history/>.

²⁰⁰ The Investor Forum, “Review 2015/2016” 19 January 2017 at 12.

²⁰¹ Kay Review at 50.

²⁰² *Ibid.*

²⁰³ *Ibid* at 51.

²⁰⁴ *Ibid.*

²⁰⁵ See the Investor Forum, “Membership Summary” at <https://www.investorforum.org.uk/membership-summary/>

²⁰⁶ Chapter 2, above at pp 50-51.

²⁰⁷ The Investor Forum, “Review 2015/2016” 19 January 2017 at 11.

which stewardship activities will be escalated.²⁰⁸ With regard to collaborative engagement, what is required is that signatories, “where necessary” participate in collaborative engagement to influence investee companies. The 2020 SC requires disclosure by signatories of “what collaborative engagement they have participated in and why, including those undertaken directly or by others on their behalf.”²⁰⁹ This statement clearly leaves the open the possibility of collective engagement by a representative group, such as the Investor Forum.

The 2020 SC also requires signatories to disclose “the outcomes of escalation either undertaken directly or by others on their behalf.”²¹⁰ Escalation undertaken “on behalf” of signatories is likely a reference to asset owners setting escalation expectations for their asset managers rather than escalation undertaken by representative groups on behalf of signatories.²¹¹ What the 2020 Code requires is that expectations and objectives are established in relation to escalation of engagement and a description of the outcomes of this engagement. The Investor Forum has described itself as “an effective mechanism for escalation”. It refers to its “collective engagement framework”, which is a structured plan for managing engagements.²¹² This framework could be sufficient to meet the requirement of establishing expectations and objectives since it offers a detailed plan for engaging, including different phases and how to approach each phase. This is likely to cover the circumstances in which an engagement could be considered to have been “escalated” from one phase to another.

The SRD2 may result in a proliferation of groups like the Investor Forum in Europe because of the possibilities for representative groups to satisfy engagement obligations. Certain necessary elements of the engagement policy that must be created and disclosed (on a comply or explain basis) under Article 3g could be covered by membership in such a group. An obvious element of the engagement policy is that institutional investors and asset managers must describe how they “cooperate with other shareholders”, which is an identical requirement to collective action in the SC. Article 3g does not require a description of how shareholders will escalate their engagement but, unlike the SC, Article

²⁰⁸ Financial Reporting Council, “The Stewardship Code 2020”, Principles 10 and 11, respectively.

²⁰⁹ Ibid at 19.

²¹⁰ Ibid at 20.

²¹¹ Ibid, (“Signatories should explain: the expectations they have set for asset managers that escalate stewardship activities on their behalf; OR how they have selected and prioritised issues, and developed well informed objectives for escalation...”)

²¹² The Investor Forum, “Collective Engagement Framework: Summary”, 18 October 2016.

3g does require a specific description of how a “dialogue” will be conducted. Though the 2012 SC does mention a dialogue as part of the guidelines of several principles, it is not a specific aspect of any of them, even though the Code defined engagement as a “purposeful dialogue” with investee companies.²¹³ It is perhaps notable that the 2020 SC does not mention “dialogue” at all. As described previously, the characterisation of some act as “dialogue” is central to the common understanding of engagement.²¹⁴ Certainly, representative groups could fulfil the provision of Article 3g that requires that institutional investors and asset managers disclose how they “conduct dialogues” with investee companies by taking on the responsibility of dialogue. The Investor Forum, for instance, defines its purpose as, *inter alia*, “facilitating a dialogue”.²¹⁵ A similar required element of the engagement policy in Article 3g is a description of how shareholders will communicate with other stakeholders. The Chairman of the Investor Forum, Simon Fraser, in his introduction to the 2015/2016 review, noted that “[t]he Forum is uniquely positioned to work with key stakeholders to help facilitate a better dialogue and make long-term investing work more effectively.”²¹⁶ Furthermore, in its Collective Engagement Framework, the Investor Forum commits to undertaking a review of finished engagements, which includes a discussion with wider stakeholders.²¹⁷

While the existing practices of the Investor Forum are used here as an example of how a representative group such as this can be used by institutional investors to tick the various boxes of an engagement code and convincingly report compliance, groups could be set up to tailor themselves to all requirements of Article 3g. Such a group could constitute a “one stop shop” for engagement regulations, the membership of which would credibly tick all boxes for Article 3g. Where institutional investors and asset managers wish to comply but to simultaneously minimise the costs of compliance, membership of such a group may be an attractive option for many European shareholders. Existing representative groups, such as the Irish Association of Investment Managers (IAIM) in Ireland, with an existing membership of asset managers, could expand their remit to seek to facilitate compliance of their members with the requirements of Article 3g. The IAIM was founded in 1986 and, at the time of writing, has fourteen full members.²¹⁸ This does not mean that each member of a representative “engagement” group will actively involve themselves in engagement.

²¹³ Financial Reporting Council, “The UK Stewardship Code” September 2012 at 6.

²¹⁴ See Chapter 1, above at pp 14-17.

²¹⁵ The Investor Forum, Review: 2015/2016, at 9.

²¹⁶ *Ibid* at 2.

²¹⁷ The Investor Forum, “Collective Engagement Framework: Summary”, 18 October 2016 at 7.

²¹⁸ See Irish Association of Investment Managers, “About” at <http://www.iaim.ie/about/>; Irish Association of Investment Managers, “Membership” at <http://www.iaim.ie/about/membership/>.

Some commentators have expressed scepticism with regard to the Investor Forum and how effective it will be in engaging to improve corporate governance. Williamson noted that many prominent members of the Investor Forum, such as the National Association of Pension Funds, the Investment Managers' Association, and the Association of British Insurers, were also members of the Institutional Shareholders' Committee (ISC), which, as noted were the originators of the SC.²¹⁹ She argued that "The ISC during its many years of existence neither promoted collective engagement effectively nor acted as a positive force for progressive reform of corporate governance."²²⁰ Williamson conceded however that membership of the Investor Forum is broader and that it will remain to be seen how it promotes collective engagement and changes the culture of participants in equity markets. It is submitted that if many groups proliferate, there may be wide variations in the quality of each group. Some may be very effective in helping members engage and others may provide little more than a means of allowing members to declare compliance, with little meaningful engagement activity.

D. Blockchain Technology

i. Introduction

As described, the provisions of the 2007 SRD were mainly focused on facilitating the use of shareholder rights and identifying those rights in the context of the AGM. Although, it was argued in Chapter 4 that the legal formalities of the AGM do not provide a barrier or obstacle to shareholder engagement since these formalities all seek to help place shareholders in a position where they could engage, some commentators have envisioned the potential for the AGM being much more efficient from the perspective of shareholder engagement.²²¹ These commentators see the technology of blockchain as creating a unique opportunity to provide shareholders with greater ability and access, while also reducing the costs of engaging at the general meeting. Blockchain is a technology that involves a distributed ledger on a public network, which is encrypted.²²² Each block contains certain

²¹⁹ Janet Williamson, "The Kay Review of Equity Markets – game changer or missed opportunity" in Sigurt Vitols (ed), *Long-term investment and the Sustainable Company: a stakeholder perspective* (ETUI, Brussels, 2015).

²²⁰ *Ibid* at 53.

²²¹ In particular, Elst and Lafarre, 'Bringing the AGM to the 21st Century: Blockchain and Smart Contracting Tech for Shareholder Involvement' David Yermack, 'Corporate Governance and Blockchains' (2017) *Review of Finance* 7.

²²² See Don Tapscott and Alex Tapscott, *Blockchain Revolution: How the Technology Behind Bitcoin is Changing Money, Business and the World*, (Penguin, 2016).

information and is connected sequentially to the next block, the information on which refers to the information on the previous block. The self-referential nature of the blockchain and the fact that each new block is created with a network consensus means that the blockchain does not have, or need, a trusted intermediary for validation of each block.²²³ Blockchain technology has been suggested as a solution for many different global issues, such as corruption in foreign aid, protection of property rights and the restoration of artists' rights in the music industry.²²⁴ With regard to the easy use of shareholder rights, many have pointed to blockchain as containing the solution to the problem of shareholder passivity in corporate governance.

ii. How blockchain could facilitate shareholder engagement

Certain attributes of blockchain technology, such as transparency, security and identification are the same attributes that some have said are missing from the shareholder voting process.²²⁵ Companies could create a blockchain in order to facilitate shareholder voting. Shares would be represented by “tokens” on this blockchain, which have been analogised as company specific cryptocurrencies.²²⁶ This token is what represents value on the blockchain.²²⁷ Many companies have undertaken “Initial Coin Offerings” (ICO) in which they issue tokens to investors that give them certain rights against the company in lieu of a share offering in order to raise funds.²²⁸ An ICO would not be necessary for companies wishing to use blockchain to facilitate voting, as a blockchain could be created, on which existing shares are assigned tokens that represent the value of the shareholding. A Centralised Securities Depository (CSD) Working Group on Distributed Ledger Technology (DLT) produced a report on proxy voting on blockchain recently, in which

²²³ Anne Lafarre and Christoph Van der Elst, 'Blockchain Technology for Corporate Governance and Shareholder Activism' (2018) Law Working Paper N° 390/2018

²²⁴ Ibid.

²²⁵ Ibid at 16.

²²⁶ Mark Fenwick and Erik PM Vermeulen, 'Technology and Corporate Governance: Blockchain, Crypto, and Artificial Intelligence' (2018) Law Working Paper N° 424/2018 at 20.

²²⁷ OECD, “Blockchain Technology and Corporate Governance Technology, Markets, Regulation and Corporate Governance,” Directorate for Financial and Enterprise Affairs Corporate Governance Committee, 6 June 2018 at 6.

²²⁸ For more detail, see Saman Adhami, Giancarlo Giudici and Stefano Martinazzi, 'Why Do Businesses Go Crypto? An Empirical Analysis of Initial Coin Offerings, ' (January 6, 2018), Journal of Economics and Business (forthcoming), available at SSRN: <https://ssrn.com/abstract=3046209>, describing a sample set of 253 ICOs that occurred from 2014 to August 2017 and originating primarily in the United States, Russia, the United Kingdom and Canada

they propose a process for how general meetings can be run on a blockchain.²²⁹ The CSD working group is made up of a number of international CSDs, including those of Switzerland, Argentina, Chile, Russia and South Africa. The process for carrying out a general meeting on a blockchain, according to this report, includes recording the original announcement of the meeting and its agenda on the blockchain created by the company, as well as loading into it the ownership records.²³⁰ The company would then issue tokenised voting rights to those eligible and authenticate those using the blockchain system.²³¹ On this blockchain, parties can assign their voting rights to proxies and those proxies can issue voting instructions with the tokenised voting rights. The CSD Working Group then suggest that the general meeting could be streamed online and a chat facility could be integrated.

A general meeting run in the manner suggested above would involve far fewer intermediaries than the current system involves. The company could connect directly with shareholders via the blockchain, rather than hope that intermediaries are passing on the relevant information and voting rights to the rightful shareholder. To an extent, the SRD2 seeks to deal with this problem, as Article 3c requires intermediaries to facilitate the exercise of shareholder voting. The SRD2 defines “intermediary” as including an investment firm, credit institution or CSD, which provides safekeeping or administrative services for shares or maintenance of securities accounts.²³² These legislative actions may overcome the unwillingness of custodians to pass voting information through to their clients. Nonetheless, the administration involved in passing voting information through the custody chain will inevitably lead to delays and errors that will mean not every shareholder will receive the information with sufficient time to make a considered decision on how to vote, or receive the information at all. The blockchain system would seem to offer an efficient solution to these problems.

As well as this, the blockchain system has been lauded for its ability to give shareholders instant confirmation of the effect of their vote, whereas remote voting in modern AGMs “does not offer shareholders (full) transparency and proof on how their vote is actually

²²⁹ CSD Working Group, “General Meeting Proxy Voting on Distributed Ledger: Product Requirements v2.1” November 2017. This report is also discussed in Lafarre and Van Der Elst (n 216) at 16-18.

²³⁰ Ibid at 10.

²³¹ This involves a deviation from more common blockchains, such as that which holds the cryptocurrency bitcoin, which involves authentication from a network of users, rather than, as here, a centralised authentication controlled by one party, the company.

²³² SRD2, Article 1(2)(b).

exercised.”²³³ In other words, the system of counting votes is not transparent and has led to anomalies and controversies at general meetings.²³⁴ Transparency is a central feature of blockchain technology and shareholders would be able to see their vote recorded on the blockchain as soon as it has been cast. Again, the SRD2 has targeted this problem, Article 3c(2) requiring that where a vote is cast electronically, an electronic confirmation of receipt of the vote is sent to the shareholder who voted. Furthermore, the shareholder or its proxy, must be able to obtain confirmation that their vote was validly recorded and counted. The blockchain solution to this problem to seem to offer a quicker option, without the need of shareholders to take the initiative to ensure their vote was validly recorded. Shareholders will likely use the option under Article 3c where they have some suspicion that their vote will not be validly received and counted, which is likely to be rare. Blockchain removes any suspicion from the beginning of the process.

Finally, commentators have noted that blockchain allows companies to no longer use physical AGMs, which are costly and take a greater amount of time to organise.²³⁵ Under the Companies Act 2014, PLCs in Ireland can provide for electronic participation in general meetings.²³⁶ The vision for a blockchain enabled general meeting seems to be “virtual only”, in the sense that all shares are represented by tokens on the blockchain and all voting and engagement occurs on the blockchain. This need not be the case, as companies can adopt a “hybrid structure”, whereby a physical meeting occurs and electronic access is available for shareholders who do not attend physically. Such a structure has the advantages that those who want to attend a physical AGM (as many shareholders are deeply sceptical of “virtual only” general meetings²³⁷) can do so and those who wish to seek the benefits of the blockchain can also do so. It has the disadvantage that the company must organise both a physical AGM and the blockchain system for shareholders, as they may prefer to choose one or the other. The costs of a physical AGM are high and it is a time-consuming process and, if the issuer is also going to organise access to a virtual meeting system, it will likely prefer to do away with the physical meeting altogether.²³⁸ This choice has led to several conflicts with shareholders, as certain classes of shareholder oppose doing away with a physical AGM on the basis that it may allow management to ignore difficult questions and

²³³ Lafarre and Van Der Elst (n 223) at 15.

²³⁴ See *ibid.*

²³⁵ Lafarre and Van Der Elst (n 223) at 18.

²³⁶ Companies Act 2014, s 1106.

²³⁷ See below, (n 239).

²³⁸ Robert Richardson, “Virtual-Only Shareholder Meetings: Streamlining Costs or Cutting Shareholders Out?” Harvard Law School Forum on Corporate Governance and Financial Regulation, 30 November 2017.

avoid serious scrutiny from shareholders.²³⁹ In the context of the 2020 coronavirus pandemic, many companies have taken the opportunity to hold virtual only AGMs.²⁴⁰ This has led to some controversy and criticism from both shareholders and commentators, despite the apparent necessity.²⁴¹

Irish law allows companies who wish to dispense with a physical meeting in favour of a virtual only meeting.²⁴² However, as the Institute of Directors in Ireland pointed out in the midst of the coronavirus pandemic, many Irish companies are precluded from holding virtual only AGMs in their Constitutions.²⁴³ In order to amend its Constitution to allow for a virtual AGM, a general meeting would have to be held and a special resolution passed.²⁴⁴ For this reason, the Institute called for a temporary amendment to the law in order to allow for virtual only AGMs in circumstances where anything other than a physical AGM is precluded by company's Constitution. The SRD was transposed in a manner whereby companies may offer participation in a general meeting by electronic means, without imposing requirements of a physical meeting.²⁴⁵ As of writing, no Irish company has opted for a virtual only AGM and only one company, Jimmy Choo PLC (now owned by Michael Kors) has done so in the UK.

Blockchain would appear to offer an elegant solution to certain problems inherent in the process of running a general meeting. These problems include the inefficiencies in passing information through the custody and investment chain to the rightful shareholder and the insufficient transparency of the voting process. Furthermore, a blockchain based general meeting would broaden access to shareholders, who may not have the time or resources to

²³⁹ Attracta Mooney, "Nuns tell companies to get real over virtual AGMs", *Financial Times*, 20 October 2017; Attracta Mooney, "Shift to virtual meetings sets stage for shareholder rebellion", *Financial Times*, 14 January 2018; "Online meetings may favour managers over shareholders" *Economist*, 30 April 2020.

²⁴⁰ Attracta Mooney, "Companies urged to hold virtual AGMs to give shareholders a say," *Financial Times*, 20 April 2020.

²⁴¹ Chris Flood, "Standard Life Aberdeen hit by investor backlash over virtual AGMs", *Financial Times*, 13 May 2020; "Low Resolution: Online annual meetings may favour managers over shareholders" *Economist*, 2 May 2020.

²⁴² See Companies Act, 2014, s 176, which provides that a general meeting can be held in or outside of Ireland and if it is held outside of Ireland, the Company has a duty to make "all necessary arrangements to ensure that members [shareholders] can by technological means participate" in the meeting.

²⁴³ Institute of Directors in Ireland press release, "90% of business leaders want law amended to allow virtual AGMs during crisis" 29 April 2020, available at <https://www.iodireland.ie/news-events/news/90-business-leaders-want-law-amended-allow-virtual-agms-during-crisis>.

²⁴⁴ By virtue of section 32 of the Companies Act 2014.

²⁴⁵ See S.I. No. 316/2009 - Shareholders' Rights (Directive 2007/36/EC) Regulations 2009.

travel to attend a physical general meeting. This could have the effect of increasing shareholder engagement on issues discussed and voted on at the meeting.

However, this technology should not be seen as only positive. In 2017, ESMA detailed a number of challenges and risks associated with blockchain technology.²⁴⁶ In particular, it stresses that governance frameworks will need to be agreed that safeguards the users of the technology.²⁴⁷ In the context of AGMs, rules that relate to the authorisation of participants on the platform are most relevant. Also relevant are cyber and security risks that are linked to blockchain technology. ESMA note that the technology “is at an early development stage and largely untested.”²⁴⁸ Since this report was published, there are examples of companies undertaking their AGM using blockchain successfully,²⁴⁹ but it is clear that this remains uncommon. Security risks that jeopardise the legitimacy of the AGM process would undermine the confidence and trust that is required for shareholders to engage at the AGM. As the “virtual only” AGM becomes more popular, it brings with it a suspicion that the technology is being used by management to render engagement less effective, as the technology can create a barrier to proper discussion and allow management to avoid difficult questions and scrutiny. While this is not necessarily the case, it would seem to create an opportunity for unscrupulous management. Furthermore, there is no question that the integration of this technology will not occur in the near future and will certainly require the co-operation and leadership of regulatory organisations.

E. Conclusion

While the preceding chapters have identified a formidable array of impediments, many can be related to the same issue: costs. Many impediments are directly related, such as the growth of intermediation in the investment chain, and many are indirectly related, such as the difficulty in acting collectively and potentially triggering a mandatory bid, thereby limiting the scope for cost reduction. The means by which impediments to engagement

²⁴⁶ ESMA, “Report: The Distributed Ledger Technology Applied to Securities Markets”, 7 February 2017.

²⁴⁷ *Ibid* at 9.

²⁴⁸ *Ibid* at 10.

²⁴⁹ A recent example is Banco Santander in 2018, see Broadridge Financial Solutions, Inc, “Santander and Broadridge Complete a First Practical Use of Blockchain for Investor Voting at an Annual General Meeting” 17 May 2018, <https://www.prnewswire.com/news-releases/santander-and-broadridge-complete-a-first-practical-use-of-blockchain-for-investor-voting-at-an-annual-general-meeting-300649733.html>.

may be overcome then will inevitably focus on cost reduction, which includes the outsourcing of engagement through representative groups and proxy advisors, who may be able to do much of the costly leg work of engagement on behalf of shareholders, and technological solutions such as blockchain. Many means of overcoming impediments to engagement are targeted at specific forms of engagement, such as collective engagement among institutional investors or voting at AGMs. These means, as well, vary with regard to the important question of “level” versus “quality” of engagement, which is a distinction emphasised throughout this thesis. Representative groups, for example, may raise the quality of engagement by careful monitoring and targeted engagements on company specific issues that relate to a wider concern of shareholders, such as environmental or governance issues. On the other hand, many solutions to the engagement problem only seem to be focused on the level of engagement. This could include transparency measures in the SRD2 itself, which encourages the disclosure of compliance with generalised engagement policies. The increased use of proxy advisors, too, gives rise to concerns about “one size fits all” engagement with respect to large numbers of investee companies. The next chapter will address a particular subset of institutional investor, that has grown and is likely to continue to grow in importance and influence: passive investors. This subset of institutional investor is worth focusing on not only because of a rapid rise in prominence in the market but also because passive investors encapsulate both the impediments that exist to engagement – they are highly diversified and therefore subject to rational apathy with regard to their portfolio of investments - and the solutions to overcoming these impediments – they cannot sell their shareholding when dissatisfied with a company and therefore arguably must engage in some way. Most pertinently, if passive investors were to engage at a greater level, consistently with the aims of the SRD2, there is a fear that “one size fits all” will be how this engagement is carried out.

6. Shareholder Engagement and Passive Investing

A. Introduction

As Chapters 2-4 have described, there is both a strong regulatory push to encourage institutional investors to engage with investee companies and formidable market and regulatory barriers to different kinds of engagement. There is an important trend in asset management, driven by asset owners, that will affect the incentives of asset managers and therefore the operation of the engagement provisions of the Revised Shareholder Rights Directive (“SRD2”):¹ the trend toward passive investing. Broadly, this passive investing involves investing on the basis of an index rather than actively choosing investee companies. Passive investors are those invested in passive products such as index funds and exchange traded funds (“ETFs”)² which are provided by larger asset managers who may also provide active funds. BlackRock, for example, is currently the world’s largest asset manager by assets under management,³ and offers both active funds in which assets are actively selected and passive funds, which follow an index. In this sense, BlackRock is both an active and passive investor. Active management involves the use of the asset manager’s expertise to choose a portfolio of investments which aims to outperform a market benchmark or index. For example, the ISEQ 20 may produce a certain return and the active manager will use quantitative and qualitative measures in order to select which company shares to buy and the relative weighting of each company in the portfolio in order to achieve greater returns. In contrast, a passive fund manager will only seek to achieve the same returns as the chosen benchmark or index and will do so by buying the shares from the companies in the index at the weighting assigned by that index.

Indexes can be formed in many different ways and on different bases, which can deliberately include certain kinds of companies and exclude others. What distinguishes passive funds from active funds is that once the criteria of an index is set, it is not normally changed. In other words, active funds can constantly evolve and alter the composition of companies in the portfolio, whereas passive funds can only change the companies in which it is invested if a company no longer complies with the criteria of selection for the index.

¹ Directive (EU) 2017/828 [hereafter “SRD2”].

² Explained further below at p 198.

³ According to their website, as of 30 June 2019, BlackRock’s assets under management totalled \$6.84 trillion, see <https://www.blackrock.com/sg/en/introduction-to-blackrock>.

Conversely, a company can enter the index if it meets the criteria for the index. For example, the ISEQ 20 is a benchmark index that tracks the 20 best performing companies by turnover and free float market capitalisation that are listed on the Euronext Dublin market.⁴ The selection criteria for an index can be discretionary. The Standard & Poor's 500 is selected by a committee on the basis of the size and importance of companies with respect to the US companies.⁵

The upward trend in the popularity of passive investing, which will be described, poses several questions for the “engagement agenda.” The first question is whether passive investors are more or less likely to be active in corporate governance. Passive investing is a different prospect than shareholder passivity, in the sense that the passive manner of portfolio construction does not necessarily imply that the portfolio manager will be more reluctant to use the rights attached to their shares. The second question is whether passive investors will be good stewards of investee companies. As will be described, there are schools of thought that passive investors have the best incentives to use their voting and intervention rights to promote the long term health of the company and other schools of thought that argue precisely the opposite, that the incentives of passive investors are such that they should be deprived of voting rights altogether.⁶

The rise of passive investing has been of such a scale that they will likely be dominant in worldwide equity markets in the coming decades, making them key corporate governance players, relative to other shareholders. In order to assess the future operation of engagement provisions, including those in the SRD2, passive investors require particular consideration. The first section of this chapter will explain why this is the case, how passive investing has grown in popularity and why.

B. The Rise of Passive Investing

i. The Rise

⁴ ISEQ 20 Factsheet, 30 September 2019.

⁵ See generally, “S&P U.S. Indices Methodology” July 2019, available at <https://us.spindices.com/documents/methodologies/methodology-sp-us-indices.pdf>.

⁶ See below at pp 216-221.

The popularity of passive investing is a relatively modern phenomenon. In the early 1970s, the first index fund was developed by Wells Fargo, which followed all stocks on the New York Stock Exchange, rather than seeking to outperform their average performance.⁷ This was refined to follow the 500 companies in the S+P 500 shortly after.⁸ While these index funds were targeted at pension fund investment, Vanguard created an investment fund targeted at a wider market.⁹ This index fund was called the “first index investment trust” and, upon its initial public offering in 1976, it raised only \$12million, which was far short of the \$30million hoped for by Vanguard.¹⁰ Indeed, the index mutual fund became known as “Bogle’s folly,” after the chief executive of Vanguard, John C Bogle.¹¹ The reason the index fund was at first considered a failure has been identified as the excessive loading costs on the fund, as well as the reluctance of asset managers at the time to support the idea of an index mutual fund due to their inability to charge higher management fees for such a fund.¹² There also seemed to be a feeling in the asset management industry that the pursuit of returns that merely matched the market was unsatisfactory since it was a pursuit of the “average.” This notion was derided by major players in the industry at the time and described as “un-American.”¹³

While this was an inauspicious start to the life of the index fund, investors did slowly direct assets to US index funds and the value of assets in them grew steadily through the 1980s and 1990s.¹⁴ Undoubtedly the Global Financial Crisis of 2008 proved to be a positive turning point in the trend toward passive investing.¹⁵ In 2005, passive fund assets

⁷ Robin Wigglesworth, “Passive attack: the story of a Wall Street revolution”, *Financial Times*, 20 December 2018.

⁸ *Ibid.*

⁹ *Ibid.*

¹⁰ John H Langbein and Richard A Posner, 'Market Funds and Trust-Investment Law II' (1977) 1 American Bar Foundation Research Journal 1 At 37.

¹¹ John A Haslem, 'Mutual Funds: To Index or Not to Index' (April 26, 2004). Available at SSRN: <https://ssrn.com/abstract=2085268>; Morningstar, “A brief history of indexing” available at <http://news.morningstar.com/articlenet/article.aspx?id=390749>

¹² Langbein and Posner (n 10) at 37-38.

¹³ John C Bogle “As The Index Fund Moves from Heresy to Dogma... What More Do We Need To Know?” The Gary M. Brinson Distinguished Lecture, 13 April 2004, available at <https://pdfs.semanticscholar.org/ff62/bca9c752045579d17fbe65b3d99cc0cc7443.pdf/> at 5.

¹⁴ John C Bogle, 'The Index Mutual Fund: 40 Years of Growth, Change, and Challenge' (2016) January/February Financial Analysts Journal 9, reports that assets in index funds were \$11 million in 1975, rising to \$511 million in 1985 to \$55 billion in 1995 at 9.

¹⁵ Robin Wigglesworth, “Passive Attack: The story of a Wall Street revolution”, *Financial Times*, 20 December 2018, (“While their genesis can be traced to the 1970s, the shift towards passive investing has been seismic since the financial crisis.”); Assets under passive management in the US grew from 4% in 1995 to 16% in 2005 and grew further to 34% by 2015, according to Jan Fichtner, Eelke M Heemskerk and Javier Garcia-Bernardo, 'Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk' (2017) 19 Business and Politics 298 at 302.

represented 14% of the total US market and this rose to 34% in 2015.¹⁶ In 2018, their market share in the US was 43% of all equity fund products.¹⁷ Moody's, the credit rating agency, reported that it projected passive to take over half of the market share in the US by 2024 "at the latest".¹⁸ In Europe, the rise of passive funds has been less precipitous but still notable. Passive funds accounted for 16% of all assets under management in Europe at the end of 2017, rising from 7% ten years earlier.¹⁹ A good example of the move from active to passive investing after the Financial Crisis is the ETF industry. ETFs are a form of mutual fund that is itself traded on a stock exchange like an equity and so investors can invest in companies by buying shares in the ETF. This gives investors more flexibility since they can redeem an investment in an ETF easily. Importantly, for present purposes, ETFs are usually passively managed funds seeking to track an index²⁰ and therefore the sudden growth rate in this sector is indicative of a trend toward passive investors. The growth in the ETF market is described by the Central Bank of Ireland, as "striking" and an uptick in the Irish market too could be seen after the Financial Crisis.²¹ Ireland is a particularly popular destination for European ETFs to domicile in and the Central Bank has noted that the growth in the ETF industry in Ireland could grow "exponentially" in the coming years.²² According to Irish Funds, there has been a 400% increase in ETF assets domiciled in Ireland from \$67 billion in 2011 to \$362 billion in December 2017.²³ In December 2008 there were \$718 billion invested in ETFs globally and at the end of 2016 there were \$3.4 trillion.²⁴

There are no signs of this trend abating. The *Financial Times* reported that, in the third quarter of 2018, active funds suffered net outflows of \$86 billion, while during this same

¹⁶ Fichtner, Heemskerk and Garcia-Bernardo (n 15) at 302.

¹⁷ Vladyslav Sushko and Grant Turner, "The implications of passive investing for securities markets," BIS Quarterly Review, March 2018, available at https://www.bis.org/publ/qtrpdf/r_qt1803j.pdf.

¹⁸ Trevor Hunnicutt, "Index funds to surpass active fund assets in U.S. by 2024: Moody's", *Reuters*, 2 February 2017, available at <http://www.reuters.com/article/us-funds-passive-idUSKBN15H1PN>.

¹⁹ Giovanni Strampelli, 'Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing' (2018) 55 San Diego Law Review 803 at 811.

²⁰ See David M Smith, "Mutual Fund Fees and Expenses" Chapter 4 in John A Haslem (ed), *Mutual Funds*, (Wiley, 2010) at 62.

²¹ Central Bank of Ireland, Exchange Traded Funds Fund Discussion Paper, 2012, available at <https://www.centralbank.ie/docs/default-source/publications/discussion-papers/discussion-paper-6/discussion-paper-6---exchange-traded-funds.pdf?sfvrsn=6> at 7. ("...since the economic crisis ETFs have received striking amounts of asset inflows...")

²² *Ibid.*

²³ Irish Funds, "Ireland – Europe's Centre of Excellence for Exchange Traded Funds," March 2018, available at https://irishfunds-secure.s3.amazonaws.com/1520434523-Exchange-Trade-Funds_Web_March-2018.pdf at 7.

²⁴ Central Bank of Ireland, Exchange Traded Funds Fund Discussion Paper, 2012 at 7.

period of time, passive funds attracted \$52 billion in net inflows.²⁵ As will be detailed in the next section, unless active asset managers can outperform benchmark indices, the trend toward passive will continue for the foreseeable future, justifying the description of passive asset managers as “the new power brokers of modern capital markets.”²⁶

ii. Reasons for the Rise

The asset management industry has for years been subject to the criticism that the fees charged lack transparency and were generally too high for the services provided.²⁷ The Financial Conduct Authority (FCA) published a review of the asset management industry in the UK in 2017 and took specific issue with the predominant fee structure of the actively managed portion of the industry.²⁸ It identified “persistent poor performance” of asset managers and stated that self-correction by way of competitive forces “alone is not sufficient for all investors.”²⁹ On the issue of price for funds, the FCA found “clustering” in the active fund market and noted that, while the price for passive funds had steadily decreased over time, the price for active funds had remained stable over time.³⁰ This is despite its finding that both active and passive funds had on average not outperformed their benchmarks net of fees.³¹ Indeed, the FCA actually found evidence that within the active fund market, the more expensive funds underperformed the cheaper active funds.³²

The failure to outperform benchmark indices is a global problem for active asset managers. A Morningstar study found that over a ten year period, June 2008 to June 2018, only 25%

²⁵ Owen Walker, “Active funds suffer worst quarter for seven years”, *Financial Times*, 29 October 2018.

²⁶ Jill Fisch, Assaf Hamdani and Steven Davidoff Solomon, 'Passive Investors' (2018) Law Working Paper N° 414/2018

²⁷ Patrick Collinson, “Investment funds: hidden fees wipe a third off returns” *The Guardian*, 4 November 2011, Burton G Malkiel, 'Asset Management Fees and the Growth of Finance' (2013)

²⁷ *Journal of Economic Perspectives* 97 at 104 (“The higher fees charged by [active] managers completely overwhelm whatever benefits they might produce.”); John P Freeman and Stewart L Brown, 'Mutual Fund Advisory Fees: The Cost of Conflicts of Interest' (2001) *Spring The Journal of Corporation Law* 609.

²⁸ Financial Conduct Authority, “Asset management market study: Final report,” June 2017 available at <https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>

²⁹ *Ibid* at 81.

³⁰ *Ibid* at 33.

³¹ *Ibid* at 37.

³² *Ibid* at 38.

of European active asset managers were successful in outperforming their passive counterparts and they outperformed their passive counterparts in just two of 49 fund categories studied.³³ In one illustrative case, the billionaire investor Warren Buffett made a public \$1 million bet on 19 December 2007 that an unmanaged passive fund (the Vanguard S+P 500 fund) would outperform an investment professional's selection of any five hedge funds over a ten year period.³⁴ Protégé Partners accepted the bet and its selection of hedge funds ultimately returned approximately 2.2%, while the S+P fund returned over 7% by the end of 2017.³⁵ As it became clear during the course of the 2000s and after the Financial Crisis, that higher fee active funds were not outperforming low fee passive funds, more and more investors moved assets from active to passive. As Fichtner et al stated:

“In the boom times before the global financial crisis, most investors tolerated high fees, hoping that mutual fund and hedge fund managers would deliver superior returns because of their active trading strategy. However, it is has been becoming increasingly clear in recent years that the majority of both actively managed mutual funds as well as hedge funds are not able to consistently generate higher returns than established benchmark indices, such as the S&P 500.”³⁶

The transformation of the asset management industry from less active stock picking of asset managers toward more of an automatic portfolio selection based on indices has important corporate governance implications. The first issue is whether or not passive investors have the right incentives to engage with investee companies. In the context of the SRD2 and Stewardship Codes in the UK and elsewhere, this is a very pertinent question. Whether or not passive investors have equivalent, better or worse incentives to engage with investee companies will be addressed in the next section.

C. Passive Investors, Active Engagement

³³ Morningstar, Morningstar's European Active/Passive Barometer, October 2018; see also Attracta Mooney, “European active managers beaten by passives, 10-year study finds” *Financial Times*, 1 October 2018.

³⁴ See Berkshire Hathaway, Shareholder Letters, 2016 and 2017; Emily Price, “Warren Buffett Just Won a \$1 Million Bet” *Fortune*, 30 December 2017.

³⁵ Emily Price, “Warren Buffett Just Won a \$1 Million Bet” *Fortune*, 30 December 2017.

³⁶ Fichtner, Heemskerk and Garcia-Bernardo (n 15) at 302-303 (footnote omitted).

i. Incentives of Passive Asset Managers

As noted, the EC pointed out several problems with institutional investors during the development of the SRD2, including that asset owners evaluate and select asset managers on a short term basis, leading the latter to focus on their short term performance relative to a benchmark index.³⁷ For this reason, the SRD2 targets asset owners (or, as defined in the SRD2, “institutional investors”) and seeks to encourage them, through disclosure, to evaluate and select their asset managers on a longer term basis.³⁸ Where asset owners are hiring passive asset managers, this issue would appear to be entirely solved. Passive asset managers are unable to adjust their portfolio in response to short term underperformance since they are tied to the index the fund is tracking. As the index underperforms, so too does the passive investor. If short termism is “rooted in a misalignment of interests between asset owners and asset managers”³⁹ as the EC claims, investing in passive funds realigns these interests without the need for regulatory intervention with respect to those investing passively. Implicit in the EC’s argument is that a long term perspective allows asset managers to take into account “the real value and longer-term value creative capacity of companies” and “[increase] the value of the equity investments through shareholder engagement.”⁴⁰ If the EC is correct about the causes of short termism and taking a “long term” perspective on investing presents an opportunity for greater engagement, passive investing represents a potential remedy for shareholder passivity.

It is far from clear that short term incentives, created by asset owners, are at the root of shareholder passivity. As has been discussed in Chapter 3, whether or not shareholders engage with investee companies largely depends on the costs of engagement.⁴¹ It may be the case that asset managers who are excessively focused on their relative performance are unlikely to expend resources on engagement. However, in the absence of asset owner pressure, the costs of engagement would, in many cases, still exceed the benefits. Even where an asset manager holds the shares of a particular company for “the long term”, they may still be unwilling to dedicate the resources to engage with that company. As a portfolio becomes more diversified, the cost benefit analysis of engaging will be affected. As noted in Chapter 3, the larger a stake an investor holds in a company, the less affected it will be

³⁷ European Commission, “Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement”, 9 April 2014 [hereafter “EC 2014 proposal”] at 4.

³⁸ SRD2, Article 3h(2).

³⁹ EC 2014 proposal at 4.

⁴⁰ *Ibid.*

⁴¹ Chapter 3: Market Impediments to Shareholder Engagement, above at pp 83-86.

by “rational apathy” and the “free rider problem”.⁴² This is because the investor stands to gain more proportionally from the value increases that the engagement is expected to bring. Using the same logic, the smaller the stake an investor has within an investee company, the lower the incentive that investor will have to engage. As Wong has argued, “[l]arge portfolios... give rise to difficulties in monitoring – particularly the resource-intensive engagements between institutional investors and boards of directors contemplated by stewardship codes in the UK and other markets – and weaken an ‘ownership’ mindset.”⁴³ By tracking an index, passive investors are necessarily highly diversified and should therefore have a strong financial disincentive against engaging.⁴⁴ Bebchuk et al have argued that index funds are disincentivised to act as stewards since this would involve higher costs and therefore higher fees for investors, whereas investors could simply opt for an index fund that tracks the same index without acting as stewards.⁴⁵ In other words, an index fund could easily free ride off any stewardship conducted by another index fund following a similar index. In this light, the engagement agenda represented by Stewardship Codes and the SRD2 could be undone simply by virtue of the increasing popularity of passive investing.

Other authors have gathered evidence that engagement is more important to passive managers than can be encompassed by a cost-benefit analysis. Bioy et al surveyed twelve of the largest providers of passive products (index funds and ETFs) across US, Europe and Asia in order to discover the views on stewardship and engagement.⁴⁶ According to this research, passive fund providers are increasing their commitment to stewardship. They noted:

⁴² Ibid.

⁴³ Simon CY Wong, 'Why Stewardship is Proving Elusive for Institutional Investors' (2010) *Butterworths Journal of International Banking and Financial Law* 406 at 407.

⁴⁴ Ibid, (“passive and active asset managers that replicate market indices can end up with hundreds of companies in their portfolios.”); Lucian Bebchuk and Scott Hirst, “Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy” (2018) ECGI Law Working Paper N° 433/2018 at 17 (“whereas the index fund managers bear all the costs of investments in stewardship, the increased revenue they receive—through increased fee revenue—will be only a tiny fraction of the expected value increase from governance improvements.”)

⁴⁵ Lucian A Bebchuk, Alma Cohen and Scott Hirst, 'The Agency Problems of Institutional Investors' (2017) 31 *The Journal of Economic Perspectives* 89 at 98.

⁴⁶ Hortense Bioy, Alex Bryan, Jackie Choy, Jose Garcia-Zarate and Ben Johnson, “Passive Fund Providers Take an Active Approach to Investment Stewardship” Morningstar Manager Research, December 2017. These passive fund providers were BlackRock, Vanguard, State Street Global Advisers, Fidelity Investments, Amundi, Legal & General Investment Management, Deustche Asset Management, UBS, Nomura, Schwab, Nikko and Lyxor.

“Of the 12 surveyed firms, nine reported that they currently engage with investees and expressed a willingness to reach more companies in years to come. They also, and perhaps more importantly, intend to improve the quality of their interactions. Of the three that do not currently engage, two... have plans to formalize an engagement strategy in the coming months, in line with their commitment to the UN PRI.”⁴⁷

Only one asset manager surveyed saw no “compelling reason” to set up an engagement plan, citing cost and a lack of evidence regarding the benefits of engagement.⁴⁸ On the issue of cost, which it is argued is at the root of shareholder passivity, Bioy et al argued that their research reveals a conclusion that would be at odds with the conclusion offered by authors such as Bebchuk, that, despite the costs, index fund providers do wish to engage. They concluded:

“All in all, it is fair to say that most index managers have no intention to free-ride with respect to engagement. All but one of the surveyed firms have plans to intensify their efforts in this area and bear the associated costs. This is because they see engagement as an important and integral part of their stewardship responsibilities and increasingly as something that clients expect from—in the words of one surveyed manager—a ‘grown-up’ asset-management organization.”⁴⁹

Bioy et al relied not simply on respondent asset manager statements to support their argument but also pointed to the growth in each asset manager’s stewardship or corporate governance team. Bebchuk and Hirst responded to this argument by pointing out that an assessment of asset managers’ willingness to invest resources into stewardship “needs to be made in light of both the vast number of portfolio companies that they invest in and the many companies in that group where they have stakes with significant monetary value.”⁵⁰ These authors claim that, despite increasing the numbers in stewardship teams, there is still a substantial under investment in stewardship, given the size of the biggest providers’ portfolios. An increase from 20 members of a stewardship team to 33, as Bioy et al reported in the case of BlackRock between 2014-2017, may allow for more engagement and more

⁴⁷ Ibid at 15 (footnote omitted).

⁴⁸ Ibid.

⁴⁹ Ibid at 19.

⁵⁰ Bebchuk and Hirst (n 44) at 32.

thorough stewardship but given the thousands and thousands of companies in BlackRock's portfolios, this increase would do little to allow each team member more than a cursory effort at engagement for each company.⁵¹

Consistent with Bebchuk and Hirst's arguments, Heath et al conducted a study of passive investors in various US databases, including the Center for Research in Security Prices, Compustat, Institutional Shareholder Services (ISS), and the Frank Russell Company from 2004 to 2017.⁵² These authors examined contentious proposals in these databases, which were proposals on which company management and ISS disagreed, and demonstrated that passive investors were 12.5% more likely to vote with company management than their active counterparts.⁵³ Breaking down the type of proposals, the authors found that index funds were 14.4% more likely to side with management than active investors on management proposals that ISS opposed and 10.3% more likely to side with management on shareholder proposals opposed by management.⁵⁴ As the authors noted, passive investors' support for management proposals could reflect private engagement with management but their support for management in the context of shareholder proposals opposed by management cannot be explained by private engagement. As they put it:

“...if index funds affect firm governance through private engagement, their tendency to vote with management should be mostly (or entirely) on management proposals and not on shareholder proposals. Yet we find that relative to active funds, index funds are more likely to vote with firm management on both management and shareholder proposals.”⁵⁵

The authors also observed that index funds are substantially less likely to abstain on votes that were supported by management but opposed by ISS.⁵⁶ These findings suggest that passive investors are more likely to “cede power to firm management”, in the words of the

⁵¹ Bioy et al (n 46) at 19; Dorothy S Lund, 'The Case Against Passive Shareholder Voting' (2018) 43 *The Journal of Corporation Law* 493 at 515-516.

⁵² Davidson Heath, Daniele Macciocchi, Roni Michaely and Matthew C Ringgenberg, 'Do Index Funds Monitor?' Finance Working Paper N° 638/2019, July 2019, available at SSRN: http://ssrn.com/abstract_id=3259433.

⁵³ *Ibid* at 20.

⁵⁴ *Ibid* at 29.

⁵⁵ *Ibid* at 6.

⁵⁶ *Ibid* at 11.

authors.⁵⁷ Furthermore, this study provides evidence the cost is a barrier to engagement of passive investors, as the authors found that low-fee index funds are even more likely to vote with company management, which, as the authors say, “indicates that the low-cost structure of index funds directly affects their capacity to monitor.”⁵⁸

ii. Competition with Active Asset Managers

In contrast, Fisch et al maintain that, in fact, passive investors have a strong incentive to engage. In particular, they point out that passive funds are at a disadvantage, compared to their active fund counterparts, because they are unable to increase the value of their fund by selling their shares when it is underperforming.⁵⁹ These authors argue that passive funds are in competition with active funds with respect to both costs and performance.⁶⁰ Passive funds, due to their lack of management and minimal administration, are able to charge very low fees to investors. Active funds, on the other hand, require constant management and administration and so tend to charge far higher fees, although it appears that the price competition with passive funds has resulted in price pressure for active products.⁶¹ With respect to performance, the authors argue that active managers have a competitive advantage through the investigation of, and careful selection of, different stocks.⁶² Passive funds, on the other hand “must invest in the bad companies along with the good ones.”⁶³ Assuming that passive funds do compete with active funds on performance and cannot respond to underperformance, the authors argue that the only remaining option to improve performance of underperforming companies in a passive fund’s portfolio is to use “voice”. In other words, stewardship and engagement are the only means available to a passive fund manager to compete with active funds in terms of performance. To support their argument, the authors have identified an increase in engagement by passive fund managers.⁶⁴ The passive managers the authors focus on to make the case for increased passive manager engagement are the so called “Big Three” of BlackRock, Vanguard and State Street. These three asset managers manage the largest amount of assets globally and are the biggest

⁵⁷ Ibid at 12.

⁵⁸ Ibid at 33.

⁵⁹ Fisch, Hamdani and Solomon (n 26).

⁶⁰ Ibid at 12.

⁶¹ PwC, “Asset & Wealth Management Revolution: Pressure on profitability” October 2018, predicting that all mutual fund fees will fall by 19.4% by 2025.

⁶² Fisch, Hamdani and Solomon (n 26) at 14.

⁶³ Ibid.

⁶⁴ Ibid at 27.

providers of passive funds.⁶⁵ It is perhaps worth noting that all three of these asset managers also provide active funds for investors, to varying degrees.⁶⁶

Certainly, the Big Three all claim to take stewardship seriously. All three asset managers produce annual “stewardship reports” containing information about the stewardship and engagement activities over the previous proxy season. BlackRock claimed to have engaged 1,453 companies between 1 July 2017 and 30 June 2018.⁶⁷ This represents an increase from the previous year, where it claimed to engage 1,274 companies.⁶⁸ Vanguard reported engagement with 721 companies during the 2018 proxy year and noted that this represented an increase of 63% since 2014.⁶⁹ State Street published an annual stewardship report that encompassed 2017, reporting engagement with 610 companies during this time.⁷⁰ All three reported voting at far more general meetings than the number of companies they reported “engagement” with, implying an understanding of “engagement” that does not include voting.⁷¹ In his 2018 letter to CEOs, Larry Fink, the CEO of BlackRock, made the point that underpins the argument of Fisch et al, saying, “[i]n managing our index funds, however, BlackRock cannot express its disapproval by selling the company’s securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever.”⁷² In a speech in 2015, William McNabb III, CEO of Vanguard, also made the case for greater board-shareholder engagement on the basis of an inability to exit a shareholding. He stated “We’re going to hold your stock when you hit your quarterly earnings target. And we’ll hold it when you don’t. We’re going to hold your stock if we like you. And if we don’t. We’re going to hold your stock when everyone else

⁶⁵ See Fichtner, Heemskerk and Garcia-Bernardo (n 15); Strampelli (n 19) at 810-811.

⁶⁶ According to data compiled by Fichtner et al, as of June 2016, BlackRock had 18.7%, Vanguard had 18.9% and State Street had 3.1% of their assets invested in active funds, see Fichtner, Heemskerk and Garcia-Bernardo (n 15) at 304, table 1.

⁶⁷ BlackRock Investment Stewardship: 2018 Annual Report, 30 August 2018, available at <https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2018.pdf>.

⁶⁸ BlackRock, Investment Stewardship Report: 2017 Voting and Engagement Report, July 1 2016 – June 30 2017, 15 July 2017, available at <https://www.blackrock.com/corporate/literature/publication/blk-2017-annual-voting-and-engagement-statistics-report.pdf>.

⁶⁹ Vanguard, Investment Stewardship Annual Report, 2018, available at https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf.

⁷⁰ State Street Global Advisors, Stewardship 2017, available at <https://www.ssga.com/investment-topics/environmental-social-governance/2018/07/annual-stewardship-report-2017.pdf>

⁷¹ See Chapter 1: Introduction, above at p 17.

⁷² BlackRock, Larry Fink’s 2018 Letter to CEOs, available at <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>.

is piling in. And when everyone else is running for the exits.”⁷³ At least in rhetoric, the biggest asset managers would appear to agree that they have the incentives to engage. Indeed, implied in this rhetoric is an argument that voice is necessarily more important than exit as a means of expressing disapproval. It will be recalled that Hirschman’s “messy” option of voice as defined as “any attempt at all to change, rather than to escape from, an objectionable state of affairs” also implies engagement as tool for changing or reforming companies and correspondingly “exit” as a form of abdication of this responsibility.⁷⁴

There have been criticisms of the argument put forward by Fisch et al. Bebchuk and Hirst argue that the trend towards more passive investing has occurred because active funds tend to underperform a target benchmark index.⁷⁵ They point out that certain active asset managers will always be able to outperform a benchmark index, even if the index as a whole improves, depending on the weighting and selection of the companies in the active manager’s portfolio. Where an index fund improves the governance of a subset of firms through engagements seeking changes in investee companies, this effect could lead to the outperformance of active managers who happen to be overweight in those particular firms in their portfolio. Therefore, according to Bebchuk and Hirst, “an interest in lowering the performance of actively managed funds relative to index funds should not be expected to provide index fund managers with a substantial incentive to bring about such changes.”⁷⁶ These authors also point to a conflict of interest that is inherent in asset management, whereby there is an excess of deference shown toward companies because of the desire for the companies to continue to employ them for the management of their pension scheme.⁷⁷ It is not clear that this conflict of interest affects index fund managers any more or less than their active counterparts.

iii. Fear of a “Backlash”

⁷³ F William McNabb III, “Getting to Know You: The Case for Significant Shareholder Engagement,” Harvard Law School Forum on Corporate Governance and Financial Regulation, 24 June 2015.

⁷⁴ Albert O Hirschman, *Exit, Voice and Loyalty: responses to decline in firms, organizations, and states* (Harvard University Press, 1970) at 30.

⁷⁵ Bebchuk and Hirst (n 44) at 21.

⁷⁶ *Ibid.*

⁷⁷ *Ibid.* at 23-25; Simon CY Wong, 'How Conflicts of Interest Thwart Institutional Investor Stewardship' (2011) *Butterworths Journal of International Banking and Financial Law* 481.

Bebchuk and Hirst point out what they believe to be “an especially strong factor inducing the Big Three to be excessively deferential to corporate managers.”⁷⁸ This factor is a “public and political backlash” against their growing power. According to these authors, an “interventional strategy” on the part of the Big Three could be met by resistance from corporate managers who could claim that these powerful asset managers are micromanaging the companies, destroying value, pressuring management into acting in the short term or providing a distraction. They opine that these forceful arguments would likely turn the public against the Big Three and pave the way for “considerable legal constraints on the power and activities of large index funds and thereby have substantial adverse effects on the Big Three.”⁷⁹ Anticipating this, the Big Three could pre-emptively decline to adopt an interventional strategy. In other words, the fear of a backlash provides strong disincentives to engage with investee companies.

Although Bebchuk and Hirst do not provide concrete examples to support this argument, it is submitted that a backlash against the engagements of the Big Three is already underway, at least in the US. The Big Three (and many more asset managers) have taken a strong position in their public statements on environmental, social and governance (“ESG”) issues. In his now famous 2018 CEO letter, mentioned above, Larry Fink advised that “[t]o prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.”⁸⁰ State Street commenced a well publicised “fearless girl” gender diversity campaign in 2017, which involved placing the statue of the fearless girl facing the iconic Wall Street Bull on the eve of International Women’s Day in 2017.⁸¹ This campaign was designed to promote gender diversity on corporate boards. According to State Street, the campaign had the effect of inducing other asset managers and owners to also make this issue a priority. Furthermore, 152 companies identified by State Street have added a female director, according to the asset manager. With respect to environmental issues, each of the Big Three have publicly called on companies and investors to consider climate change a risk that must be taken into account.⁸² In 2017, shareholders of ExxonMobil, including BlackRock, Vanguard and State Street,

⁷⁸ Bebchuk and Hirst (n 44) at 27.

⁷⁹ Ibid at 28.

⁸⁰ BlackRock, Larry Fink’s 2018 Letter to CEOs,

⁸¹ State Street Global Advisors, Stewardship 2017 at 44-46.

⁸² Ross Kerber, “Vanguard seeks corporate disclosure on risks from climate change” *Reuters*, 14 August 2017; BlackRock, “Adaptability portfolios to climate change: implications and strategies for all investors” BlackRock Investment Institute Global Insights, September 2016; SSGA’s Perspectives on Effective Climate Change Disclosure, 7 August 2017, available at <https://www.ssga.com/investment-topics/environmental-social-governance/2017/perspectives-on-effective-climate-change-disclosure.pdf>.

voted against management recommendation to force the company to produce environmental impact reports annually.⁸³

This kind of activism from the Big Three and other asset managers has attracted a backlash in the US, most notably by the National Association of Manufacturers (“NAM”), which is an industry lobby group. NAM sponsored research which claimed to find that the adoption of climate change-related proposals is not associated with positive stock valuation of companies.⁸⁴ The authors of this research then made arguments that are similar to the arguments Bebchuk and Hirst predicted critics of engaged shareholders would make; that climate change proposals can be an expensive distraction for public companies.⁸⁵ As critics Kalt and Turki argue: “Shareholder proposals seeking to direct company resources towards achieving environmental and social goals also may open the door to the diversion of resources towards other goals besides profit maximization, with consequent harm to good corporate governance standards.”⁸⁶ In 2018, an organisation was set up, with funding from the NAM, called the “Main Street Investors Coalition”, which seeks to undermine the influence of big passive fund managers.⁸⁷ This group have sought to use the US media to promulgate their message, as well as using lobbying efforts to seek “proxy reform”, which amounts to regulation of proxy advisors and restrictions on the ability of shareholders to make proposals at general meetings.⁸⁸ All of this activity could plausibly be described as a “backlash” that seeks to restrict the actions of passive investors, in accordance with Bebchuk and Hirst’s prediction. This, however, is not the full picture.

Arguably, the bigger public “backlash” against the Big Three stems not from their activism and the use of their immense influence and voting power but rather from *not* being sufficiently engaged on ESG issues. Social media has been an effective tool to encourage

⁸³ Steven Mufson, “Financial firms lead shareholder rebellion against ExxonMobil climate change policies”, *Washington Post*, 31 May 2017.

⁸⁴ Joseph P Kalt and L Adel Turki, “Political, Social, Environmental Shareholder Resolutions: Do they create or destroy shareholder value?” May 2018, available at https://corpgov.law.harvard.edu/wp-content/uploads/2018/06/ESG-Paper-FINAL_reduced-size-002.pdf.

⁸⁵ *Ibid* at 50-51.

⁸⁶ *Ibid* at 51.

⁸⁷ Main Street Investors Coalition, “Our Mission”, <https://mainstreetinvestors.org/>; Andrew Ross Sorkin, “What’s Behind a Pitch for the Little-Guy Investor? Big Money Interests”, *New York Times*, 24 July 2018.

⁸⁸ Main Street Investors Coalition, “Despite Shutdown, Drumbeat for Proxy Reform Grows Louder,” 18 January 2019, available at <https://mainstreetinvestors.org/despite-shutdown-drumbeat-for-proxy-reform-grows-louder/>

the Big Three to take certain social or environmental positions in their engagement. Again, focusing on environmental issues, a collective of environmental NGOs, including Greenpeace, Friends of the Earth USA and the Rainforest Action Project, sent a public letter to Larry Fink in May 2018. In this letter, the NGOs asked Fink to consider BlackRock's "social purpose and contribution to society" and asserted that "[a]s a result of the sheer size of your holdings, BlackRock is responsible for more greenhouse pollution than almost any other company in the world."⁸⁹ If BlackRock declines to engage on environmental issues, the public pressure from groups will inevitably increase. It is telling that this letter came even after BlackRock's vote against ExxonMobil management, mentioned above. Other campaigns from society groups, including social media campaigns, to seek to force the Big Three to engage on ESG issues with investee companies include a campaign to boycott BlackRock and Vanguard unless they addressed their holdings in gun manufacturers in the US.⁹⁰ In response, Vanguard published a piece in which they said, "[f]ollowing the attack in Parkland, Vanguard arranged meetings with the leaders of public companies that manufacture and sell guns to civilians. We asked questions and sought to understand how the companies plan to help prevent similar tragedies from happening again."⁹¹ In its 2018 Stewardship Annual Report, Vanguard dedicated a section to gun violence and stated it engaged with three publicly owned gun manufacturers. BlackRock, prior to the boycott call, had already published a statement regarding its investments in gun manufacturers.⁹² It noted that it owned no gun manufacturer stocks in any of its active equity portfolios but did hold shares of all three publicly owned gun manufacturers in its index funds. Illustrating the point about passive funds and engagement, BlackRock declared that, since it had no choice but to hold the gun manufacturers in its index funds, it resolved to engage with them regarding various risks posed by manufacturing and selling firearms to civilians and how these risks may be mitigated.

The above is set out to illustrate the point that Bebchuk and Hirst's concern about the disincentive for passive managers to engage due to the risk of public and political backlash

⁸⁹ NGO Letter to Larry Fink, 4 May 2018, available at <https://1bps6437gg8c169i0y1drtgz-wpengine.netdna-ssl.com/wp-content/uploads/2018/05/Larry-Fink-NGO-Letter-May-4-2018-1.pdf>

⁹⁰ Chris Morris, "Parkland Survivor Wants Investors to Boycott BlackRock and Vanguard", *Fortune*, 18 April 2018.

⁹¹ Vanguard, "Vanguard's voice on societal risks", 20 April 2018, available at <https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/voice-on-societal-risks.html>

⁹² BlackRock, "BlackRock's Approach to Companies that Manufacture and Distribute Civilian Firearms", 2 March 2018, available at <https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-approach-to-companies-manufacturing-distributing-firearms>.

is arguably overcome by the possible public backlash of not engaging, especially with regard to ESG issues. Reputation is an enormously important factor for the Big Three and “reputational competition” can drive engagement in spaces considered publicly important, such as ESG issues.⁹³ The nature of the engagement with gun manufacturers, a social issue in the US, has been criticised, as both asset managers last year voted with management of Sturm Ruger on their resolutions to re-elect the board, despite this board stating that it would not engage with either shareholder.⁹⁴ If anything, this shows that there is an incentive for passive investors in particular to be seen to be engaging on critical public interest issues. Due to ESG issues being controversial, asset managers are in a somewhat invidious position, having to appear to be taking their role in, and impact on, society seriously by engaging, while at the same time not risking a backlash from industry interests lobbying to restrict their powers and abilities to engage. This is a complex environment for asset managers and it is certainly not true to say that the fear of backlash from their engagement provides the only relevant incentive in the context of engagement, as Bebchuk and Hirst imply. However, there is no doubt that there is a fear of reputational damage based on the manner in which asset managers engage and it must be weighed against the potential damage of not engaging. This conflict will be heightened depending on the issue – climate change, as noted, is one example where both sides of the debate will be particularly forceful – and therefore in particular cases, there may be a greater incentive for engagement over non-engagement.

Finally, it is worth considering whether ESG engagement will be a unique species of engagement among institutional investors or whether it will be absorbed into a general practice of engagement. In other words, will ESG engagement be more prominent than, for example, engagement in relation to shareholder distributions or financial performance. Certainly, as the next section will detail, ESG issues form the basis for other regulatory initiatives which will require institutional investors and asset managers to better integrate and consider ESG issues. As well as this, “social and environmental impact and corporate governance” issues are specifically included in article 3g of the SRD2. ESG engagement

⁹³ Strampelli (n 19) at 834 (“‘reputational competition’ within the investment industry is a factor that can induce most institutional investors to increase their efforts in engagement with investee companies and to bear the related costs.”) (footnote omitted).

⁹⁴ Ross Kerber, “Limited engagement: Top funds backed gunmaker Ruger board despite no talks” *Reuters*, 30 August 2018, available at <https://www.reuters.com/article/us-usa-guns-investors/limited-engagement-top-funds-backed-gunmaker-ruger-board-despite-no-talks-idUSKCN1LF2QV>; Chris Isidore, “BlackRock and Vanguard fought for gun changes yet rubber stamped Sturm Ruger's board”, *CNN Money*, 31 August 2018, available at <https://money.cnn.com/2018/08/31/news/companies/blackrock-vanguard-sturm-ruger-board-vote/index.html>

has received more attention from commentators and more public commitments from large asset managers than engagement generally. It is submitted that due to the public interest in environmental and social issues and the public pressure on companies from environmental and social activists, ESG engagement will be a unique species of engagement that asset managers will feel compelled to discuss publicly, beyond their general engagement policy.

iv. ESG Sustainable Finance Regulation

There is a growing expectation upon institutional investors and asset managers for engagement on ESG issues that arises from a wider legal context than just the SRD2. While passive investors weigh up the reputational cost of taking political positions in their engagement on ESG issues with the reputational cost of remaining passive, the EC continues to seek to nudge all institutional investors toward greater integration of ESG issues in investment strategies. In December 2016, it established a High Level Expert Group on Sustainable Finance (“HLEG”), which published its Final Report in January 2018.⁹⁵ This Report set out eight priority recommendations including the creation of a sustainable finance taxonomy, clarification of the duties of institutional investors and asset managers with respect to time horizons and ESG factors, to upgrade Europe’s rules on disclosure of climate change risks and to reform governance and leadership of companies to build sustainable finance competencies.⁹⁶

In 2018, the EC followed up on the HLEG’s Report with an Action Plan on “financing sustainable growth” which was primarily focused on the risks that climate change posed to the EU economy.⁹⁷ This Action Plan had three specific aims:

1. Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
2. manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
3. foster transparency and long-termism in financial and economic activity.⁹⁸

⁹⁵ EU High Level Expert Group on Sustainable Finance, “Financing a Sustainable European Economy: Final Report” 31 January 2018 [hereafter “HLEG Group Report 2018”].

⁹⁶ *Ibid* at 13.

⁹⁷ European Commission, “Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth,” 8 March 2018 [hereafter “2018 EC Action Plan”].

⁹⁸ *Ibid* at 2.

The first aim is related to the HLEG's recommendation that a sustainable finance taxonomy be created. According to the EC, reorienting capital flows should be underpinned by such a taxonomy in order to provide clarity on which activities can be considered "sustainable."⁹⁹ Subsequently, the EU Technical Expert Group on Sustainable Finance, which is a group of experts mandated by the EC to develop policy recommendations, consisting of 35 members from civil society, academia, business, the finance sector and 10 from EU and international public bodies,¹⁰⁰ elaborated: "The EU Taxonomy is an implementation tool that can enable capital markets to identify and respond to investment opportunities that contribute to environmental policy objectives."¹⁰¹ In May 2018, the EC published three proposals for Regulations that addressed ESG concerns in the financial system of Europe. The first of these was a proposal for a Regulation for the establishment of a framework to facilitate sustainable investment. This proposal culminated in the Taxonomy Regulation in early 2020 and in this, *inter alia*, four criteria are identified for an "environmentally sustainable economic activity":

- (a) the economic activity contributes substantially to one or more of the specified environmental objectives;
- (b) the economic activity does not significantly harm any of these environmental objectives;
- (c) the economic activity is carried out in compliance with certain minimum safeguards;
- (d) the economic activity complies with technical screening criteria.¹⁰²

The aim to reorient capital flows towards sustainable investment implicates passive investors in important ways, as the HLEG noted that indices and benchmarks that are the reference structure for passive investors "have an indirect but important impact on the

⁹⁹ Ibid at 4.

¹⁰⁰ EU Technical Expert Group on Sustainable Finance, "Financing a Sustainable European Economy: Taxonomy Technical Report" June 2019 at 16.

¹⁰¹ Ibid at 10.

¹⁰² At the time of writing, the finalised Taxonomy Regulation has not been published but the text of the agreement has been reached by the European Parliament and Council, which is the text relied on in this article. See Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, and amending Regulation 2019/2088 on sustainability-related disclosures in the financial services sector, 17 December 2017, available at <https://data.consilium.europa.eu/doc/document/ST-14970-2019-ADD-1/en/pdf>, Article 3.

orientation of capital, but are not necessarily aligned with sustainability objectives.”¹⁰³ Based upon this, the HLEG recommended that index providers should be asked to provide details of the exposure of widely used and referenced benchmarks to climate and sustainability parameters and that both passive and active investors enable investors, through disclosures, to understand the sustainability characteristics and exposures of different fund options.¹⁰⁴ The EC later noted a danger of “greenwashing”, which it explained as being where “all low carbon indices are being equally promoted as environmentally relevant despite having different characteristics.”¹⁰⁵

In the Action Plan, the EC note that “current EU rules on the duty of institutional investors and asset managers to consider sustainability factors and risks in the investment decision process are neither sufficiently clear nor consistent across sectors.”¹⁰⁶ In line with the recommendations of the High Level Group’s Report, the EC lament that institutional investors and asset managers do not systematically consider sustainability factors and risks in the investment decision making process.¹⁰⁷ It also noted that institutional investors and assets managers do not sufficiently disclose to their clients how sustainability factors and risks are considered, which does not allow these clients to take into account sustainability risks when assessing and selecting the institutional investors and asset managers with whom they invest.¹⁰⁸

The second proposed Regulation also culminated in a finalised Regulation in late 2019, which dealt with, *inter alia*, the reorientation of capital flows by setting minimum standards for “low carbon benchmarks.”¹⁰⁹ The EU Regulation on indices used as benchmarks in financial instruments,¹¹⁰ which particularly affects passive providers is proposed to be amended to require that the legal person who is in control of determining a benchmark index must disclose “how the key elements of the methodology laid down in point (a) reflect environmental, social or governance (‘ESG’) factors for each benchmark or family

¹⁰³ HLEG Report 2018 at 53.

¹⁰⁴ *Ibid* at 55.

¹⁰⁵ European Commission, “Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks,” 24 May 2018 at 3.

¹⁰⁶ 2018 EC Action Plan at 8.

¹⁰⁷ *Ibid*.

¹⁰⁸ *Ibid*.

¹⁰⁹ Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks.

¹¹⁰ Regulation (EU) 2016/1011.

of benchmarks which pursue or take into account ESG objectives.”¹¹¹ This Regulation introduces “EU Climate Transition Benchmarks” and “EU Paris-aligned Benchmarks” as regulated benchmarks, which will clearly affect passive investors in particular seeking to offer ESG oriented benchmarks. However, it is worth noting that passive investors creating benchmark indexes, under which certain companies are necessarily included and excluded, does not necessarily involve “engagement”. Excluding high carbon impact companies from a benchmark represents an awareness of climate change, for example, but it precludes “voice” as a means of changing the behaviour of those high carbon impact companies. Such companies may feel pressure indirectly, however, from a higher cost of raising capital that benchmark providers can supply.

The third Regulation that culminated from the 2018 proposals was the Disclosures Regulation, which further increases the transparency requirements for all financial market participants, which would include institutional investors and asset managers subject to the SRD2.¹¹² This Regulation will come into force across the EU on 10 March 2021.¹¹³ Broadly, for the purposes of the present discussion, this Regulation would require institutional investors and asset managers to disclose how they have integrated “sustainability risks” into the investment decision-making process.¹¹⁴ Some disclosure requirements apply to all financial market participants, as defined in the Regulation, regardless of whether they are marketing products as “environmentally sustainable” or seeking to attract investment on the basis of being low carbon. For example, under Article 3 of this Regulation, financial market participants must disclose information about their policies on the integration of sustainability risks in their investment decision-making process.¹¹⁵ Other disclosure requirements apply only to financial market participants who market an investment product that purports to promote environmental or social characteristics, and the Regulation requires disclosure of details of those characteristics.¹¹⁶

¹¹¹ European Commission, “Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks,” 24 May 2018 at 17.

¹¹² Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

¹¹³ *Ibid*, Article 20(2).

¹¹⁴ See *ibid*, Recital 10 (“This Regulation aims to reduce information asymmetries in principal-agent relationships with regard to the integration of sustainability risks...”)

¹¹⁵ *Ibid*, Article 3(1).

¹¹⁶ *Ibid*, Article 8(1).

The European Commission has also presented the “European Green Deal Investment Plan” in late 2019 and early 2020.¹¹⁷ This project is an ambitious initiative seeking to make the EU climate neutral by 2050. This will involve an array of different actions, including the “Just Transition Mechanism”, which will be a fund to support businesses transitioning toward a “green economy” and a “European Climate Law”, which is a proposal for a Regulation establishing the framework for achieving climate neutrality.¹¹⁸ This Law sets an aim of climate neutrality and a trajectory for achieving this aim, with periodic 5 year reviews by the European Commission of the overall trajectory and of national measures. In Ireland, the Central Bank has published an Economic Letter, detailing the risks of climate change to the Irish financial system and possible responses available.¹¹⁹ This Letter noted several steps that are required, including the setting out of expectations for regulated investment companies and disclosures of exposures to climate change risks by such companies.¹²⁰ The Bank stated an intention to participate in the design of regulatory rules as well as coordinating with the international community of central banks. Ultimately, there are incentives for certain passive managers to engage on certain issues. The regulatory developments above will undoubtedly encourage institutional investors and asset managers to incorporate ESG issues into public statements about their engagement and will, it is submitted, make it more difficult for institutional investors and asset managers to disclose non-compliance with Article 3g. This is because Article 3g aligns engagement with ESG issues, requiring institutional investors and asset managers to disclose how their engagement policy considers how they monitor investee companies on non-financial matters, “including... social and environmental impact and corporate governance...”¹²¹ It is submitted that the regulatory proposals outlined above, in effect, take this aspect of Article 3g and remove the “explain” option. Making this disclosure aspect of Article 3g mandatory will place greater pressure on any justification for non-compliance with other, related aspects of Article 3g, such as how dialogues are conducted and voting rights exercised. While ESG issues are just three interrelated categories of issues on which shareholders can engage, the overarching focus on the concept of “sustainability” links

¹¹⁷ European Commission, “Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: The European Green Deal” 11 December 2019, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1588580774040&uri=CELEX:52019DC0640>.

¹¹⁸ European Commission, “Proposal for a Regulation of the European Parliament and of the Council establishing the framework for achieving climate neutrality and amending Regulation (EU) 2018/1999 (European Climate Law)” 4 March 2020.

¹¹⁹ Philip R Lane, Central Bank of Ireland, “Economic Letter: Climate Change and the Irish Financial System,” Vol. 2019, No. 1.

¹²⁰ *Ibid* at 8.

¹²¹ SRD2, Article 3g(1)(a).

ESG issues and “engagement”, which, as described, is viewed by the EC as a long term approach to investing.¹²²

A distinction should be drawn between the Big Three and other passive managers. Enriques and Romano make the argument that the Big Three are “too-big-to-be-passive”, that the sheer size of their holdings makes it politically untenable that they would not themselves use the influence they have.¹²³ As should be clear from the discussion above on the various “backlashes” that asset managers face, a major driver of incentives for engagement is the concern for the asset manager’s reputation in the market. Smaller passive managers who are not subject to the same media coverage as the Big Three and do not have the same amount of influence, due to having far fewer assets under management, might therefore be less inclined to engage. Also, for smaller investors, the proportion of the benefit that they would receive, relative to the costs expended in engaging, would be too small. As far as the competition they face from asset managers goes, smaller passive managers would likely choose to compete primarily by keeping their fees much lower than their active counterparts, rather than by choosing to engage in order to improve performance. There is little evidence to suggest that the “advantage” that Fisch et al claim active managers have through their ability to sell off underperforming shares has resulted in better performance relative to passive managers.¹²⁴ While passive strategies continue to beat active strategies, there is no reason to believe passive managers will generally expend resources on engagement in order to improve performance. Having said this, the pressure that the Big Three are under to engage due to the media and public advocacy groups may be experienced to a degree by smaller passive managers due to regulation such as the SRD2. Asset owners may prefer passive managers that declare compliance with the engagement provisions in the SRD2, giving an advantage to the Big Three, who already publicise their apparent commitment to stewardship and engagement with portfolio companies, and

¹²² For instance, see European Commission, “Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies”, 12 December 2012, which specifically links “engaged shareholders and sustainable companies”.

¹²³ Luca Enriques and Alessandro Romano, “Institutional Investor Voting Behavior: A Network Theory Perspective”, (2018) ECGI Law Working Paper N° 393/2018 at 15.

¹²⁴ JB Heaton, “Where the Fisch, Hamdani, and Davidoff Solomon Theory of Passive Investors Goes Awry”, 25 July 2018, <http://clsbluesky.law.columbia.edu/2018/07/25/where-the-fisch-hamdani-and-davidoff-solomon-theory-of-passive-investors-goes-awry/>, (“No evidence demonstrates that funds run by stock brokers, managers of active mutual funds, or even the best-known hedge fund managers reliably beat passive strategies. This accumulated evidence of underperformance has generated a strong shift to passive investing. The [Fisch et al] theory rests on the false premise that passive managers are competitively disadvantaged relative to active funds; they are not.”)

especially passive portfolio companies. This raises the possibility that passive asset managers will engage but will do so in a superficial and minimalistic manner. This issue and the other possible negative result of passive asset manager engagement, the undermining of competitive forces among public companies, are explored in the next section.

D. Consequences of Engaged Passive Asset Managers

The rise of passive investing has led to a debate about the negative effects of powerful passive managers in corporate governance. These possible negative effects can be separated into two categories: “one size fits all” voting and the anticompetitive effects of common ownership. The first criticism involves the claim that passive managers will not dedicate sufficient resources to engagement and stewardship and will therefore be forced to take a superficial and “one size fits all” approach to voting and engagement that lacks nuance and company specific information. The second criticism focuses on common ownership by passive firms and the incentive this provides shareholders to encourage less competition among firms than may serve the common good. These will be dealt with in turn.

i. One Size Fits All Engagement

Dorothy Lund has put forward a powerful critique of passive funds in corporate governance, asserting that it is likely that the most powerful passive fund providers, when intervening, “will pursue an unthinking and automated approach to governance that is unlikely to be in the company's best interest.”¹²⁵ Lund makes a number of arguments to support this prediction. First of all, since index funds simply track an index, index fund managers have no incentive to ensure that any one company in the index is well governed. The concern for index fund managers will be the performance of the index overall and the performance of individual companies will be secondary. She points out that index funds are necessarily highly diversified, far more so than their active counterparts, exacerbating the collective action problem among shareholders. As well as this, “thoughtful” engagements with investee companies would incur especially high costs for highly diversified passive funds which would require the passive fund to raise its fees to meet the

¹²⁵ Lund (n 51) at 510.

cost. Since passive funds compete primarily on fees charged, “thoughtful” engagements are not encompassed within the business model of the passive fund. She makes the point that passive fund managers can, to a certain extent, free ride on information gleaned from active funds where a provider offers both the passive fund and active funds.¹²⁶ As noted, the Big Three offer both active and passive funds, though all three have far more passive funds than active. Lund argues that overlap of investee companies in passive and active funds is not guaranteed and any existing overlap reduces as more assets flow from active to passive funds.

As may be apparent, these arguments are essentially a re-airing of the reasons why many believe shareholders are “rationally apathetic” and why they may prefer to “free ride” on the stewardship of others.¹²⁷ Lund takes the position that this is an enhanced problem for passive funds and that active funds do indeed have an incentive to monitor and discipline investee company management.¹²⁸ She notes that “the collective action problem facing active funds has been overstated.”¹²⁹ She describes the incentive for active funds to be overweight in certain companies’ stocks and then engage in governance. This analysis appears to run contrary to a lot of the commentary and observations relating to shareholder engagement following the Financial Crisis. As noted, the Walker Review, Kay Review, European Commission green papers and numerous consultations all concluded that during the run up to the 2008 Financial Crisis, asset managers were generally unwilling to engage qualitatively with investee companies, many citing the same reasoning Lund reserves only for passive investors.¹³⁰ It is clear that many active asset managers are also affected by rational apathy, preferring to take a low cost approach and to sell underperforming shares rather than engage to improve performance. While she argues that active funds have a

¹²⁶ *Ibid* at 496.

¹²⁷ See Chapter 3, above at pp 83-85.

¹²⁸ Lund (n 51) at 512 (“unlike active funds, passive funds have no financial incentive to monitor management or invest in governance interventions.”)

¹²⁹ Lund, ‘The Case Against Passive Shareholder Voting’ at 500.

¹³⁰ Sir David Walker, “A review of corporate governance in UK banks and other financial industry entities: Final recommendations” 26 November 2009 at par 5.11 (“the board and director shortcomings... would have been tackled more effectively had there been more vigorous scrutiny and engagement by major investors acting as owners.”); John Kay, “The Kay Review of UK equity markets and long-term decision making” 2012 [hereafter “Kay Review”] at 42 (par 5.33) “Even if the benefits of analysis and engagement would be large, for both companies and beneficiaries, the incentives for any individual fund manager to pursue these benefits are weak, since although the individual fund manager bears all the costs most of the additional return will accrue to people who are not his clients and most of the business benefits will accrue to other firms.”); European Commission 2014 Proposal at 4 (“The financial crisis has revealed that shareholders in many cases supported managers’ excessive short-term risk taking. Moreover, there is clear evidence that the current level of ‘monitoring’ of investee companies and engagement by institutional investors and asset managers is sub-optimal.”).

powerful incentive to use voice, at the very least it must be acknowledged that “exit” provides a correspondingly powerful incentive for active funds that does not affect passive funds. Similarly, Lund points to conflicts of interest of passive funds, mentioned above, involving a desire to attract and maintain the business of companies wishing to have their pension assets managed.¹³¹ This presents fund managers with an incentive not to confront management. Again, this conflict of interest arguably afflicts all asset managers, whether active or passive, who are hoping to be selected by investee companies to manage their pension assets. While pension funds are an important source of funds for passive funds, active fund managers also have a desire to attract their business. Rather than concluding that passive funds can be expected to be passive owners as a result of the financial disincentives, Lund argues that passive funds are likely to follow a rigid set of voting guidelines and proxy advice without examining it closely in order to determine whether it applies appropriately to each company.

Assuming passive fund providers will use their voting rights rather than choosing to be entirely passive with regard to engagement, it is reasonable to speculate that they will apply a one size fits all approach, since the costs of engaging with each company in a vast portfolio will be enormously high. Lund worries that this effect “will result in substantial economic harm” because of an imposition of “uniform governance structures across widely divergent firms.”¹³² A number of empirical investigations have been undertaken in order to ascertain the effect of passive fund ownership upon public listed companies. These studies reveal apparently conflicting results. Schmidt and Fahlenbrach find that the power of CEOs increases, in terms of their likelihood to occupy the roles of chairman or company president, as the level of passive ownership in the company increases.¹³³ They also find an association between passive ownership and “value decreasing” mergers and acquisitions activity. Similarly, Qin and Wang find that the probability of a CEO also holding the title of chairman is increased by passive ownership and decreased by active ownership.¹³⁴ This is one factor in a range of negative factors identified in this latter study of passive ownership, including evidence of association between passive ownership and reduced expenditure on research and development in companies and reduced CEO pay-for-performance sensitivity. Overall this latter study concludes that there is an association between passive ownership

¹³¹ Lund (n 51) at 513.

¹³² *Ibid* at 524.

¹³³ Cornelius Schmidt and Rüdiger Fahlenbrach, 'Do exogenous changes in passive institutional ownership affect corporate governance and firm value?' (2017) 124 *Journal of Financial Economics* 285.

¹³⁴ Nan Qin and Di Wang, “Are Passive Investors a Challenge to Corporate Governance?” 23 March 2018, available at SSRN: <https://ssrn.com/abstract=3148309>

and lower firm value.¹³⁵ In contrast, Appel et al find that passive ownership is associated with more independent directors and less support for management proposals.¹³⁶ A later study conducted by the same authors finds that passive ownership is associated with more aggressive activist tactics, such as an increase in proxy fights and a greater likelihood for activists to seek board seats on target companies.¹³⁷

These studies either paint a positive or highly negative picture of passive ownership of companies in terms of its effects on managerial oversight and agency costs. This does not necessarily mean that the findings are inconsistent with one another. Schmidt and Fahlenbrach posit that a higher level of passive ownership may have positive effects when it comes to “low cost” governance activities but negative effects for “high cost” activities.¹³⁸ These authors find an association between passive ownership and value decreasing mergers and acquisitions, the monitoring of which could be considered a “high cost” governance activity. Appel et al find that passive ownership correlates with more independent directors, the removal of poison pill and staggered boards and more equal voting rights. Schmidt and Fahlenbrach suggest that voting according to a “pre-defined program” which might include these governance issues, for example to always vote against the imposition of a poison pill structure or introduction of dual class shares, is a “low cost” governance activity. This analysis is consistent with Lund’s criticism, that passive funds will undertake stewardship and engagement in a low-cost, one-size-fits-all-manner. The harm that this would do could vary from company to company, as the imposition of inflexible voting policies on a vast swathe of public companies’ shareholder bases would impact each company differently.

With regard to the studies that have found negative associations with passive ownership, many authors speculate that these findings are due to a lack of financial incentives to engage. For example, Qin and Wang argue that “passive funds cannot give credible threat of exit and do not have strong bargaining power—and possibly motivation—to effectively monitor and pressure managers.”¹³⁹ Similarly, Schmidt and Fahlenbrach make the point

¹³⁵ “Lower firm value” as measured by Tobin’s Q.

¹³⁶ Ian R Appel, Todd A Gormley and Donald B Keim, 'Passive investors, not passive owners' (2016) 121 *Journal of Financial Economics* 111.

¹³⁷ Ian Appel, Todd A Gormley and Donald B Keim, 'Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism' (June 30, 2018), available at SSRN: <https://ssrn.com/abstract=2693145>.

¹³⁸ Schmidt and Fahlenbrach (n 133) at 287.

¹³⁹ Qin and Wang (n 134) at 6.

that “[t]he voice channel, in which institutional investors actively interact with management to voice their preferences, seems expensive for low-cost and low-overhead passive institutional investors that cover thousands of stocks.”¹⁴⁰ It cannot therefore be assumed that these findings are the result of passive fund intervention but, rather, the result of not intervening. Lund’s ultimate conclusion, that passive funds should be deprived of voting rights, does not, however, find support in these studies. Indeed, the opposite conclusion could be reached, that passive funds ought to be compelled to vote, in order to address the agency costs that may arise in the absence of their scrutiny.¹⁴¹

This does not imply that one-size-fits-all engagement is either likely to occur or be damaging when it does occur. Lund’s argument boils down to a concern that, while passive investors have strong incentives to be apathetic and decline to use shareholder rights, when they do, they will rely on inflexible guidelines and apply these guidelines to a vast array of different companies. This criticism of the behaviour of passive investors is reminiscent of a criticism of the operation of the UK Corporate Governance Code. As will be recalled from Chapter 5 “tick the box” voting involves shareholders applying the Code inflexibly and voting against any deviations from it.¹⁴² As noted, Hampel criticised this practice as pervasive as early as 1998, noting that “[t]oo often they believe that the codes have been treated as sets of prescriptive rules.”¹⁴³ “Rational apathy” and the free rider problem affect active asset managers as they do passive managers and so there are incentives for active managers to remain uninformed about investee companies. All of this is to say that “one size fits all” engagement is not a problem that is restricted to passive investors. Rather than the rise in passive investing creating an inflexible approach to engagement, it may be that it is the expectation on investors to engage which encourages this approach. In other words, the provisions of the SRD2 may contribute not to a culture of higher quality, thoughtful and reasoned engagement but to a culture in which the level of engagement must be maintained, without proper consideration for the quality of that engagement.

¹⁴⁰ Schimdt and Fahlenbrach (n 133) at 286.

¹⁴¹ Bebchuk and Hirst (n 44) at 56 (“Policymakers should explore ways to encourage index fund managers to move towards... higher levels of stewardship investment.”)

¹⁴² Chapter 5: Overcoming Impediments to Engagement, above at pp 160-162; Marc Moore, “Whispering sweet nothings”: The limitations of informal conformance in UK corporate governance’ (2009) 9 *Journal of Corporate Law Studies* 95 at 117-125.

¹⁴³ “Committee on Corporate Governance: Final Report,” January 1998 Chaired by Ronnie Hampel, (Hampel Report) at par 1.12.

It should be noted that Lund's stated fears of a "proliferation of an unthinking, one-size-fits-all approach to governance" are valid and should be taken seriously. The argument that this thesis is at pains to make throughout is that such an approach to governance is not limited to passive investors and may inevitably follow from a regulatory environment that creates an expectation of engagement, without simultaneously being clear on what exactly "engagement" means in practice. Shareholders subject to the SRD2, that is asset owners and asset managers in EU public listed companies, may feel pressure to disclose compliance with the engagement provisions while at the same time not having economic incentives to dedicate the resources that higher quality engagement necessarily entails. "One size fits all" engagement is tempting for all shareholders because it is low cost and allows them to disclose compliance with engagement provisions in the SRD2 that require a general engagement policy. It is also tempting for proxy advisors for similar reasons; it allows for more generalised analysis that is less resource consuming than examining the nuances of individual companies. While comply or explain is designed to avoid a one size fits all approach in the SRD2, this approach has historically failed to avoid inculcating an inflexible "comply or else" approach. In the context of shareholder engagement, this could have the effects that Lund fears in respect of passive investors but for many more shareholders subject to the engagement provisions of the SRD2.

ii. Anti-competitive effects

Another prominent claim with regard to the effects of the rise of passive investing is that it will lead to a greater common ownership in public markets and this will have anti-competitive effects. As has been noted, passive investors will be more diversified than their active counterparts, which means that they will have ownership interests in a far greater number of companies in their investment portfolios. This will inevitably lead to the ownership by passive investors of multiple companies in the same industry. Where two competing companies are in the same portfolio of an investor, that investor has an interest in competition being reduced between the two, since any market share gained by one will mean a reduced market share of the other and a consequent reduction in total value in the portfolio.¹⁴⁴ In theory, those investors with large common ownership, which are likely to be highly diversified, passive funds, have an incentive to discourage competition among companies in the same industry. This undermining of competitive forces could be expected to lead to higher prices for consumers. Azar et al conducted a study of US airlines in order

¹⁴⁴ José Azar, Martin C. Schmalz and Isabel Tecu, 'Anti-Competitive Effects of Common Ownership' (2018) 73 *The Journal of Finance* 1513 at 1514.

to determine the effect of common ownership.¹⁴⁵ They found in their study that the top seven shareholders of American Airlines were also among the top ten shareholders in Southwest Airlines and the top six shareholders of Southwest were among the top ten shareholders of American and Delta Airlines, five of which were also among the top ten shareholders of United Airlines.¹⁴⁶ Furthermore the authors found that airline ticket prices are 3% to 7% higher due to common ownership.

It is not proposed to examine the methodology of the various studies on the anti-competitive effects of common ownership in detail but it is necessary for present purposes to have an overview of the different measures used in these various studies. The measure used in Azar et al's airline paper is called the "modified Herfindahl-Hirschman Index delta" (MHIIΔ). The Herfindahl-Hirschman Index (HHI) is an index of market structure and is commonly used to assess structural changes in the event of a merger or mergers.¹⁴⁷ In other words, HHI is used to measure market concentration. MHIIΔ is an element of the "modified Herfindahl-Hirschman index" ("MHII"), which captures disincentives occasioned by common ownership. MHII, then, represents the market concentration in particular industries, as well as the disincentives created by common ownership.¹⁴⁸ Characterised more simply, $MHII = HHI + MHII\Delta$.¹⁴⁹ The key variable, MHIIΔ, is isolated as a measure of market concentration that is caused by ownership and then compared with prices in order to discover a potential correlation between the movements of the two.

Other commentators have studied the link between common ownership and management incentives in their compensation to compete with industry peers.¹⁵⁰ Antón et al claim to

¹⁴⁵ Ibid.

¹⁴⁶ Ibid at 1525.

¹⁴⁷ Richard A Miller, 'The Herfindahl-Hirschman Index as a market structure variable: an exposition for antitrust practitioners' (1982) 27 *The Antitrust Bulletin* 593. HHI is defined as the sum of the squares of individual firm's market share.

¹⁴⁸ For more detail, see Timothy F Bresnahan and Steven C. Salop, 'Quantifying the competitive effects of production joint ventures' (1986) 4 *International Journal of Industrial Organization* 155; Steven C Salop and Daniel P O'Brien, 'Competitive Effects of Partial Ownership: Financial Interest and Corporate Control' (2000) 67 *Antitrust Law Journal* 559; Azar, Schmalz and Tecu (n 144).

¹⁴⁹ Daniel P O'Brien and Keith Waehrer, "The Competitive Effects of Common Ownership: We Know Less than We Think", 23 February 2017, available at SSRN: <https://ssrn.com/abstract=2922677> at 13; Thomas A Lambert and Michael E Sykuta, 'Calm Down about Common Ownership' (2018) *Regulation* 28. This is sometimes characterised as $MHII\Delta = MHII - HHI$, see Einer Elhauge, 'Horizontal Shareholding' (2016) 129 *Harvard Law Review* 1267 at 1275

¹⁵⁰ Miguel Antón, Florian Ederer, Mireia Giné and Martin Schmalz 'Common Ownership, Competition and Top Management Incentives' (2018) ECGI Working Paper Series in Finance No

find that “wealth-performance sensitives” (the amount of managerial compensation tied to performance of the company) reduces as an industry becomes more commonly owned.¹⁵¹ Kwon, in a similar study, but using MHHIA as his measure, claims to find just the opposite: that in more commonly owned industries, there is a greater use of “relative performance evaluation”.¹⁵² In other words, the more common ownership in an industry, the higher the level of performance based compensation. Another study focuses on the banking industry, claiming to find evidence of a causal relationship between common ownership and higher prices for banking products.¹⁵³ In this paper, Azar et al use a “generalised HHI” (GHHI) which purports to capture both common ownership and cross ownership among banks. Similar to the compensation evidence, the banking studies have been challenged by other studies using different methodology. For example, Gramlich and Grundl use a different measure entirely of the competitive effects of common ownership in the banking industry and find no statistical relationship between prices and common ownership, although they note that their empirical findings are preliminary.¹⁵⁴ The measure that these authors use focuses not on the market concentration or common ownership incentives that are captured by, variously, MHHIA or GHHI but on the weight that managers place on their firm’s profits relative to the profits of its rivals.

The evidence that passive investing has led to common ownership and anti-competitive pressures on public companies has resulted in several prominent commentators calling for regulatory intervention. Einer Elhauge argues that existing US antitrust law ought to be enforced against stock acquisitions that create common ownership (or “horizontal ownership” as he puts it).¹⁵⁵ Posner et al point out that enforcement of this kind would lead to uncertainty among institutional investors since compliance with US antitrust law would be dependent on the shareholdings of other institutional investors, as well as their own shareholdings.¹⁵⁶ These authors argue that there ought to be limitations on company

511/2017 Heung Jin Kwon, 'Executive Compensation under Common Ownership' (2016) University of Chicago Working Paper.

¹⁵¹ Antón, Ederer, Giné and Schmalz (n 150).

¹⁵² Kwon (n 150).

¹⁵³ José Azar, Sahil Raina and Martin C Schmalz, 'Ultimate Ownership and Bank Competition' (2016) SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252

¹⁵⁴ Jacob Gramlich and Serafin Grundl, 'Estimating the Competitive Effects of Common Ownership,' (2017) Finance and Economics Discussion Series 2017-029, Washington: Board of Governors of the Federal Reserve System, available at SSRN: <https://ssrn.com/abstract=2940137>.

¹⁵⁵ Elhauge (n 149) at 1302.

¹⁵⁶ Eric A Posner, Fiona M Scott Morton and Eric Glen Weyl, 'A Proposal to Limit the Anti-Competitive Power of Institutional Investors' (March 22, 2017). *Antitrust Law Journal*, Forthcoming. Available at SSRN: <https://ssrn.com/abstract=2872754>.

ownership in the same industry but argue for a “safe harbour” for institutional investors committed to not voting their shares or ownership that falls below a certain level.

The theories of common ownership and evidence of its possible anti-competitive effects has also attracted the attention of financial regulators globally.¹⁵⁷ In 2015, the chemical companies Dow and DuPont announced a “merger of equals”, which triggered an EC inquiry.¹⁵⁸ In its judgment regarding the legality of this merger, the EC analysed the common ownership circumstances that exists in the chemical industry, observing that “the presence of significant common shareholding is likely to negatively affect the benefits of innovation competition for firms subject to this common shareholding.”¹⁵⁹ While the merger was conditionally approved and no specific regulatory intervention was suggested, the acceptance of the EC of the harmful effects of common ownership implies possible future action. The OECD has also tackled the issue, raising questions about the best empirical measure of common ownership effects, whether MHHI or something else, and whether existing fiduciary duties are an effective safeguard against management catering to anti-competitive incentives of some of their investors.¹⁶⁰ The OECD acknowledged empirical methodological concerns but maintain that “the underlying conceptual concerns associated with common ownership remain.”¹⁶¹ Finally, the US Federal Trade Commission (FTC) held hearings in late 2018 in order to determine various academic, industry and regulatory views on the subject of common ownership. Ultimately, the question they sought to answer was whether Government intervention was necessary, concluding that more research was necessary before choosing one side of the debate over the other.¹⁶²

Unsurprisingly, the biggest providers of passive funds have responded to this research by defending index funds. BlackRock published a “viewpoint” in which they set out some of the above research and outlined why it believes theories of common ownership demonstrate

¹⁵⁷ Brooke Fox and Robin Wigglesworth, “Common ownership of shares faces regulatory scrutiny”, *Financial Times*, 22 January 2019.

¹⁵⁸ European Commission, Case M.7932 – Dow/DuPont, 27 March 2017.

¹⁵⁹ *Ibid* at 383.

¹⁶⁰ OECD, ‘Common Ownership by Institutional Investors and its Impact on Competition: Background Note by the Secretariat’, 5-6 December 2017, available at [https://one.oecd.org/document/DAF/COMP\(2017\)10/en/pdf](https://one.oecd.org/document/DAF/COMP(2017)10/en/pdf) at 40-42.

¹⁶¹ *Ibid* at 41.

¹⁶² See Noah Pinegar, Competition Policy International Presents: “FTC Hearing #8: Common Ownership,” December 2018, available at <https://www.competitionpolicyinternational.com/wp-content/uploads/2018/12/North-America-Column-December-2018-2-Full.pdf>

“misconceptions regarding shareholder engagement.”¹⁶³ According to BlackRock, asset managers engage on behalf of asset owner clients, and do so as a fiduciaries. Engagement, according to its argument, is a value enhancing action and is done in order to benefit asset owners.¹⁶⁴ BlackRock also referred to the point referred to above that engagement is especially vital for index investors since “exit” is not an option. Certainly, implied within criticisms of common ownership is an assumption that passive managers must use their influence, presumably through some form of engagement, to discourage competitive impulses in investee companies. Otherwise, the management of investee companies would continue to compete with industry peers in order to improve the performance of the company. With respect to the suggestion that common ownership affects managerial incentives in compensation, Blackrock also argued that asset managers have an extremely limited role in crafting or setting executive pay. Shareholders can vote “yes” or “no” to compensation packages, where required by regulation or put forward by the company and, as BlackRock point out, they “do not have the opportunity to fine-tune compensation to drive incentives”¹⁶⁵ in the manner suggested in some of the compensation studies. In their submission to the FTC hearings mentioned above, State Street challenged the empirical research, asserting, “[a]t best it appears that these theories identify potential correlations while utterly failing to prove any sort of causal effects.”¹⁶⁶

This criticism, that the empirical research detailed above does not demonstrate that common ownership causes anti-competitive results, is repeated by several authors, who argue that exogenous factors could affect both prices in industries and the measurements used in empirical research, including MHHIA, GHHI and MHHI. O’Brien and Waehrer argued that as “a change in common ownership that raises the MHHI may reduce price, and a change in common ownership that lowers the MHHI may increase price...the MHHI does not provide a reliable prediction of the effects of common ownership on price.”¹⁶⁷ Similarly, Lambert and Sykuta stated that as “MHHIA is itself affected by factors that

¹⁶³ BlackRock, “Index Investing and Theories of Common Ownership”, Viewpoint, March 2017, available at <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-index-investing-and-common-ownership-theories-eng-march.pdf>, at 8.

¹⁶⁴ This is echoed by other commentators, including the Kay Review in which Professor Kay, though emphasising the quality of the engagement, asserted at par 5.32: “Effective engagement will directly increase the value of a company: thus even if its effects were immediately reflected in share prices some returns would immediately accrue to those who undertake it.”

¹⁶⁵ BlackRock, “Index Investing and Theories of Common Ownership” at 10.

¹⁶⁶ State Street Global Advisors, FTC Hearing #8: Competition and Consumer Protection in the 21st Century, Submission number: FTC-2018-0107-D-0023, available at https://www.ftc.gov/system/files/documents/public_comments/2019/01/ftc-2018-0107-d-0023-163651.pdf.

¹⁶⁷ O’Brien and Waehrer (n 149) at 15 (emphasis and footnote omitted).

independently influence market prices” it would thus be “improper to infer that changes in MHHIA caused changes in portfolio firms’ pricing practices; the pricing changes could have resulted from the very factors that changed MHHIA.”¹⁶⁸ The conclusion that should be taken from these arguments, is that the evidence does not show that increases in common ownership causes price increase, merely that there are correlations between the two.

Ultimately, as the OECD asserted, the underlying conceptual concerns attached to common ownership will persist even if the empirical evidence proves unreliable. It simply appears as if a conflict of interest exists where a shareholder owns a substantial portion of competing companies. What is critical is how that shareholder uses their shareholder rights in the context of this conflict of interest i.e. how they engage. This issue, of course, is as relevant with regard to anti-competitive behaviour as the fears of “one size fits all” engagement.. With regard to the latter, the nature of the engagement by the passive investor is itself the concern. Passive investors will apply rigid rules regarding engagement that do not suit many companies and do not promote good corporate governance. With regard to anti-competitive behaviour, the fear is slightly different and more subtle. Shareholders that own substantial stakes in competing companies must engage in order to discourage normal competitive actions by one or all of the competing companies. Suggestions have been made that the mere presence of common owners may lead managers to take anti-competitive actions, or that the absence of express demands by shareholders for the company to act more competitively will lead to less competition.¹⁶⁹ This seems unlikely. Common owners may be among the biggest investors in certain companies but they are still outnumbered in the general body of shareholders by those invested only in one of the competing companies.¹⁷⁰ If common owners do nothing to encourage anti-competitive actions, management will still have an incentive to seek to please the other shareholders.¹⁷¹

Furthermore, as BlackRock and many others point out, common owners will not only own stakes in competitor companies, but also they will own stakes in their suppliers, customers

¹⁶⁸ Lambert and Sykuta (n 149) at 33.

¹⁶⁹ Azar, Schmalz and Tecu (n 144).

¹⁷⁰ C Scott Hemphill and Marcel Kahan, 'The Strategies of Anti-Competitive Common Ownership', (2018) ECGI Law Working Paper N° 423/2018 (describing the conflicts of interest between “common concentrated owners”, “noncommon concentrated owners” and “dispersed owners”).

¹⁷¹ If passive investing rises to a level where most of the asset management industry is passive, this will not be the case but the level of passive investing is thus far from there.

and other stakeholders of such competitor companies.¹⁷² While common owners may have an interest in competing companies reducing their competition to benefit the overall portfolio, a reduction in competition will hurt the economic interests of those stakeholders that trade with those competing companies. Lambert and Sykuta use the example of Vanguard's Value Index Fund, which they note holds approximately 2% of every major US airline but also significant positions in companies such as Expedia, Boeing, United Technologies Corp, AARP Corp, Hertz and Accenture, all of whom would be negatively affected by anti-competitive behaviour among airlines.¹⁷³ Therefore, perceived conflicts of interest may not affect common owners as heavily as may first be thought. The interests of passive investors may have in companies that support an industry may outweigh the anti-competitive incentives, aligning the interests of common owners with shareholders who own only one company in a competitive industry. In terms of the "underlying conceptual concerns" the OECD referred to, these considerations provide a powerful counterpoint.

When engaging with investee companies, common owners are unlikely to discourage competitive actions. Similar to the issue of ESG investments, fear of a public backlash is likely to motivate asset managers, especially the Big Three. Passive investors will be concerned about attracting legal liability and a common owner encouraging competing companies to reduce competitive pressures would be likely to be subject to antitrust liability.¹⁷⁴ As well as this, encouraging reduced competition may breach the fiduciary duties of asset managers, where a client holds an investment only in one of the competing companies and the asset manager manages funds that hold investments in more than one competing company.¹⁷⁵ This occurs when different mutual funds in the same mutual fund family have different portfolios. In the context of passive investing, a large asset manager may have different index constructions for index funds or have a mix of passive and active funds but vote as a family.¹⁷⁶ Where an asset manager wishes to avoid fiduciary liability, as Hemphill and Kahan argue, "the safest solution is for the voting group to base its

¹⁷² BlackRock, "Index Investing and Theories of Common Ownership" at 11-12; Edward B. Rock and Daniel L. Rubinfeld, "Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance", NYU School of Law, Law & Economics Research Paper Series Working Paper No 17-05, March 2017 at 7 (The problem becomes an order of magnitude more complicated when one realizes that BlackRock and Vanguard also manage funds that own shares of the airlines' suppliers (e.g., Exxon, Boeing) and customers (e.g. GE, GM, and IBM))."

¹⁷³ Lambert and Sykuta (n 149) at 30-31.

¹⁷⁴ Hemphill and Kahan (n 170) at 49 ("A [common concentrated owner] pursuing an active micro strategy – for example, pressing several airlines to avoid competition with one another – might well face antitrust liability.")

¹⁷⁵ Ibid at 50-53.

¹⁷⁶ Fisch, Hamdani and Solomon (n 26) at 22-23.

recommendations on what vote maximizes the value of a portfolio company.”¹⁷⁷ This is especially so where a “squeaky clean” reputation is a priority for investors, which it is for the largest providers of passive funds. A high profile fiduciary breach could lead to regulatory intervention, sanctions and capital outflows, benefitting rival passive fund managers. There are, therefore, powerful disincentives for using shareholder rights to discourage competition.

E. Conclusion

There are clear incentives as well as disincentives for passive investors to engage with investee companies. Recent experience has shown that the biggest providers of passive funds – the Big Three – will strongly commit themselves, at least in their public statements, to engaging with portfolio companies and acting as stewards. The areas with the greatest growth in engagement are ESG issues, as big asset managers seek to demonstrate their commitment to engagement by engaging on these issues. It is submitted that concerns about reputation drives much of this activity. As an expectation of engagement is created, the biggest asset managers, which happen to be the biggest passive managers, do not want to signal a disinterest in acting as stewards or a disinterest in ESG issues more generally. It is likely then that two factors may reduce the incentives to engage: (1) the size of asset manager, as smaller investors will receive less scrutiny from public organisations and the media and (2) whether or not the engagement occurs in the ESG space, with ESG issues attracting greater attention from engaged investors.

Whether the concern is that passive investors will be apathetic or apply inflexible voting guidelines to investee companies or discourage competition, the thread that unifies them is how passive investors engage. The SRD2 and stewardship codes are designed to deal with the first problem and, for reasons given above, it is unlikely that passive investors will use shareholder rights to discourage competition. The problem identified by Lund, that of one-size-fits-all engagement, as argued, may affect passive investors due to their financial incentives to remain uninformed. But active investors also have incentives to remain uninformed and have taken “box-ticking” approach to engagement in the past. Creating an expectation of engagement may encourage a “one size fits all” approach from both passive

¹⁷⁷ Hemphill and Kahan (n 170) at 51.

and active managers, which could have the damaging effects that Lund describes. Therefore, the concern ought not to be focused on the trend toward passive investing but on the current regulatory push for greater engagement of shareholders that do not always have the incentives to engage

7. Conclusion and Final Remarks

A. Introduction

This thesis has examined the practice of shareholder engagement through the paradigm of the most recent regulatory attempt to increase the levels and quality of engagement: the SRD2. Shareholder engagement is a fundamental aspect of shareholder democracy, which itself is a highly controversial vision of corporate governance policy. This thesis has primarily been concerned with the operation of shareholder democracy in law and how it may be impeded by practical and regulatory realities. A clear understanding of shareholder engagement is a prerequisite to making a case for shareholder democracy. The aim of this thesis is not to argue the case for shareholder democracy, but to clarify the meaning of shareholder engagement in order to better understand how shareholder democracy operates in practice. As well as this, the thesis is concerned with the integration of shareholder democracy norms into law and describing the various options legislators have with respect to such integration. Specifically, the SRD2 chooses neither a purely facilitative approach nor a mandatory approach. It is important to place the foregoing into the context of the shareholder democracy debate and identify how examining the SRD2 and the impediments to the achievement of its goals contributes more generally to this debate.

This thesis has approached the SRD2 in a number of different ways, from its development to a discussion of its provisions, to assessing the various impediments to the aims of the SRD2 and how they might be overcome. The following is a breakdown of what has been discussed in the previous chapters and what each has demonstrated in respect of shareholder engagement and the SRD2.

- Chapter 1 has shown that rooted in the regulatory and legal frameworks that seek to engage shareholders is an assumption that engagement is an action that should be encouraged because it adds value and improves corporate governance decision making. With respect to the UK Stewardship Code, this is apparent in its origins as a Statement of the Institutional Shareholders' Committee, in the findings of the Walker Review, and in its most recent revision. With respect to the SRD2, the assumption is evident from the EC's statements in the various Green Papers and

Action Plans discussed in the thesis, as well as the proposal for the SRD2. This is an important point to establish because it reveals an underlying commitment to a shareholder democracy form of agency theory, which may be at odds with the views of shareholders themselves.

- Chapter 2 has set out certain reasons why shareholders may not hold the same views as the regulators who are seeking to create a legal framework that encourages engagement. These reasons are related to the fact that engagement is often not considered to be a value adding activity.
- Chapters 3 and 4 set out the various impediments to engagement as they exist both in the marketplace and in regulation. These two chapters demonstrate that, although cost is certainly the biggest impediment to engagement, and this is well understood in economic and legal theory, different variables impose different costs on different shareholders and different forms of engagement. In considering how these impediments may operate to defeat the aims of the SRD2 (and SC), these chapters have demonstrated that there is a level of complexity that is involved in considering impediments to engagement that has not received sufficient attention in discussions surrounding the SRD2. Some variables will encourage engagement for certain shareholders in relation to certain forms of engagement and will simultaneously discourage engagement with respect to other shareholders undertaking other forms of engagement. For example, Control Enhancing Mechanisms (CEMs) like loyalty shares can impede engagement by shareholders who do not benefit from the CEM but can enhance the incentives to engage of those who do. Similarly, shareholder identification provisions can increase the level of engagement by making it easier for companies to identify with whom to engage but can discourage other forms of engagement, such as hedge fund activism. It is for this reason that a coherent understanding of “engagement” in all its forms and a focus on which “shareholder” is to undertake the engagement is so important. Vague descriptions or conceptions of engagement in legislation or other forms of regulation will inevitably fail to grapple with the complexities of the impediments that face shareholders seeking to engage.
- Chapter 5 addresses certain avenues that could provide an opportunity for the SRD2 to be successful in its aims of improving both the level and quality of engagement. As the Chapter shows, many of the solutions represent the mitigation of the costs of engagement: the hiring of proxy advisors and the formation of collective groups. This reveals the extent to which cost is an important factor in the engagement process. As well as this, a number of these perceived to the

engagement problem may not be solutions at all: while proxy advisors may raise the level of disclosed engagement, there are serious concerns about how that engagement is conducted, and in particular whether it is meaningful. This emphasises a distinction that must be carefully drawn when discussing engagement: quantity versus quality.

- Chapter 6 considers one form of institutional investor that encapsulates both the impediments to engagement and the means by which these impediments may be overcome. Passive investors are particularly affected by the cost of engagement as they necessarily have highly diversified portfolios that contain a large number of companies. This will involve greater costs of engagement and the free rider problem will correspondingly affect passive investors disproportionately. In terms of overcoming these cost impediments, passive investors have pointed to the fact that they cannot exit their shareholding if they are dissatisfied and this is the motivation for engagement. In other words, passive investors can be seen as having the incentives for inaction simultaneously be seen as having the incentives to engage qualitatively. It is the nature of engagement which forms the focus of this thesis and passive investors have been accused of undertaking engagement in a manner that is low quality and on a blanket “one size fits all” basis. If this is true, this has important implications for the SRD2, which creates a regulatory expectation of engagement. While engagement by passive investors has been extensively discussed by other scholars, this thesis contributes to the debate by analysing passive investor engagement in the regulatory environment of the SRD2.

B. Answering the Research Questions

Returning to the research questions, set out in the Introduction, a number of tentative answers can be put forward, with a caveat that it is difficult to predict the effect of a regulation such as the SRD2 on shareholder behaviour. As was stated, this thesis has at its heart the following primary research question: will the SRD2 be effective in achieving its aims in raising the level and quality of shareholder engagement? Dealing with the question of the “level” of shareholder engagement, there are a number of factors, distilled from the previous chapters, that suggest some answers:

1. The history of the “comply or explain” approach in inculcating “comply or else”: As noted in Chapter 5, the experience of the UK Corporate Governance Code suggests that disclosures of compliance with the Code will increase as the SRD2 comes into effect.¹ However, it was noted with regret that companies subject to the UK Corporate Governance Code were disclosing compliance with that Code but not complying in spirit by way of their actual corporate governance practices.² It is possible that compliance with engagement provisions will be disclosed at a high rate among shareholders subject to the SRD2 but that little more actual engagement will occur. It was submitted that the UK Corporate Governance Code is not a perfect comparator to regulations that target shareholder behaviour, such as the SRD2,³ since the financial incentives are more powerful than for shareholders with respect to engagement. This suggests that shareholders subject to the SRD2 may be more inclined to choose “explain” and simply detail the financial costs of engagement as an explanation for not creating, disclosing and carrying out an engagement policy under Article 3g. This choice would satisfy those worried about the problem of “one size fits all” engagement, as set out in this thesis, but would not fulfil the stated aim in the SRD2 of increasing the level of engagement. It is also possible that asset managers would be punished for choosing to “explain” rather than “comply” by asset owners adopting a “tick the box” attitude with regard to disclosures. This would also be consistent with the UK experience of the Corporate Governance Code - complaints were voiced in the Hampel Report that shareholders were adopting such an approach as early as 1998, and it is not clear that shareholders, such as asset owners, have become any better in the intervening years.⁴ This is an issue of engagement “quality” and as such is discussed below.⁵

2. The cost/benefit calculus. There is a significant amount of evidence, detailed in the thesis, that cost is the biggest impediment to shareholder engagement. The cost of engagement can explain a great deal of the passivity observed that in turn led to the development of the SRD2. While regulators and commentators have taken as a starting position the view that engagement necessarily adds value to an investment,⁶ the basis for “rational apathy” theory is that the benefits of engagement are at least uncertain. From the perspective of shareholders, engagement could involve low or high intensity actions with

¹ See Chapter 5: Overcoming Impediments to Engagement, above at p 168.

² See discussion of this, see Chapter 5, above at p 161.

³ Chapter 5, above at p 168.

⁴ See Chapter 5, above at p 160.

⁵ Below at pp 233-235..

⁶ See Chapter 2: The Shareholder Rights Directive, its Development and its Revision, above at p 55.

varying costs. It cannot be true to say that engagement will always result in a benefit that exceeds the cost.

3. A culture of stewardship and engagement: There is no doubt that instances of engagement are increasing. The SRD2 is likely to contribute by keeping the question of how a shareholder has engaged in focus. Shareholder engagement has become inextricably connected to the culture of “sustainable finance”. Certain shareholders, whether subject to the SRD2 or not, may wish to conduct high quality engagement and may find investee companies more receptive due to a growing expectation of engagement. As noted, there are a suite of proposals published by the European Commission that seek to require institutional investors and asset managers to incorporate environmental, social and governance factors and risks into investment decision making.⁷ This is also designed to bring about a cultural shift toward sustainability and it is undoubtedly linked to the SRD2’s vision of engagement, which is oriented to the long term. The Stewardship Code was undoubtedly designed to create a certain culture among signatories.⁸ The SRD2 has similar ambitions to the Stewardship Code and was also designed to change attitudes and behaviour surrounding engagement. By creating an expectation of engagement, the SRD2 could contribute to a culture of engagement. However, as has been pointed out, “A battle for hearts must be won as well as the battle for minds otherwise a minimum compliance approach may be taken.”⁹ This minimum compliance approach might be labelled “one size fits all” or involve “low quality engagement” or a disclosure of compliance without substantive engagement. Again, it remains to be seen if a cultural change will occur with the help of regulations such as the SRD2.

It is submitted that shareholder engagement will continue to rise as long as it is seen to be a desirable activity. Setting out the meaning of shareholder engagement showed that there is a continuum of engagement, from low intensity to much higher intensity engagement. Considering the cost impediments to engagement, it is submitted that lower cost forms of engagement will see a disproportionate increase among other forms of engagement. This is especially so when generalised policy based engagement is a low cost means of

⁷ See Chapter 6: Passive Investors and Engagement, above at pp 210-216.

⁸ Principle 1 of the 2020 Stewardship Code sets out that “Signatories should explain: the purpose of the organisation and an outline of its culture, values, business model and strategy...”

⁹ 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 at 113.

engagement, since it has the capacity to avoid assessing the differences between individual company circumstances, and is also all that is required from the engagement provisions of the SRD2.

With regard to the question of the “quality” of engagement, there are also a number of factors that can be distilled from the preceding chapters:

1. The availability of lower cost mechanisms to engage suggests shareholders will not voluntarily increase the quality of engagement on a systematic basis. Lower cost engagement mechanisms refer to policies that reduce the costs of engagement, such as blanket voting policies or outsourcing engagement to proxy advisors who may also reduce their research costs by adopting blanket policies. These are no less “engagement” than more intense forms, for reasons explained in Chapter 1, but are certainly not the type of engagement envisioned by the EC after the Financial Crisis. What would be considered high quality engagement requires the dedication of resources that many asset managers do not have and such engagement will usually have uncertain benefits and be subject to the free rider problem.

2. Establishing what is hoped for with respect to the quality of engagement is not clear cut: short termism is a difficult and controversial concept and it remains a moot point whether it was a major problem in capital markets that substantially contributed to the Financial Crisis. It is clear from the development of the SRD2 and its provisions that short termism, as understood in this context, is regarded as being linked to passive ownership since short term approaches to investing are thought to not allow for a more qualitative view of investee companies that involves engagement.¹⁰ At the same time, short termism clearly forms the basis of what is understood as “low quality” engagement in the SRD2.¹¹ Accepting that asset owners create short term incentives for asset managers by selecting and evaluating them on a short term basis, which forms the basis of provisions within the SRD2, requires an understanding of why this is so. It is not clear why asset owners select and evaluate asset managers on a short term basis if this prevents them from adding value through engagement. Certainly, introducing transparency requirements in respect of the asset owner-manager relationship, as the SRD2 does, may not get to the root of why asset owners create such incentives.

¹⁰ See Chapter 2, above at p 60.

¹¹ See Directive (EU) 2017/828 [hereafter “SRD2”], Recital 2.

3. Whether or not asset owners will create incentives to disclose compliance rather than explain: This is one of the most difficult questions that has arisen in this thesis and one whose answer is among the most difficult to predict. As noted in the previous paragraph, the experience with comply or explain in the UK has been that shareholders have too often adopted a “tick the box” approach and punished companies for non-compliance with the Code. Asset managers who choose not to create, disclose or carry out an engagement policy may find themselves vulnerable when it comes to being selected and evaluated by their asset owner clients. This could be because engagement is truly important to many asset owners or it could be because asset owners wish to rely on an absence of compliance with engagement provisions to discipline asset managers for underperformance. If asset owners do seek to encourage compliance and adopt a “tick the box” approach reminiscent of the criticisms of the UK Corporate Governance Code, a financial incentive will exist for asset managers to disclose compliance with the SRD2, while at the same time a financial disincentive will exist to actually engage. This may lead to superficial compliance, where there is compliance in name but not in spirit, or it may lead to asset managers dedicating resources to conduct actual engagement. This remains to be seen.

Ultimately, the conclusion drawn from the research for this thesis is that engagement is a complex concept and one that is not necessarily a desirable behaviour. High quality engagement that considers the circumstances and strategies of individual companies is likely to add value to the corporate governance structure but aiming to raise the level of engagement in and of itself may impose compliance costs for individual beneficial investors and impose rigid governance practices on companies which may not be appropriate. Agency theory presents a problem of costs and shirking to which shareholders must respond, but engagement is not a straightforward solution. Creating regulation that seeks to increase the amount of engagement needs to be very clear about how that engagement is carried out, what actions constitute engagement for the purposes of the regulation and how engagement takes into account the different circumstances of investee companies. An engagement policy that is generalised to cover all investee companies is likely to inculcate “one size fits all” into engagement practices, especially in circumstances where shareholders want to signal compliance with engagement regulation but do not want to bear the costs of high quality engagement.

C. Contributions

The preceding chapters have contributed to the shareholder democracy debate by focusing on the SRD2, to examine the specifics of shareholder power. The first contribution is to clarify elemental concepts of shareholder engagement, such as what exactly “engagement” means in practice and in law. There have been numerous calls for more research with respect to shareholder engagement and this thesis responds to such calls, with the focus on a specific piece of engagement legislation.¹² The thesis stresses that engagement involves a range of different actions with different levels of intensity. While it has often been noted that “engagement” faces barriers, this thesis has detailed how different barriers exist for different forms of engagement which will affect different kinds of shareholders. Seeking to enhance shareholder engagement is therefore not one problem but a diversity of different problems, and each of these problems cannot be overcome simultaneously with one legislative act. The aim of this thesis is to bring clarity to this focus by describing the different problems and addressing how each might be addressed.

In bringing clarity to the question of shareholder engagement, a number of important distinctions have been made that are not sufficiently taken into account in the present discussions of shareholder engagement.

1. The difference between short/long term “shareholders” and short/long term “engagement”: A central aspect of many provisions of the SRD2 is how to discourage “short termism” and to encourage “long termism” in European capital markets. The wording in the SRD2 to explain these temporal concepts involves some variation of the following line “consistency with the profile and duration of, in particular, medium and long term liabilities and the contribution to medium to long term performance of assets of shareholders.” A distinction that has been drawn where relevant in the thesis is that between actions that are “short/long term” and shareholders that are “short/long term.” For example, passive investors are considered to be “long term” in the sense that they will hold their shares for a relatively long period of time but it does not necessarily follow that passive investors will use engagement to further the “long term” interests of the company. Conversely, hedge funds activists are widely considered to be “short term” shareholders

¹² Emma Sjöström, 'Shareholder Activism for Corporate Social Responsibility: What Do We Know?' (2008) 16 *Sustainable Development* 141 at 152-153; Matthew J Mallow and Jasmin Sethi, 'Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate' (2016) 12 *NYU Journal of Law and Business* 385 at 396; Terry McNulty and Donald Nordberg, 'Ownership, Activism and Engagement: Institutional Investors as Active Owners' (2016) 24 *Corporate Governance: An International Review* 346 at 353-355.

because their investment strategy often involves selling their shareholding shortly after targeting a company. This does not necessarily imply that all engagement conducted by such a shareholder will come at a cost to the long term welfare of the company. In order to evaluate the quality of engagement, one must examine the engagement itself, on its own merits and not the length of time the engaging shareholder has held shares.

2. The difference between “activism” and “engagement”: The position of hedge fund activists has been considered throughout this thesis, including in the preceding section, which is concerned with the broader question of shareholder engagement. It is clear that it is a mistake to entirely distinguish shareholder activism and shareholder engagement but that the concept of “activism” must be understood in relation to the concept of “engagement”. Activism is associated with particular forms of engagement and particular shareholders; before hedge fund activists for example there were pension fund activists such as CalPERS. The question of the “quality” of engagement sought under the SRD2 primarily relates to a long term approach, although this thesis has identified “one size fits all” as another quality concern. Shareholder activism has, in recent years, been identified as a source of short termism in capital markets.¹³ These accusations against activists raise the question of whether and to what extent activism is encouraged or discouraged under the SRD2’s provisions. Answering this question requires a clear understanding of: what form of “engagement” is sought under the SRD2; what “activism” involves that may be distinct from, or the same as, the engagement sought; and whether or not activism does contribute to, or cause, short termism. This latter question is too large and complex to be dealt with comprehensively in this thesis but, at the very least, the differences and similarities between “engagement” under the SRD2 and “activism” as broadly understood should be addressed, which this thesis has sought to do.

3. The difference between “stewardship” and “engagement”: As described in the Chapter 1, there are many similarities between the concepts of stewardship and engagement but they should not be treated as interchangeable. Stewardship actions can involve actions that could be considered pre-engagement, such as monitoring. Actions that are unquestionably engagement may not qualify as stewardship, such as engaging in order to transfer short term wealth to shareholders. Furthermore, as the 2020 Stewardship Code has made clear, “stewardship” may, in certain circumstances, be antithetical to engagement. This is because

¹³ See Chapter 4: Regulatory Impediments to Shareholder Engagement, above at pp 129-130.

the subject of the “stewardship” is now considered to be the beneficiaries’ assets, rather than the investee companies themselves. Engagement, with its certain costs and uncertain benefits, may not be justifiable where to do so would expend beneficiary assets.

A number of arguments have been made in the thesis reflect the early stage of research on shareholder engagement in the current market environment. How institutional investors will react to the quasi-mandatory nature of engagement norms is unclear and will depend on a number of factors. First, how important a driver of engagement reputation will be will depend on whether engagement and compliance with the engagement provisions of the SRD2 affects reputation. An argument has been made in the thesis that too much emphasis has been placed on the incentives not to engage, which are long established and based on costs and free riding, and not enough emphasis has been placed on the possibility that there are cost incentives to engaging. Certain institutional investors may mitigate costs by engaging for several reasons. They may wish to protect their public reputation by engaging on social and environmental issues, they may wish to “tick the box” of compliance to expected practice, or they may wish to protect an investment that are unable to exit. While the vast majority of commentary on shareholder engagement points to “rational apathy” and the general passivity of shareholders, these incentives remain underexplored. This thesis seeks to identify them as a starting point for future research and to reframe the area of shareholder engagement not simply as a question of a costs versus benefits of engagement calculus. This thesis has sought to show that the cost benefit calculus that institutional investors face is, in reality, much more complex.

While shareholder engagement is not a new phenomenon, the SRD2 presents a new frontier of shareholder duties of disclosure of engagement practices and policies. The disclosure duties arguably create norms and expectations that, in one sense, restricts the freedom of shareholders to choose to act in a manner of each shareholder’s choosing, reducing shareholder power. In another sense, the same legislation can be regarded as increasing shareholder power. These same norms that are being forced upon shareholders create an avenue for increased influence. Engaged shareholders (even if engaging against their will) can sway company strategy, can change particular company decisions and can guide the direction of a company in one way or another. The extent to which shareholders should be

empowered is at the heart of the corporate purpose debate, which has had a long history.¹⁴ As this thesis has emphasised, the SRD2 is a legal intervention which does not fit easily into either side of this debate. The thesis contributes to the general debate about shareholder empowerment by analysing it through the prism of the SRD2, especially from an Irish company law perspective.

D. Further Questions Regarding Stakeholders

The issue of stakeholders other than shareholders and their place in corporate governance is relevant to the topic of shareholder engagement and, albeit beyond the scope of this thesis, it is proposed that a brief mention is appropriate in this concluding chapter. Shareholder engagement involves a range of different considerations and the place of other stakeholders can be considered relevant for two reasons: engaging shareholders may come at the cost of the influence of stakeholders and engaging shareholders may be undertaken with stakeholders in mind.

The SRD2 represents a vision of shareholder democracy wherein institutional investors are engaged and use their rights and voting power to monitor and discipline company management. Recital 14 of the SRD2 suggests that stakeholders other than shareholders have a role in corporate governance, stating that “greater involvement of all stakeholders, in particular employees, in corporate governance is an important factor in ensuring a more long-term approach by listed companies that needs to be encouraged and taken into consideration.”¹⁵ However, the provisions of the SRD2 contain nothing that will provide stakeholders that are not institutional investors with an avenue to engage, beyond the disclosures of the institutional investors themselves. The position of stakeholders in the framework of the SRD2 is limited to being an audience for the disclosures of shareholders. Recital 16 of the SRD2, referred to in chapter 1, sets out a vision of accountable shareholder democracy, whereby the mandatory disclosures of institutional investors help to enhance accountability of shareholders to “stakeholders and civil society.” Similarly, other recitals emphasise that transparency provisions of the SRD2, such as the publication of the remuneration report should help stakeholders to “be informed of”, “assess” and “to obtain

¹⁴ A good early example is the “Berle-Dodd debate”, see E Merrick Dodd Jr, 'For Whom Are Corporate Managers Trustees?' (1932) 45 Harvard Law Review 1145; Adolph A Berle, 'Corporate Powers as Powers in Trust' (1931) 44 Harvard Law Review 1049.

¹⁵ SRD2, Recital 14.

a full and reliable picture” of directors’ remuneration.¹⁶ While institutional investors are extended a right to vote on the remuneration policy and report, the recitals do not explain the benefit to stakeholders of receiving the information. Prior to the finalisation of the SRD2, the Legal Affairs Committee of the European Parliament recommended that employees should have an input into the remuneration of directors, but this suggestion was rejected by the European Council.¹⁷

Under Article 3g, an element of the engagement policy that must be disclosed, or an explanation given as to why it has not been disclosed, is how institutional investors and asset managers “communicate with relevant stakeholders of investee companies.”¹⁸ How and why shareholders would engage with stakeholders other than other shareholders is an underexplored area and worth briefly considering here. Shareholder engagement with other stakeholders is not a feature of the 2012 UK Stewardship Code but the recent proposed changes adopt a position that is more similar to the SRD2. A new provision of the 2020 SC states “Signatories should explain how they have worked with other stakeholders to promote continued improvement of the functioning of financial markets.”¹⁹ A provision that targets service providers, such as investment consultants, proxy advisors, and data and research providers echoes this.²⁰ Whereas the 2012 SC defined engagement in terms of communication with companies exclusively, the new definition takes a much broader view, defining it as “Communication between different stakeholders, e.g. between asset owners and beneficiaries or investors and investee companies.”²¹ Furthermore, the term “stakeholder” itself is defined in the 2020 SC as “an entity or person with an interest or concern in effective stewardship.”

The SRD2 has been subject to the criticism that it is too focused on shareholders and that the EU has missed an opportunity to elevate the voices of stakeholders.²² To be clear,

¹⁶ SRD2, recitals 32, 33 and 34 respectively.

¹⁷ Andrew Johnston and Paige Morrow, 'The revised Shareholder Rights Directive 2017: policy implications for workers' ETUI Policy Brief: European Economic, Employment and Social Policy, No. 2/2018, March 2018.

¹⁸ SRD2, Article 3g(1)(a).

¹⁹ See Financial Reporting Council, “The UK Stewardship Code 2020”, Principle 4, at 11.

²⁰ Ibid at 27.

²¹ Ibid at 20.

²² Andrew Johnston and Paige Morrow, “Towards long termism in corporate governance: the Shareholder Rights Directive and beyond” in Sigurt Vitols (ed), *Long Term Investment and the Sustainable Company: Vol III*, (ETUI, Brussels, 2015) at 22 (“Yet despite recognising that wider interests are at stake in corporate governance, the Commission confined its proposals almost entirely to shareholders...”)

stakeholder theory can encompass both the involvement of stakeholders in corporate governance and the idea that the company should be managed in the interests of all stakeholders. This is because all that stakeholder theory requires is for controllers of companies to balance the interests of all stakeholders in a company and not simply pursue the interests of shareholders.²³ This can be done either by involving stakeholders more in company decisions or by requiring those making the decisions to consider and balance the interests of all stakeholders. Stakeholder theory has gained traction among market participants and regulators in recent years. As was described in Chapter 1 of this thesis, the Cadbury Code was strongly influenced by agency theory and took a perspective that was in line with shareholder democracy.²⁴ Recent developments have shifted this perspective towards a more stakeholder oriented approach embedded within the Code. The 2018 UK Corporate Governance Code emphasises engagement with both shareholders and stakeholders. A provision of the Code states: “The board should understand the views of the company’s other key stakeholders and describe in the annual report how their interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and decision-making.”²⁵ This references the “enlightened shareholder value”, mentioned in Chapter 2,²⁶ which could itself be regarded as a (tentative) step towards integrating stakeholder theory into UK company law.²⁷ Notably, Ireland specifically did not choose to move in this direction and companies listed on the Irish Stock Exchange’s Main Securities Market (now operated by Euronext) must disclose how the company has applied the principles of the 2016 iteration of the UK Corporate Governance Code, rather than its 2018 iteration.²⁸ While the 2016 iteration does mention “effective engagement with key stakeholders”, there is a far greater emphasis on engagement with investors throughout its provisions.²⁹ In the US, which has long had a tradition of shareholder primacy, the Business Roundtable, which consists of 181 CEOs of major American companies declared that they had a new understanding of the purpose of their companies, setting out, “[w]hile each of our individual companies serves its own corporate

²³ For a discussion of stakeholder theory see Andrew Keay, 'Stakeholder Theory in Corporate Law: Has it Got What it Takes?' (2010) 9 Richmond Journal of Global Law and Business 249

²⁴ See Chapter 1: Introduction, above at pp 24-25.

²⁵ FRC “The Corporate Governance Code” July 2018 at 5.

²⁶ Chapters 1 and 2, above at pp 4; 77.

²⁷ Whether and to what extent section 172 of the Companies Act 2006 incorporates stakeholder theory into UK company law is a controversial idea. For a greater discussion see Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance*, (Routledge, 2013) at 211-218.

²⁸ See Euronext Dublin Rulebook, Book II: Listing Rules, 21 July 2019, Rule 6.1.82(6) and the definition of “UK Corporate Governance Code” at 20.

²⁹ FRC “The UK Corporate Governance Code” April 2016. See, for example at 4 (“Satisfactory engagement between company boards and investors is crucial to the health of the UK’s corporate governance regime.”)

purpose, we share a fundamental commitment to all of our stakeholders.”³⁰ This received a great deal of attention and criticism, with many commentators arguing that this deviation from shareholder primacy was a tactical move to pre-empt regulatory intervention.³¹ This criticism underlines the effect that stakeholder theory has had in the US, that so many prominent CEOs felt the need to publicly accept the premises of stakeholder theory instead of arguing that a shareholder primacy model better served society.

Enhancing the voice of shareholders, as the SRD2 seeks to do, furthers the goal of shareholder democracy but not necessarily shareholder wealth maximisation. This is because shareholders may use their voice to seek aims other than shareholder wealth maximisation. Public pension funds, for example, may engage on the behalf of employee rights and welfare. In theory, enhancing the voice of shareholders could benefit stakeholders, depending on the type of shareholder and stakeholder in question. In this way, shareholder democracy and stakeholder theory are not necessarily mutually exclusive. While it is difficult to know to what end shareholders would engage with companies, there are indications that environmental, social and governance issues would be prominent.³² As noted, asset managers have pushed recently to force investee companies to give consideration to their environmental impact.³³ Furthermore, as described, there are a range of different proposals put forward by the EC that will require asset managers and institutional investors to take into account ESG factors and disclose how these have been taken into account.³⁴ There is a clear overlap between issues that affect stakeholders and those that promote shareholder value since shareholders are stakeholders themselves and areas that affect the interests of other stakeholders may also affect shareholder value. Issues that relate to other stakeholders that are worthy of further exploration and are beyond the scope of the present thesis include the following:

³⁰ Business Roundtable, “Statement on the Purpose of a Corporation”, 19 August 2019, available at <https://opportunity.businessroundtable.org/wp-content/uploads/2019/08/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf>

³¹ “What companies are for: competition, not corporatism, is the answer to capitalism’s problems,” *Economist*, 22 August 2019; Simon Goodley and Rupert Neate, “Leading US bosses drop shareholder-first principle”, *The Guardian*, 19 August 2019, David L Bahnsen, “Business Roundtable Pretends to Redefine What a Corporation Does,” *National Review*, 26 August 2019.

³² Tamas Barko, Martijn Cremers and Luc Renneboog, “Shareholder Engagement on Environmental, Social, and Governance Performance,” ECGI Finance Working Paper N° 509/2017, August 2017.

³³ See Chapter 6, above at pp 208-210.

³⁴ See Chapter 6, above at pp 210-216.

1. How and under what circumstances would institutional investors engage with other stakeholders? Since stakeholders other than shareholder do not have a vote, their ability to put pressure on management is limited. In certain jurisdictions, however, certain stakeholders have an outsized voice in company decision making. For example, in German companies that have between 500-2,000 employees must have a third employee directors on their supervisory board.³⁵ Where employees have such an influence, it might make sense for institutional investors to engage with employee groups in such companies. Where other stakeholders do not have an influence within the management of companies, is there any reason to expect shareholders to engage with them? It may be that the disclosure element of communication with stakeholders in Article 3g forces institutional investors to consider stakeholder engagement simply in order to be in compliance. This compliance would come at a cost, as all engagement does, and it is difficult to see the benefit that could accrue to shareholders since the stakeholders little direct influence on company decisions. In other words, there is no financial incentive to comply with this element of Article 3g. It is possible that institutional investors will craft a policy statement on engagement with stakeholders but do little to carry it out.

2. Will enhancing the engagement of shareholders be detrimental to other stakeholders? It is clear that such a result would not be what the EU intended with the SRD2. As noted above, its provisions are designed to enhance accountability of shareholders to other stakeholders. While this is the stated aim of the provisions, the accountability mechanism is limited to disclosure, without any mechanism for enforcement. If institutional investors increase levels of engagement and do so on a basis that disadvantages other stakeholders – for example, by pushing for higher dividends at the expense of increased wages or seeking to undertake a risky transaction, pushing the company closer to bankruptcy – there could be little these stakeholders can do to have their voice considered, at least with respect to the SRD2 provisions. The disclosures of institutional investors within Article 3g offer little to other stakeholders by way of empowerment. The engagement policy that is disclosed may contain general information about how institutional investors exercise voting rights, how they monitor companies and how they engage collectively but this would give little indication about the specific areas on which they engage and to what end. If an institutional investor begins a campaign that will advantage shareholders and disadvantage other

³⁵ Paul Davies, Klaus Hopt and Wolf-Georg Ringe, in Kraakman, Armour, Davies, Enriques, Hansmann, Hertig, Kopt, Kanda, Pargendler, Ringe and Rock, *Anatomy of Corporate Law*, (3rd ed, Oxford University Press, 2017), at 90, citing ss 1 and 7 Mitbestimmungsgesetz and ss 1 and 4 Drittelbeteiligungsgesetz.

stakeholders, this will not be disclosed ahead of time in the engagement policy. Article 3g also requires disclosure of how the engagement policy has been carried out, which might contain information about votes that would indicate the preferences of shareholders with respect to certain specific campaigns or issues that have disadvantaged other stakeholders. However, this is disclosed post hoc. The only hope from a stakeholder perspective with respect to the engagement provisions of the SRD2 is that institutional investors would engage in a manner that does not disadvantage them. This places stakeholders who otherwise have no means of influence in a precarious position. It remains to be seen how institutional investors will use an enhanced voice in corporate governance (or if they will use it at all).

3. Will enhancing the engagement of shareholders result in reduced influence for other stakeholders? Stakeholder engagement with companies is not an area that is covered by the SRD2, which is concerned only with the engagement and transparency of certain shareholders. The SRD2 does raise the possibility that increasing the level of shareholder engagement may have the unintended consequence that the voices of other stakeholders are given a reduced priority by companies. It is possible that enhanced shareholder engagement will occupy the attention of company managers and leave less room for them to hear the views of other stakeholders. Concerns of this nature are potentially mitigated by the UK Corporate Governance Code, which requires engagement with particular other stakeholders, most particularly with “the workforce”.³⁶ For example, it contains a principle that “The workforce should be able to raise any matters of concern.”³⁷ It also states that “For engagement with the workforce, one or a combination of the following methods should be used: a director appointed from the workforce; a formal workforce advisory panel; a designated non-executive director.”³⁸ In a supporting document, the Financial Reporting Council goes into greater detail on the engagement activities a board can undertake with the workforce, listing, among other activities: hosting talent breakfast/lunches, town halls and open-door days; listening groups for frontline workers and supervisors; focus or consultative groups; meeting groups of elected workforce representatives; meeting future leaders without senior management present; and social media updates.³⁹ It is perhaps notable then that Irish companies do not have to disclose

³⁶ The term “workforce” is specifically not given a legal meaning and is considered a broader term than “employee”, see FRC, “Guidance on Board Effectiveness”, July 2018, available at <https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-Guidance-on-Board-Effectiveness-FINAL.PDF>.

³⁷ See FRC “The Corporate Governance Code” July 2018 at 4.

³⁸ Ibid at 5 (reference omitted).

³⁹ FRC, “Guidance on Board Effectiveness,” July 2018 at 16.

compliance with the 2018 Code but with the 2016 Code, which does not contain these provisions regarding employee engagement.⁴⁰

Much of the above assumes that shareholder engagement will be enhanced or increased in the years after the SRD2 has come into force in Member States and that this will raise issues with respect to the other stakeholders of the company. This may not come to pass. As Chapters 3 and 4 have set out, there are many formidable impediments to shareholder engagement with companies, both market and regulatory, and the provisions of the SRD2 are unlikely to help overcome these impediments most of the time for most shareholders. Where companies do not face increased shareholder engagement, the effects of the SRD2 provisions on other stakeholders will be minimal to non-existent.⁴¹ However, the possibility that the SRD2 will succeed for some shareholders some of the time and that therefore the average level of engagement across European companies will increase should be considered.

E. Final Remarks

Shareholder engagement is an integral element to a functioning shareholder democracy. It is a key objective of regulators seeking to solve the agency problem and improve corporate governance in PLCs. The fact that engagement is considered by these same regulators to be both value adding for shareholders and at the same time undertaken far less than is optimal suggests a paradox. This thesis has addressed why shareholders decline to engage much of the time. The SRD2 is a pioneering piece of legislation in the sense that it seeks to encourage all institutional investors subject to it to engage at a greater level. Unlike Stewardship Codes, it is not voluntary for the shareholders subject to it. For this reason, it remains to be seen how successful it will be in achieving its aims. What is clear from the development of the SRD2 and its provisions is that there is a deep commitment at an EU legislative level to shareholder democracy as a means of organising the corporate governance frameworks and structures of EU PLCs. The merits of shareholder democracy

⁴⁰ See above p 242.

⁴¹ Johnston and Morrow make a similar point with regard to the 2014 proposal for a revision to the Shareholder Rights Directive, stating that the engagement provisions “will not cause any harm (beyond increasing costs)”, see Andrew Johnston and Paige Morrow, 'Commentary on the Shareholder Rights Directive' (2014) No. 2014-41 University of Oslo Faculty of Law Legal Studies Research Paper Series 1 at 7.

have been argued back and forth for decades. The SRD2 represents a further important step, guided by what were seen as failures of the Financial Crisis, in embedding the normative values of shareholder democracy in the legal systems of every EU Member State. There is perhaps an irony in attributing blame to shareholders for the severity of the Crisis on the basis that they are too often short term in their investment approach and subsequently seeking to enhance their influence in companies by way of remedy. Whether or not this is self-defeating will depend on how effective the SRD2 is in changing behaviour and eliminating the short term approach that the EC identified.

Since the SRD2 has only recently been transposed in Ireland, in March 2020, the impact of its provisions on institutional investors and asset managers acquiring shares on the Euronext Dublin Market, as well as on the Irish PLCs listed on that market is not clear. The impact that eventually is felt may be borne by individual end user investors, as fees are increased to cover increased compliance costs that are associated with the greater number of disclosures that must be made by the institutional investor that is managing their assets. The impact may be felt by smaller asset managers who do not have the resources available to engage substantively and may be forced to make disclosures of non-compliance. Such asset managers may find that they lose clients to larger asset managers who disclose robust engagement. Of course, the impact may be felt by those managing PLCs in the form of greater scrutiny and accountability checks from their shareholders, reducing the opportunities to impose agency costs. The value of the SRD2 is that transparency requirements will force institutional investors and asset managers to consider their roles in corporate governance in a manner they have not had to do heretofore. Whether this manifests in more effective engagement that is oriented to the long term health of the investee company and the long term value of assets that are being invested remains to be seen.

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APPENDIX

1. Does your organisation have an engagement policy?

- a) Yes
- b) No

2. Is engagement with investee companies an element of your investment strategy?

- a) Yes
- b) No

3. If yes to Q.2, how important an element is engagement?

- a) Very Important
- b) Quite Important
- c) Not Important

4. Why is engagement important to you? Tick any or all that you consider appropriate.

- a) It can add value to an investment
- b) It is required by our fiduciary duty to our clients
- c) It holds management of companies accountable for their decisions
- d) It makes management aware of shareholder concerns
- e) Other (please explain):

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5. Which of the following, if any, do you regard as constituting “engagement”:

- a) Exercising voting rights at a general meeting
- b) Voting against management recommendations

- c) Hiring proxy advisory services to provide advice
- d) Monitoring investee companies
- e) Sending a letter to company management
- f) Initiating personal contact with representatives in the investee company
- g) Conducting a private dialogue with representatives of an investee company
- h) Selling some or all of an investee company's shares
- i) Public criticism of an investee company
- j) None of the above
- k) Other (please explain):

6. Which of the following engagement action(s), if any, you have taken in the past 12 months, on behalf of a client or in a professional capacity:

- a) Exercising voting rights at a general meeting
- b) Voting against management recommendations
- c) Hiring proxy advisory services to provide advice
- d) Monitoring investee companies
- e) Sending a letter to company management
- f) Initiating personal contact with representatives in the investee company
- g) Conducting a private dialogue with representatives of an investee company
- h) Selling some or all of an investee company's shares
- i) Public criticism of an investee company
- j) None of the above
- k) Other (please note):

7. Which of the above engagement actions do you undertake most often and how often (approximately) have you undertaken this action in the previous 12 months (please indicate):

8. In general, have the representatives of investee companies or investee companies as a whole, in your view, been receptive to the engagement actions you have undertaken?

- a) Very receptive
- b) Quite receptive
- c) Not receptive
- d) Not applicable/none of the above

9. In general, which type funds do you engage more with?

- a) Actively managed funds
- b) Passively managed funds
- c) A mix of active and passive funds
- d) None of the above (feel free to explain):

10. What proportion of your institutional or individual clients have sought to influence engagement with investee companies in the previous 12 months?

- a) Most clients seek to influence our engagement
- b) Approximately half our clients
- c) Very few
- d) None

11. If clients do seek to influence engagement, which of the following areas do they generally feel are appropriate for engagement?

- a) Executive/Director remuneration
- b) Governance structure of investee companies
- c) Sustainability issues
- d) Social issues (including corporate social responsibility)
- e) Shareholder distributions (eg issues relating to dividends and share buybacks)
- f) None (clients do not generally seek to influence engagement)
- g) Other (please note)

12. Which of the following areas do you consider are particularly appropriate for engagement?

- a) Executive/Director remuneration
- b) Governance structure of investee companies
- c) Sustainability issues
- d) Social issues (including corporate social responsibility)
- e) Shareholder distributions (eg issues relating to dividends and share buybacks)
- f) None (no areas are inherently appropriate for engagement)
- g) Other (please note)

13. Do you view your engagement role as being within your discretion or subject to the views and direction of clients?

- a) Within the discretion of our organisation as part of the portfolio management function
- b) Subject to the direction and views of clients

14. Does your client mandate include provisions on how you are to engage with investee companies?

a) Yes

b) No

15. Do you view any of the following as barriers to engaging? (Please indicate which, if any)

a) Direct costs of engagement (resources required to be allocated for the purposes of engagement)

b) Lack of clear benefits to engaging

c) Possibility of acting in concert and triggering a mandatory offer

d) Dual class structures of investee companies

e) Lack of access to shareholder rights in the investment chain

f) Other, please indicate: