

# **Chapter 12**

## **The emperor's new clothes – enlightened shareholder value and the UK Stewardship Code**

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### **1. The role of shareholders in the UK's system of corporate governance**

In the UK, when it comes to corporate governance, there is only one stakeholder group that really counts: company shareholders. Unlike many continental European systems, workers do not have participation rights in corporate governance, and the rights to information and consultation that they do have – which are generally much weaker than those of continental European workers – are not linked to corporate governance but operate quite separately. While the terms ‘Anglo-Saxon’ or ‘Anglo-American’ are often used to link the UK and the US systems of corporate governance, what the two have most clearly in common is an absence of any element of workers’ participation, rather than sharing the same system of shareholder control. Although recent developments in the US such as ‘say on pay’ are starting to change this, shareholder rights remain significantly stronger in the UK than they are in the US. Thus, the shareholder value model of corporate governance is uniquely strong in the UK.

One reason for this is that, since the early 1990s, successive UK corporate governance reviews have emphasised the role of shareholders in monitoring and engaging with company boards, rather than regulation, as the means to improve corporate standards and behaviour. First came the Cadbury Committee, established in the early 1990s in response to the corporate scandals of BCCI and Polly Peck, which produced what became known as the Cadbury Code. This was followed by the Greenbury Committee set up in 1995 to address the issue of executive pay. In the late 1990s, the Hampel Committee reviewed the Greenbury Committee’s recommendations and amalgamated them with the Cadbury Committee’s to form one corporate governance code (known at the time as

the Combined Code of Corporate Governance); this was followed by the Turnbull Report on internal control and risk management in 1999, and the Higgs review of the role of non-executive directors in 2002. The now renamed Corporate Governance Code has continued to develop, with the most recent version being published in 2010. Throughout its genesis, the central theme of the Code has been the accountability of the board of directors to company shareholders.

Whether their powers are enshrined in the Corporate Governance Code, company law or in companies' Articles of Association, shareholders wield significant rights in the UK in relation to the companies whose shares they own. They have the power to elect directors at the annual general meetings of FTSE 350 companies, now on an annual basis. They have had an advisory vote on remuneration reports since 2003, and the UK Government announced in January 2012 that it will introduce a binding shareholder vote on directors' pay (Department for Business, Innovation and Skills 2012). Shareholders can propose resolutions at AGMs and vote on all resolutions. They can convene extraordinary general meetings.

Moreover, there is a widespread assumption in the UK that it is right and proper that shareholders should be the ones to act against corporate misdemeanours, and a common response from Government, when confronted with public outrage at egregious corporate behaviour, is 'it's a matter for shareholders' (unless it turns out that the Government is in fact the main shareholder as is the case with one of the UK's largest banks, Royal Bank of Scotland). Thus alongside the market for corporate control – in which shareholders also hold all the cards – shareholder engagement and power is seen as the main discipline on company behaviour in the UK, other than basic legal requirements.

However, the most fundamental right that shareholders enjoy is that in UK law directors' duties require company directors to promote shareholder interests. Recognising that there is a 'high road' to profitability based on investing in research and development and employee training and developing long-term relationships with stakeholders based on respect and trust, and a 'low road' route based on a low-wage, low-skill and low-investment model, the law encourages directors to serve shareholder interests in an 'enlightened' way. Thus, the 2006 Companies Act requires directors, in serving shareholder interests, to have regard to the interests of employees, suppliers and the local community, environmental and reputational impacts and the long-term consequences of their decisions.

Directors are required to report on how they have carried out these duties and on key information concerning employees, supplier relationships, social and community issues and environmental impacts. This is the 'enlightened' component of the term 'enlightened shareholder value'.

The rationale behind this formulation was the view that in the long term there is a convergence of interests between shareholders and other company stakeholders. Thus, the argument went, there is no need to give stakeholder interests equal status to those of shareholders or give stakeholders participation rights, because in the long run promoting shareholder interests is good for other stakeholders and indeed for the company itself.

## **2. Genesis of the Stewardship Code**

The financial crisis shattered the illusion that shareholders were monitoring boards effectively and turned a spotlight on the whole area of corporate governance and shareholder engagement as a discipline on company boards. In the UK, Sir David Walker was asked to undertake a review of corporate governance in UK banks and other financial industry entities, which reported in 2009 (Walker 2009). This was very critical of the quality and extent of shareholder engagement with bank boards and its recommendations included a proposal that the responsibilities of investors towards the companies whose shares they own should be set out in a code that would complement the Corporate Governance Code that focuses on the role of directors. The Stewardship Code was launched by the Financial Reporting Council (FRC) in July 2010.

The Stewardship Code is addressed to institutional investors (FRC 2010: 2). It is aimed primarily at asset managers, but encourages pension funds and other asset owners to apply the Code. Like the Corporate Governance Code, it is applied on a 'comply or explain basis'. While applying the Corporate Governance Code has long been a requirement of the UK Listing Rules, the Financial Services Authority (responsible for licensing UK financial services institutions) amended its rules so that since December 2010 all UK-authorized asset managers have been required to produce a statement of commitment to the Stewardship Code or explain why it is not appropriate to their business model (FSA 2010). Both are under the remit of the FRC, which has responsibility for updates and reviews of the Codes.

The content of the Stewardship Code was based on an existing code already drawn up by the Institutional Shareholders' Committee (ISC).<sup>1</sup> Its seven principles require that institutional investors should:

- publicly disclose their policy on how they will discharge their stewardship responsibilities;
- have a robust policy on managing conflicts of interest in relation to stewardship, which should be publicly disclosed;
- monitor their investee companies;
- establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value;
- be willing to act collectively with other investors where appropriate;
- have a clear policy on voting and disclosure of voting activity; and
- report periodically on their stewardship and voting activities.

These principles are supplemented by guidance, which is more detailed on some areas of the Code than others.

### **3. A critique of the Stewardship Code and enlightened shareholder value**

Given the central role ascribed to shareholders within corporate governance in the UK, it is absolutely right and long overdue that some standards governing investors' responsibilities in relation to the companies whose shares they hold should be established. For this reason, the Trades Union Congress (TUC) welcomed the introduction of the Stewardship Code. It is the first high-level initiative to set out the responsibilities of investors and its introduction has already boosted discussion and debate on this important area.

In relation to the contents of the Code, it is a limitation in the TUC's view that, despite carrying out an extensive consultation on what should be included in the Stewardship Code, the FRC then decided to use the

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1. The ISC is a group of trade associations that represent institutional investors and comprises the Association of British Insurers, the Investment Management Association and the National Association of Pension Funds. The ISC has now been renamed the Institutional Investor Committee.

existing ISC Code as the basis for the Stewardship Code, making only minor changes. The TUC would have wished the Stewardship Code to be considerably stronger on several issues, including voting disclosure. Another weakness is that it does not address the different parts of the investment chain clearly, and does not therefore set out the respective responsibilities of asset owners and consultants in relation to stewardship. Nonetheless, the Stewardship Code does encourage collaboration between investors over their engagement strategies with companies and encourages voting, reporting and the systematic monitoring of investee companies.

However, there is a more fundamental question that needs to be asked. Is the enlightened shareholder value system that the Stewardship Code enhances working as it should be, or is it the system itself that needs to change?

The rationale behind enlightened shareholder value is that, in the long run, the interests of shareholders converge with those of other stakeholders and, even more importantly, those of the company itself. Therefore, requiring directors to promote the interests of shareholders will, in the long run, be good for other stakeholders and for company performance. Following and extending this argument, if the purpose of companies is to promote their shareholders' interests, it makes sense to give shareholders the rights and tools to enable them to hold company boards to account. Or does it?

Patterns of share ownership have changed dramatically in recent years, posing a major challenge to the UK's reliance on shareholder engagement within its corporate governance system. In the 1960s, the majority of shares in UK companies were owned by individuals, many of whom took a reasonable level of interest in the companies whose shares they owned. By the 1980s, the majority of shares were owned by UK institutional investors such as pension funds and insurance companies. Today, this has changed again. The most recent figures from the Office for National Statistics (ONS) figures show that by the end of 2010 UK pension funds and insurance companies held just 5.1 per cent and 8.6 per cent of UK equities, respectively, the lowest percentages since the survey started in 1963 and sharply down from a combined total of 43 per cent in 1998 and 26 per cent in 2008. By December 2010, investors from outside the UK owned 41.2 per cent of UK listed shares, while individuals held 11.5 per cent (ONS 2012).

It will, by definition, be harder for investors from outside the UK to develop the kind of engaged relationships with UK companies that are envisaged by the UK's corporate governance system. Language, culture, proximity and availability of information all make engagement much more straightforward within a national context in comparison with engaging with companies abroad. This is reflected in responses to the TUC's Fund Manager Voting Survey. In the 2011 Survey, all 19 respondents to this question said they voted all their UK shares (with a couple of minor qualifications), while ten voted all their overseas shares (with a further seven saying they voted a significant proportion of their overseas shares). The UK's corporate governance system was not designed on the basis that the largest single share ownership block would be investors from outside the UK.

In contrast with individuals who generally own shares in a limited number of companies whose progress they follow closely, institutional investors generally hold highly diversified portfolios. The Investment Management Association (IMA) says that the average fund manager holds shares in 450 different companies, and for some it will be in the thousands. Just as an increasing proportion of UK shares are held by investors from outside the UK, an increasing proportion of equity holdings of UK institutional investors are global, rather than UK, equities. The sheer number of companies whose shares they hold poses major practical challenges for the ability of institutional investors to carry out their corporate governance responsibilities effectively. The TUC's Fund Manager Voting Survey asks each year about how many people fund managers have working on corporate governance and responsibility issues. With five exceptions – two teams of 30 or more, two teams of twenty or more and one with twelve people – all other respondents have less than ten staff working on these issues (TUC 2011). However skilled and dedicated such staff may be, it cannot be possible for them to engage effectively with all the companies whose shares they hold over all the issues for which shareholders are ultimately responsible.

The IMA's own survey makes it clear that its members are wary of too weighty expectations being placed on their governance role: 'The fact that UK investors now own a smaller proportion of UK companies has implications for the corporate engagement role that investment managers play in the governance of companies. There is concern amongst investment managers that there should not be unrealistic expectations of what they can achieve through engagement' (IMA 2010). If UK institu-

tional investors are to engage effectively on an informed and consistent basis with all the companies whose shares they own, this would require a very significant deployment of resources, considerably above the levels that most currently devote to engagement.

By setting out high-level guidance on monitoring and engagement with investee companies and encouraging collaboration between investors, the Stewardship Code does try to address these challenges. However, while it is still early days in the life of the Stewardship Code, there is no evidence to date that it has led to increased resources being allocated by asset managers to stewardship. The TUC's 2011 Fund Manager Voting Survey asked respondents what, if any, changes they had made to their voting and engagement practices as a result of the introduction of the Stewardship Code. Several respondents said that they had made no changes in response to the Code, with some saying they believed they already met its requirements. However, a number of respondents did identify changes made as a result of its introduction: several mentioned that they had improved engagement recordkeeping, and in addition, changes to stock-lending and conflicts of interest policies, reporting to clients and public reporting were all mentioned. Notably, only one respondent stated that it had increased the resources devoted to stewardship and only one said that communication with companies had changed as a result of the Stewardship Code (TUC 2011). Worryingly, recent changes within the market place suggest that, despite the Stewardship Code, asset managers are currently cutting back, rather than expanding, their engagement capacity (Aviva 2012). If shareholders do not have the capacity or motivation to engage sufficiently with the companies whose shares they own, this leaves a dangerous vacuum in corporate governance.

A further challenge for good stewardship is to ensure that voting and engagement is carried out in accordance with the wishes of the ultimate beneficiaries of investments. The TUC believes that the Stewardship Code should include a provision stating that asset managers should consult with their clients and beneficiaries on the policies on which their voting and engagement is based. Unfortunately, this area is not addressed by the Code, which stipulates that asset managers should report periodically to clients, which is welcome, but contains nothing to encourage asset managers to actively seek client and beneficiary views on their policies and stewardship performance. Given the disparate nature of asset managers' clients and beneficiaries and the lack of avenues for

engagement that exist between the latter and their fund managers, this is a serious omission. In the area of pensions, it can be difficult enough for trustees of a trust-based, defined benefit pension scheme to engage their fund managers in discussion around stewardship issues, but at least in this case there is a governance body that can act as a direct link between beneficiaries and the asset manager. In contract-based defined contribution pension schemes, the beneficiaries have no channel through which to raise issues or express their views. The impact on stewardship of the switch made by increasing numbers of UK companies from trust-based defined benefit pension schemes to contract-based defined contribution pension schemes has been insufficiently acknowledged in public policy debate. Similarly, with insurance, private pension and other retail products, beneficiaries have no democratic voice in discussions on stewardship decisions that are taken on their behalf. Failure to address this vital area is a significant deficiency in the Stewardship Code.

However, even if fund managers were to find the capacity and motivation for engagement and an effective way of ensuring that their strategies take into account their beneficiaries' views, there is an even more fundamental problem with reliance on shareholder interests as a proxy for wider stakeholder and company interests. The convergence between shareholder interests and those of other stakeholders and indeed the company itself only works if shareholders are long-term investors whose economic interest in a company is in receiving dividend payments over a period of time. If, however, the shareholder is a short-term share trader, whose economic interest is in selling a company's shares for a higher price than it bought them for, it will have a direct interest in promoting short-term strategies to boost the company's share price, even where these are in direct conflict with strategies for long-term, organic growth. In this case, its interests will not coincide with those of company stakeholders such as employees and suppliers, nor, very significantly, with the interests of the company itself. If the investor is shorting the stock, its interests will be diametrically opposed to those of the company and other stakeholders, including long-term shareholders, as it will stand to gain if the company's share price falls. In this scenario, it is far from clear why shareholders are the group whose interests companies are required to promote, and why shareholders have the ultimate say over how companies are run.

This fundamental issue of the divergence between the interests of short-term share traders and long-term company interests is not addressed in the Stewardship Code, which treats all investors the same. The Code has

nothing to say on share trading strategies or the desirability of long-term share ownership, restricting its focus to stewardship activities without acknowledging that the shape and impact of these activities will vary considerably depending on the underlying financial strategy of the fund manager.

The TUC has proposed that investors' governance rights in companies, including voting rights, should be dependent on a minimum period of share ownership, which we suggest should be two years. This would help to reduce the role played by short-term share traders in company decision making.

In addition, the TUC believes that directors' duties should be rewritten, so that directors are required to promote the long-term success of the company as their primary aim. In carrying out this duty, directors should be required to deliver sustainable returns to shareholders, promote the interests of employees, suppliers and customers, and have regard to community, environmental, human rights and reputational impacts. This would have the effect of rebalancing the interests of shareholders and other stakeholders, but all their interests would be secondary to the long-term success of the company itself.

## **4. Conclusion**

In conclusion, the Stewardship Code provides a welcome focus on the quality of investor engagement by encouraging asset managers to monitor and engage with investee companies. It does not address the respective roles of the different parts of the investment chain and nor does it encourage fund managers to consult with their clients and beneficiaries about their stewardship policies and performance, but it would be possible to amend it to repair these deficiencies.

But the Stewardship Code does not and indeed cannot address the fundamental problem with enlightened shareholder value, which is the divergence between the interests of short-term shareholders and those of other stakeholders, long-term shareholders and the company itself. This is the central contradiction at the heart of shareholder value systems of corporate governance, and addressing it requires steps that go beyond reforms of the existing system, welcome though these may be.

Nor can the Stewardship Code address the difficulties that fund managers face trying to engage with hundreds or thousands of companies whose shares they hold. This remains a major practical obstacle to the quality and quantity of engagement, and again addressing this would require structural change that is beyond the scope of the Stewardship Code.

The Stewardship Code has given the emperor some new clothes, but underneath the problems with enlightened shareholder value have not gone away. The time has come to look at more fundamental reform of the UK corporate governance system and the interests and rights that underpin it. Rather than prioritising shareholders over other stakeholder groups, corporate governance should be rebalanced so that its governing principles are the interests of long-term stakeholders and above all the long-term interests of the company.

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