Activism and collaboration among shareholders in UK listed companies

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Key points

- The new Stewardship Code published by the Financial Reporting Council in July 2010 supersedes the Code developed by the Institutional Shareholders Committee and will apply to institutional investors on a 'comply or explain' basis.
- Underlying the development of the Code is the perception that passivity on the part of institutional investors contributed to the financial crisis through failures in monitoring and holding to account the boards of financial institutions.
- In conjunction with publication of the Code, both the Financial Services Authority and the Takeover Panel have taken action in relation to perceived regulatory constraints on shareholder collaboration.
- While the private nature of much engagement and the variety of factors influencing share prices limits the value of empirical studies of the financial benefits of engagement, evidence of such benefits has emerged from recent studies.
- The new Code brings engagement and collaboration into a semi-regulatory framework but its value must ultimately lie in the extent to which it can facilitate engagement and collaboration that adds value in the long term.

1. Introduction

On 6 March 2001, Paul Myners[1] wrote to the then Chancellor Gordon Brown setting out the conclusions of his review into institutional investment in the UK. He commented that:

> . . . the review is clear that fund managers remain unnecessarily reluctant to take an activist stance in relation to corporate underperformance, even where this would be in their clients' financial interests.[2]

While this conclusion was influential in prompting a number of changes in the legal and regulatory framework and in the practices of institutional investors, the issue came to the fore once again in the wake of the global financial crisis. Sir David Walker observed in his 2009 review of corporate governance in UK banks and other financial institutions that:

> With hindsight it seems clear that the board and director shortcomings discussed in the previous chapter would have been tackled rather more effectively had there been more vigorous scrutiny and persistence by major investors acting as owners.[3]

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1 Now Lord Myners.

2 Myners Review of Institutional Investment: Final Report. <http://archive.treasury.gov.uk/docs/2001/myners_report0602.html> accessed 13 August 2010.

3 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities' (July 2009) <http://www.hm-treasury.gov.uk/walker_review_information.htm> at 60, accessed 13 August 2010.

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The Stewardship Code[4] is the outcome of the recommendation made by Sir David Walker that the Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders Committee (ISC), should be ratified by the Financial Reporting Council (FRC) and operate on a comply-or-explain basis. The preface to the Code sets out its objectives clearly:

> The Stewardship Code aims to enhance the quality of engagement between institutional investors and companies and to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities.

This article explores the potential for the Code to meet those objectives. It starts by identifying some key features of the UK system of corporate governance that influence the manner in which engagement occurs. It then moves on to consider the nature and potential benefits of activism. Collaboration between shareholders is considered, in the way that it is envisaged by the Code, as a subset of activism. Attention is then focused on aspects of the Code in operation, in particular the 'comply or explain' basis according to which institutional investors will adhere to the Code. The recent focus of the European Commission[5] on the role of corporate governance failures in the financial crisis and its launch of a more wide-ranging review of corporate governance adds another dimension to the discussion since the success of industry initiatives such as the Code carries direct implications for the likelihood of legislative or regulatory intervention. So too does the potential role envisaged by the FRC for the Stewardship Code in underpinning the 'comply or explain' obligation under the Combined Code, especially since variants of that model have been adopted across Europe and are therefore implicated in the Commission's view that the financial crisis 'raises questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders'.[6]

2. Key features of the system of corporate governance in the UK

The extent to which activism and collaboration form part of the UK system of corporate governance can only be understood by reference to the basic characteristics of the system. Those characteristics set the context within which activism and collaboration can occur and both provide incentives and pose constraints in respect of activism and collaboration.

Ownership structure

The UK is generally described as a system of dispersed share ownership, implying that listed companies do not normally have a controlling shareholder or even an influential

4 See the final version at <http://www.frc.org.uk/corporate/investorgovernance.cfm> accessed 13 August 2010.

5 Commission (EC), 'Corporate Governance in Financial Institutions and Remuneration Policy' (Green Paper) COM 284 final, 2 June 2010.

6 Ibid 3.5.

'blockholder'.[7] From the perspective of monitoring and disciplining management, diversified ownership poses a 'collective action' problem in that no single shareholder has an incentive to engage since the process is costly and any benefits have to be shared with other investors. The high-level of institutional ownership[8] of the UK equity market may help to overcome the collective action problem in two ways: first it can be expected that large (and diversified) investors may be willing to incur the costs of engagement on the basis that it will generate 'positive externalities' by sending the right message to other companies: second, it might be expected that institutional shareholders may well engage in various forms of collective action to protect and advance their interests. However, the high level of foreign ownership (now over 40 per cent of the market[9]) potentially exacerbates the collective action problem, since even in the case of foreign investors who are inclined to engage as a matter of principle, there may be coordination problems (eg as regards the UK regulatory framework for intervention). Another relevant factor, albeit difficult to measure, is the presence of short-term shareholders on the share register of listed companies. Two developments in particular point to this as a significant factor. One is the substantial level of high-speed trading as a proportion of equity market turnover,[10] which indicates that shareholding is often transient. Another is the growth in stock-lending by institutional investors, which results in voting and other shareholder rights being transferred temporarily to the borrower.[11] The impact of these developments for activism and collaboration are, however, more difficult to judge since both may form part of the *modus operandi* of an institution that generally adopts an activist approach. Similarly, the impact of the growth in 'passive' funds is difficult to determine, since that mode of operation does not imply that the fund should be indifferent to governance or performance matters: on the contrary, it may well be argued that since a passive fund is tied into portfolio companies in a way that an 'active' fund is not, it should consider adopting an 'activist' stance in appropriate cases.[12]

Shareholders' rights

Shareholders' rights are an important determinant of the structure and process of corporate governance. They are particularly important for determining the key relationships between shareholders and others stakeholders (such as creditors) and between shareholders and the board of directors. In the UK, corporate governance tends to focus most on the latter relationship and, in that context, shareholders' rights can be

7 See generally M Becht, P Bolton and A Röell 'Corporate Governance and Control' (2002) ECGI Finance Working Paper No 02/2002 <http://ssrn.com/abstract_id=34346> accessed 13 August 2010.

8 See Office for National Statistics, 'Share Ownership Survey 2008', reporting that individual ownership of UK listed shares fell to 10.2 per cent at the end of 2008. As recently as 1994 that figure was above 20 per cent.

9 Ibid, reporting that investors from outside the UK owned 41.5 per cent of UK listed shares at the end of 2008.

10 Estimates vary but the Securities and Exchange Commission (SEC) recently put the figure at 60–70 per cent for the USA and 30–50 per cent for the EU: see SEC Market Access Release at <http://www.sec.gov/news/press/2010/2010-7.htm> accessed 13 August 2010.

11 See Investment Management Association (IMA), 'Survey of Fund Managers' Engagement with Companies For the Two Years Ended 30 June 2008' at 25–27 for more details on the practice of stock-lending.

12 Passive funds generally seek to replicate the performance of an index and therefore must invest in the constituent companies of the index or instruments that provide an equivalent economic interest.

broadly classified into four groups: decision-making rights; appointment and removal rights; shareholding rights and intervention rights.

As regards the first category, a characteristic of the UK system is the wide range of decisions that are reserved to the shareholders. They include (in the case of a listed company): the power to approve changes to the constitution;[13] decisions to issue shares[14] or disapply pre-emption rights;[15] the approval of certain transactions between directors or their associates and the company;[16] and the approval of 'Class 1' transactions under the listing rules.[17] The overall effect of these provisions is to limit the power of the board, which would otherwise be commensurately broader since the default provision in the standard articles grants the board all the powers of the company.[18]

The powers of shareholders with regard to the appointment and removal of directors are also significant in this context. While the formal legal rights are not particularly unusual in an international context, the power to remove[19] is simpler than in many other jurisdictions, since dismissal is possible through an ordinary resolution without having to show good cause.[20] The recent change in the Combined Code is also significant in this regard since it now recommends that all directors of FTSE 350 companies be subject to annual election by shareholders, thereby limiting the need to resort to removal.

Shareholding rights are evident in the UK system in particular with respect to equality of treatment of shareholders and pre-emption rights. While many systems would claim to treat shareholders equally, few implement the principle to quite the same extent as the UK. It is evident in particular in the practice whereby institutional investors generally insist that listed companies should not issue shares with enhanced voting rights. These shares are sometimes used in some other systems to concentrate control in a 'pyramid' structure, where control is exerted through voting rights that are proportionately higher than the economic interest of the investor. The stance of institutional investors in the UK means that such structures are largely absent from the UK listed sector and that voting power generally matches economic interest.[21] Pre-emption rights protect shareholders from the risk of dilution (both in voting and financial terms) arising in share issues to outside investors. While they are now applicable to public companies across the EU, they

13 Companies Act 2006, s 21. Although most systems of corporate law require such approval, some US states devolve power to directors to make changes to bye-laws, thereby altering the distribution of power as between shareholders and the board: see R Kraakman and others, *The Anatomy of Corporate Law, A Comparative and Functional Approach* (OUP, Oxford 2004) 138.

14 Companies Act 2006, s 549.

15 See below text at n 22.

16 Companies Act 2006, Part 10, Chapter 3. See also FSA Handbook: Listing Rules 11 'Related party transactions' <http://www.fsa.gov.uk> accessed 13 August 2010.

17 See FSA Handbook: Listing Rules 10.

18 See Art 3 of the Model Articles for Public Companies (Schedule 3) in The Companies (Model Articles) Regulations 2008 (SI 2008/3229).

19 Companies Act 2006, s 168.

20 See Kraakman and others (n 13) 37–8 for a summary of the position in other major jurisdictions.

21 So-called 'empty voting' is a separate problem linked with the use of derivatives that separate voting rights and economic interest: see H Hu and B Black, 'Empty Voting and Hidden Ownership: Taxonomy, Implications and Reform' (2006) ECGI Law Working Paper No 64/2006 <http://papers.ssrn.com/abstract=887183> accessed 13 August 2010.

have a particularly long history in the UK.[22] The importance attached to pre-emption rights is reflected in the strict requirements for disapplication (through the articles or by special resolution) and the limited scope for disapplication that is contained in the guidelines of the Pre-emption Group.[23]

Finally, intervention rights are important in providing a mechanism for shareholders to contest the view of the board on particular issues. While it has been argued (especially in the US context) that such contestation (and activism in its broader sense) may be damaging to companies,[24] the UK approach has generally facilitated intervention by shareholders. The rights of shareholders to call a general meeting[25] and to propose resolutions at an annual general meeting (AGM)[26] are long-standing features of British company law. In the former case, the EC Shareholders' Rights Directive[27] has strengthened the hand of shareholders by reducing the threshold for calling a meeting to 5 per cent. A similar approach is evident in two other changes introduced by that Directive: the right of members to add items to the AGM agenda other than through the process of proposing a resolution[28] and an obligation on companies to respond to questions posed by members at general meetings.[29] All these rights provide a formal and public route for shareholders to intervene and, while many shareholders will regard them more as a last resort rather than a matter of routine, they are important in providing a credible threat to back up private forms of engagement.

Collective corporate governance and collaboration

The dispersed nature of shareholding in UK listed companies means that collective action may often be the only solution to ensure effective monitoring and disciplining of companies. There are several ways in which such collective action can occur. In the UK, the development of self-regulatory standards by institutional investors has been a particularly important form of collective action. The Combined Code of Corporate Governance, the Pre-emption Guidelines, the Association of British Insurers (ABI) Remuneration Guidelines and, most recently, the Stewardship Code were all developed as forms of collective standard setting by institutional investors. They differ both from statutory governance provisions and those found in the articles of companies by reference to their flexibility and their arrangements for monitoring and compliance. In principle, their flexibility is derived from the fact that none have a formal legal status: compliance is

22 See generally I MacNeil, 'Shareholders Pre-Emptive Rights' (2002) JBL 78–100.

23 See PL Davies, *Gower and Davies Principles of Modern Company Law* (8th edn Thomson Sweet & Maxwell, London 2008) 835–45. The Pre-Emption Group was set up in 2005 to produce a Statement of Principles to be taken into account when considering the case for disapplying pre-emption rights. Its members comprise listed companies, investors and intermediaries.

24 SM Bainbridge, 'Shareholder Activism and Institutional Investors' UCLA Law & Economics Research Paper No 05-20 <http://ssrn.com/abstract=796227> accessed 13 August 2010.

25 Companies Act 2006, s 303.

26 Ibid s 338.

27 Council Directive (EC) 2007/36 as implemented in the UK by the Companies (Shareholders' Rights) Regulations 2009 (SI 2009/1632).

28 See Companies Act 2006, s 338A, effective from 3 August 2009.

29 See Companies Act 2006, s 319A and ICSA, 'Guidance on the Implementation of the Shareholder Rights Directive' at 3.5.

thus entirely a matter between shareholders and the company and there is scope to permit non-compliance in appropriate cases.

However, that form of collective action can only work when a standard solution can be set for all companies (albeit that it can be applied in a flexible manner). The inference in all these cases is that both a potential problem and its solution can be identified and resolved *ex ante*. However, while that approach may be capable of dealing with common problems in corporate governance it cannot deal with cases where a specific form of engagement or intervention is required. In those instances, the collective action can be termed 'collaboration', meaning that shareholders form a coalition to intervene in a manner that is not addressed by the forms of collective action just mentioned. In that sense, 'collaboration' is much more of an *ad hoc* process and one that operates outside the established framework that supports each of the Codes or Guidelines above. Over time, it may well be that issues move from collaboration to collective action as it becomes clear that standard solutions are available: the gradual development of the Combined Code, for example, would appear to correspond to that pattern. In the case of the Stewardship Code, however, the standardization is quite limited since the Code is more focused on disclosure than the process for activism and collaboration. In that sense, the potential for the Code to change the practice of engagement may appear quite limited. However, the more difficult issue to determine is how far disclosure of engagement will stimulate demand from clients for a more activist stance on the part of institutional investors.

3. Shareholder activism

Meaning and objectives

Although the term 'shareholder activism' is often used in a manner that presumes a shared understanding of the context, objectives and techniques of activism, it is probably better to regard activism as something that can placed on an axis between two quite different approaches. The model of activism envisaged by the Stewardship Code (and its predecessor the ISC Statement) is one in which long-term investors engage with portfolio companies with a view to improving long-term returns to shareholders. Implicit in this model is the understanding that long-term institutional investors will often be required to hold diversified portfolios and therefore will be constrained as to the use of the 'exit' option should problems emerge.[30] In those circumstances, activism provides a form of intervention to address performance or governance issues either through initiatives undertaken 'behind the scenes' or in a more public challenge to the board. An alternative approach to activism, adopted in particular by hedge funds, is to make an investment in an undervalued company on the basis that intervention may result in changes which lead to a rise in the share price. These two approaches have been labelled, respectively,

30 This constraint is particularly to the fore in the case of passive/indexed funds.

'defensive' and 'offensive' activism:[31] the former because it seeks to defend the value of an existing position and the latter because the investment is made explicitly on the basis that intervention will follow.[32] While the difference in approach and the techniques employed may be fundamental, the objective in each case is the same, namely, an improvement in the returns to shareholders. Moreover, the nature of shareholding and the traditional insistence of UK institutional investors on simple shareholding structures in UK listed companies means that the benefits of activism (if any) will be shared among all shareholders. That remains true irrespective of who participates in activist initiatives and irrespective of the techniques that are used. However, it does not in itself imply that all forms of activism are positive in their effect: that is a more difficult question that may prompt different legal and regulatory approaches to the facilitation of activism in different national systems of corporate governance.

Legal and regulatory obligations underlying activism

The introduction to the Stewardship Code recognizes that activism is a strategy that should be considered by institutional investors in order to discharge their fiduciary obligations to end-beneficiaries. That approach prompts two questions. First, do fiduciary obligations arise in all institutional investment contexts? And second, to what extent do legal and regulatory duties require activism to be considered or undertaken?

As regards the first issue, the Code (sensibly) avoids the issue of to whom and in what circumstances fiduciary duties are owed to investors. However, in so doing it may have the effect of extending the strict fiduciary framework beyond the circumstances in which it would apply according to a strict interpretation of the law. For example, in the case of 'with-profits' funds operated by life assurance companies, the relationship with the policyholder is contractual rather than fiduciary. That analysis reflects the contractual nature of the claim inherent in the life assurance policy and the outright ownership of the fund assets by the assurance company.[33] The implications for investment management are that, absent the agreement of fiduciary-type obligations between the parties, the approach to activism is entirely in the hands of the life fund rather than a matter that is subject to fiduciary duty. While there may be many circumstances in which an institutional investor such as a life fund would act in the same way irrespective of the presence of legal duties or their nature (as between contractual and fiduciary), it must logically be the case that fiduciary duties will also prompt different behaviour in some circumstances: if that were not the case, they would be of little value as an investor-protection mechanism. Thus, while the question of who owes fiduciary duties

31 J Armour and B Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' (2009) ECGI – Law Working Paper No 136/2009 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1489336> accessed 13 August 2010.

32 This categorization relates to the stage at which a shareholding is acquired and not to the techniques or duration of the intervention. Hedge funds, for example, (contrary to popular belief) do not generally adopt a confrontational approach with the boards of targets, nor are they particularly short term in their approach: see A Brav and others, 'Hedge Fund Activism, Corporate Governance and Firm Performance' (2008) 64 J Fin 1729–55.

33 The position remains the same in a mutual life company except that the policyholder is also a member of the company and has a separate set of rights as a member. But even membership rights in a mutual life assurance company do not directly give rise to fiduciary duties since company directors owe fiduciary duties to the company and not directly to members.

does matter, the issue of whether the Code seeks to extend the legal regime cannot be definitively answered. The better view is probably that it does not and that it is more appropriately viewed as an articulation of existing fiduciary duties.

As regards the second question, the Code can be viewed as providing some clarification and expansion of the rather sparse legal framework that surrounds activism. The focus of the law is on ensuring that a fiduciary exercises discretion[34] in the interests of his constituent rather than on mandating that activism be undertaken in particular circumstances. The Code recognizes the importance of the outcomes of activism for the formulation of an institution's guidelines on intervention under Principle 4. In that sense, the issue of the potential benefits that can be derived from activism is a central issue and one on which investors should have regard to evidence that extends beyond their own immediate experience: to that end, some recent empirical evidence is assessed in the following section.

Intervention: nature and process

Both observation and measurement of shareholder activism is complicated by the fact that much of it takes place behind closed doors and that in many instances a public initiative is the outcome of a failed private dialogue between a company and shareholders.[35] Public initiatives may be informal in that they may do no more than publicly contest the management's view of a particular issue. That represents an important and potentially powerful form of intervention at key points in a company's development, such as at the time of a strategic acquisition.[36] However, public intervention with a longer-term objective or a broader focus, such as a change in strategy, is likely to take the form of a shareholder-sponsored resolution. As already noted, such resolutions are binding in the UK. While they are rare in the case of large listed companies, empirical studies agree that poorly performing companies are most likely to be the target of such resolutions.[37] Moreover, it is not surprising that the relative ease with which directors can be removed in the UK results in resolutions with that objective being the most common form of public intervention. Changes to the board of directors represent the most direct route to a change in strategy and while bidders (in a full takeover) and providers of new finance are most likely to promote board change,[38]

34 Discretion has been described as the *conditio sine qua non* of fiduciary relationships—see L Van Setten, *The Law of Institutional Investment Management* (OUP, Oxford 2009) para 3.64.

35 See IMA (n 11) 19; and J McCahery, Z Sautner and L Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' (2009) ECGI Finance Working Paper No 235/2009 <http://ssrn.com/abstract_id=1331390> accessed 13 August 2010.

36 The proposed acquisition by Prudential acquisition of AIA provides several examples of public intervention by shareholders during the past year: see eg *Financial Times* of 21 June 2010 'Investors Sharpen Knives for Pru Chiefs'.

37 See, as regards the UK, B Buchanan, J Netter and T Yang, 'Proxy Rules and Proxy Practices: An Empirical Study of US and UK Shareholder Proposals' (2009) <http://ssrn.com/abstract=1474062> accessed 13 August 2010; and as regards the USA, S Gillan and L Starks, 'The Evolution of Shareholder Activism in the United States' <http://ssrn.com/abstract=959670> accessed 13 August 2010.

38 J Franks, C Mayer and L Renneboog, 'Who Disciplines Management in Poorly Performing Companies?' 10 J Fin Intermed (2001) 209–48.

there is also a significant role undertaken by activist investors, especially in smaller companies.[39]

The rise of activist hedge funds in recent years has introduced an important new dynamic to activism that was largely absent in the previous two decades. That development has been attributed to a range of factors: on the supply side, the fall in share prices following the dot.com boom meant that many companies were trading at prices below measures of 'fair value' and once-conservative fund managers adopted a more active stance that lent support to hedge fund initiatives; while, on the demand side, relaxation of hedge fund regulation facilitated the growth of hedge funds and reform of Securities and Exchange Commission (SEC) rules governing communications between shareholders facilitated dialogue between activists, enabling them to go public with their campaigns.[40] While hedge fund activism has attracted considerable public criticism, suggesting that it is confrontational, short-term and damaging to other stakeholders, the (limited) empirical evidence does not support that analysis. A recent study,[41] covering hedge fund activism in the USA during the period 2001–2006 found that in most cases (around two-thirds) interventions by hedge funds were not hostile and relied on cooperation from the incumbent board to implement their value-improving agenda. Moreover, both the actual holding periods for investments by hedge funds and the predicted durations conditional on stated objectives indicated that hedge fund activism could not generally be viewed as short term in its nature. Moreover, there was no evidence that the value generated by hedge fund activism represented an appropriation of value from creditors, although there was evidence that it had a significant effect in curtailing executive pay, enhancing pay-for-performance and removing chief executive officers. The authors concluded that 'hedge fund activism can be viewed as a new middle ground between internal monitoring by large shareholders and external monitoring by corporate raiders'.[42]

Alternative channels for contesting the view of the incumbent board on specific issues may also be relevant for understanding the nature of activism. For example, the mandatory resolution on the directors' remuneration report[43] provides an opportunity for investors to express dissatisfaction over remuneration policy. Recent experience has been that investors are increasingly willing either to withhold their vote or vote against the remuneration report.[44] While that does not have a direct effect on the remuneration paid, it has been shown to have an important restraining effect on remuneration design

39 See Table 6, Panel B in Buchanan and others (n 37) for details of the characteristics of UK companies in receipt of shareholder-sponsored resolutions.

40 Armour and Cheffins (n 31).

41 Brav and others (n 32).

42 Ibid 1773.

43 Under the Companies Act 2006, s 420.

44 See the ABI/IVIS Review (2009) at <http://www.abi.org.uk/Media/Releases/2010/04/IVIS_Review_2009_.aspx> accessed 13 August 2010; and KM Sheehan, 'Is the Outrage Constraint an Effective Constraint on Executive Remuneration? Evidence from the UK and Preliminary Results from Australia' (2007) <http://ssrn.com/abstract=974965> accessed 13 August 2010.

even if not on quantum.[45] Moreover, although voting against board-sponsored resolutions on other issues remains rare, there have been recent instances indicating a more robust approach among investors.[46] In that sense, shareholder-sponsored resolutions should not be viewed in isolation but as part of the broader public interaction between companies and shareholders that is represented by the voting process.

Constraints on activism

Although activism offers considerable potential to improve long-term value, it is widely recognized that there are both practical and legal constraints on the extent to which an activist stance can be adopted. The practical constraints relate primarily to cost. In a system of dispersed shareholding such as the UK, activism typically involves substantial cost relative to the size of shareholding and since the benefits (if any) of activism will be shared with all shareholders, there is a classic 'free rider' problem. The extent to which that represents a constraint will vary as between different types of investor, and some may be more prepared than others to incur the cost of intervention in the expectation that it will generate 'positive externalities' by sending a message to other companies and thus act as a disciplinary mechanism that has the potential to improve portfolio value and not just firm value. Conflicts of interest between investment managers and portfolio companies have also been regarded as a potential constraint.[47] Such conflicts can arise especially when the investment manager is a subsidiary of a bank or other financial institution which has a client relationship with the portfolio company that might be threatened by activism. The Stewardship Code deals with the issue by requiring that institutional investors should have a robust policy on managing conflicts of interest and that this policy should be publicly disclosed (Principle 2). Finally, diversification requirements may be a barrier to the acquisition of a shareholding sufficiently large to justify activism from a cost or relative-power (eg to call a general meeting) perspective—less so for hedge funds.

The market-abuse regime under FSMA 2000 has often been viewed as the main legal constraint on activism.[48] While the primary objective of the regime is to promote market integrity, it may have the effect of limiting activism by constraining the ability of an investor to deal in shares if the investor can be considered to have become an 'insider' as a result of an intervention. In that sense, activism may have the (unintended) effect of eliminating the choice between 'voice and exit', at least for the duration of the intervention. However, the Financial Services Authority's (FSA) recent clarification of the

45 See Sheehan ibid, observing (on the basis of an empirical study) that 'outrage' among shareholders prompted changes to contract terms; performance criteria for long-term incentive plans and 're-tests' for such plans.

46 See the IVIS Review (2009) at 6.0, referring to five instances in 2009 in which five resolutions that had been 'red-topped' by the ABI were not passed and two further 'amber-topped' resolutions that failed to secure shareholder approval.

47 B Black and J Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1997) 92 MLR 1999–2086 at 2055.

48 F Curtiss, I Levine and J Browning, 'The Institutional Investor's Role in "Responsible Ownership"' in I MacNeil and J O'Brien (eds) *The Future of Financial Regulation* (Hart, Oxford 2010) at 309.

relevance of the market-abuse regime to shareholder engagement both casts doubt over the extent to which the market-abuse regime has operated as a constraint in the past and limits the extent to which it may do so in the future.[49] On the first issue, the FSA noted that 'the firms that we have met do not consider that the market abuse regime is an impediment to their activist strategies'. On the second point, the FSA made clear that a firm would not be committing market abuse if it carried out trading on the basis of its own intentions or knowledge of its own strategy.[50] Thus, buying shares in a company as a platform for intervention or re-structuring does not in itself represent market abuse.[51]

Finally, the Stewardship Code itself (Principle 4) constrains activism of the public type by creating a ladder according to which intervention should be escalated. According to that ladder, the first stage of intervention should be discussion with the company on a confidential basis. If that process is not successful, there remain another four options that should be explored before the matter becomes public. They are:

- holding additional meetings with management specifically to discuss concerns;
- expressing concerns through the company's advisers;
- meeting with the Chairman, senior independent director or with all independent directors; and
- intervening jointly with other institutions on particular issues.

Since this ladder for escalation formed part of the Stewardship Code in its former existence as the Institutional Shareholders Committee Code (which itself attempted to capture existing best practice), it seems clear that public intervention is the exception rather than the norm[52] and that conclusions based on the potential value of such intervention cannot claim to represent the value of intervention as a whole.[53] However, since public interventions by definition represent the most serious forms of disagreement between shareholders and boards of portfolio companies, they do merit special attention in terms of their characteristics and outcomes, especially from the perspective of determining whether an 'investor protection' response is appropriate to resolve a 'systemic' problem that is commonly encountered in such interventions.

Outcomes

The Stewardship Code's approach to activism is premised on its potential to improve long-term returns to shareholders and to discharge fiduciary obligations to the ultimate investors. Thus, it is important to consider the outcome of intervention in terms of its capacity to improve operating performance or to generate governance changes which

49 See the letter from the FSA to the Chairman of the Institutional Shareholders Committee dated 19 August 2009 at <http://www.fsa.gov.uk/pubs/other/shareholder_engagement.pdf> accessed 13 August 2010.

50 This repeated a clarification that had already been given by the FSA in issue 20 of *Market Watch* in May 2007.

51 The FSA did, however, stress that the circumstances would be different if one party dealt on the basis of the intentions of another party's intentions or strategy or if several parties colluded to avoid making market disclosures that would be triggered were the shares to be acquired by a single entity.

52 Buchanan and others (n 37) 36.

53 It may also explain why some empirical studies have found that investors are more willing to engage in activism than is typically assumed: see eg McCahery and others (n 35) finding (in a study of investors in companies in the USA and The Netherlands) that 55 per cent of the investors in their survey would engage in discussions with the board of portfolio companies.

offer the potential to improve operating performance in the long term. While there are now a large number of empirical studies[54] that focus on public intervention, there is no clear evidence that it has observable benefits for target companies. For example, in a review of some early studies covering activism targeted at US companies in the 1980s and the early part of the 1990s, Karpoff found that: in most cases, the abnormal stock return[55] was negative; there were insignificant changes in earnings during a 2-year window surrounding the intervention and that there was only modest success in securing specific governance changes.[56] A more recent study comparing the UK and the USA found that, while shareholder-sponsored proposals had a positive effect on targeted companies in the USA, both in terms of operating performance and share price, the opposite was the case in the UK.[57] The authors express some surprise at that outcome given the greater power available to shareholders in the UK to make changes to the management team but rationalize it on the basis that 'a shareholder proposal is a governing device of last resort, used only when firms are in dire situation and other mechanisms have failed (such as private negotiation)'.[58] Another recent study found that shareholder proposals have a negative effect on the share price when they are voted on at the general meeting.[59] Once again the authors rationalize the outcome by reference to the signal that a shareholder-sponsored resolution provides to the market, concluding that 'This [the fall in the share price] implies that rather than attribute proposals meaningful control benefits, the market often interprets the shareholder vote as a negative signal of governance concerns'.[60]

A more positive outcome is reported in a recent study of the Hermes UK Focus Fund.[61] That study, based on data that is not in the public domain, focused on the use of private intervention as a means to enhance value and found that intervention was successful in a high proportion of cases and accounted for a large proportion of the significant outperformance of the fund relative to a variety of benchmarks. Thus, on the assumption that private interventions account for most instances of activism, it may be better to regard that study as a better guide to the potential benefits of intervention than the studies (above) of shareholder-sponsored resolutions.[62] Further support for the

54 Since most of the studies are based on samples of companies drawn from the USA, care is required in extending the conclusions to the UK, since, as alluded to in Part 1, the system of corporate governance in the UK differs in several significant ways from the USA.

55 That is the return in excess of the 'normal' return from an appropriate benchmark.

56 JM Karpoff, 'The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings' <http://ssrn.com/abstract=885365> accessed 13 August 2010.

57 Buchanan and others (n 37).

58 Ibid 36.

59 P Cziraki, L Renneboog and PG Szilagyi, 'Shareholder Activism through Proxy Proposals: The European Perspective' <http://ssrn.com/abstract=1413125> accessed 13 August 2010.

60 Ibid 33.

61 M Becht and others, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2009) 22 Rev Fin Stud 3093–129.

62 Although the structure and mode of operation of that fund is unusual, the activist techniques employed are, in principle, open to any investor. However, not all investors would be able to employ the techniques in the same way as a result *inter alia* of limitations on the stake they might be able to acquire in the target.

potential benefits of activism is provided by a study of hedge fund activism in the USA:[63] it found that activism generated significant abnormal returns in a (−20-, +20-day) window surrounding filing of a Schedule D,[64] that returns were higher in the case of hostile interventions and that the returns could be attributed to activism rather than simply the identification of undervalued targets whose price rose on disclosure of a substantial hedge fund holding.

Thus, the absence of wide-ranging evidence supporting the case for intervention in the UK context should not in itself be viewed as establishing some kind of presumption against intervention. It seems clear that the potential benefits of intervention in appropriate cases have been demonstrated and therefore the focus should be on identifying appropriate cases, specific objectives and techniques for intervention.

4. Collaboration among shareholders

Objectives

In a system of dispersed shareholding such as the UK, collaboration among shareholders can create a coalition that is able to exercise influence over the incumbent board. As a technique for resolving the agency problem in corporate governance and exercising effective discipline over management, it offers a functional equivalent to blockholding, which has emerged as the more common solution to that problem worldwide.[65] The degree of influence that can be exerted by a coalition is linked with the intervention options that are open to shareholders at critical levels of ownership (such as calling a general meeting at the 5-per cent ownership level[66]) since the threat posed by a coalition that has sufficient votes to trigger those measures will often be sufficient to secure the cooperation of the incumbent board. Reflecting past practice,[67] the Stewardship Code envisages that 'collaborative engagement may be most appropriate at times of significant corporate or wider economic stress, or when the risks posed threaten the ability of the company to continue'.[68] Collaboration is clearly viewed as appropriate only in a subset of circumstances in which intervention is appropriate since Principle 4 leaves (individual) institutional investors to formulate their own policy on intervention, including the circumstances in which it is appropriate. The preference for individual over collective intervention is clearly evident in the ladder for escalation provided in the guidance to Principle 4, in which joint intervention is the fourth step after three stages of individual

63 Brav and others (n 32).

64 Under s 13(d) of the 1934 Securities Exchange Act, investors who acquire more than a 5 per cent holding in any class of security of a publicly traded company must register their interest with the SEC within 10 days if they have an interest in influencing the management of the company. Passive institutional investors are required to file a Schedule 13G. The boundary between the two remains a matter of some controversy, especially in cases of so-called 'wolf-packs' who become follow-on investors once a Schedule 13D has been registered.

65 Becht and others (n 7).

66 Under s 303 of the Companies Act 2006.

67 See eg the interview-based study of British institutional investment in Black and Coffee (n 47) 31: 'What types of issues trigger the formation of a coalition? Most interviewees responded that it usually took a financial crisis, including a sharp decline in share price . . . '.

68 Stewardship Code, Principle 5, Guidance.

dialogue with the company. That preference for individual over joint action also reflects a long-standing tradition of equality of treatment for shareholders and strong minority rights, both of which can be viewed as antidotes to the threat of excessive influence being wielded by blockholders and the risk of value-decreasing behaviour associated with that influence.[69] There is ultimately a trade-off that has to be made between the potential benefits that may arise from blockholder influence as a disciplinary mechanism and the risks that may arise from undue influence and value-decreasing behaviour: and while most systems of corporate governance prioritize the former (as evidenced by a legal and institutional framework that supports blockholding), the UK has placed relatively greater emphasis on the latter in its legal and institutional framework.[70]

Moreover, it seems likely that the growth of hedge funds and private equity during the past decade have been influential in causing a re-evaluation by traditional institutional investors of the value of collaborative action. As mentioned earlier, hedge funds have often adopted an activist stance, both individually and collectively, and have captured the benefits of activism in a way that traditional institutional investors generally have not. At the other end of the spectrum of activism, private equity firms have captured the benefits of activism through taking control of targets and making governance changes that have the capacity to improve performance in the long term. Viewed from that broad perspective, it is probably not an overstatement to say that hedge funds and private equity firms (the so-called 'alternative' fund managers) have displaced traditional institutional investors as drivers of activism and the development of firm-level corporate governance. While the institutional structure of the UK equity market is still largely in the hands of traditional institutional investors, its relevance has declined as the asset classes controlled by alternative fund managers have expanded rapidly and they have pursued corporate governance strategies that are quite different from their traditional counterparts. From that perspective, the recent regulatory developments can be viewed as recognition of the need for traditional institutional investors to capture some of the returns from activism that have been left to the alternative fund managers. It may also indicate that those returns may well have peaked as activism through collaboration becomes more common and the market moves to discount a greater likelihood of successful intervention on a routine basis.

Constraints on collaboration

It is hardly a surprise to find that a system such as the UK which implicitly distrusts the exercise of blockholder influence does not facilitate the creation of functional equivalents in the form of coalitions of shareholders. The Stewardship Code is only the latest evidence of that long-standing approach. The provisions of the 'Takeover Code' and the

69 Such value-decreasing behaviour can be in the form of expropriation of private benefits or collusion with management at the expense of minority shareholders: see Becht and others (n 7) 5.2.

70 The same conclusion tends to be made in respect of the USA, but care should be taken in characterizing the US system as one of dispersed ownership: see A Pichhadze, 'The Nature of Corporate Ownership in the USA: The Trend Towards the Market Oriented Blockholder Model' (2010) 5 CMLJ 63–88.

requirements for public disclosure of (voting) shares have a much longer history as constraints on shareholder collaboration.[71] In both cases, the concept of 'acting in concert' has been the key constraint on collaboration between shareholders. In the case of the Takeover Code, the risk posed through 'acting in concert' is that it may give rise to the requirement to make a mandatory bid[72] for the target company. That is a serious constraint in the sense that the relevant investors would face a choice between making a bid for a company or (more likely) placing themselves in breach of the Takeover Code.[73] In the case of public disclosure of voting shares, the requirement to aggregate holdings in the case of shareholders who are 'acting in concert' limits the capacity of coalitions to exercise influence covertly. Covert influence may be favoured because it may permit the shareholders who intervene to capture more of the benefits of intervention. Since it is well known that the disclosure of a shareholding by activist investors can itself prompt a rise in the share price,[74] the level at which disclosure obligations are set can be an important determinant of the distribution of the benefits of intervention.

Recent developments, however, indicate some movement away from the traditional distrust of collaboration and covert influence. The (limited) validation of collaboration in the Stewardship Code is one step in that direction. Two others steps have more direct implications. The first is the Takeover Panel's clarification of the concept of 'acting in concert'.[75] While the clarification does provide some guidance as to how the Panel will approach the determination of whether a 'concert party' exists, the core of its approach has been part of the Code since 2002, when changes were made with the specific aim of assisting normal shareholder activism. The effect of those changes and the recent clarification has been to considerably narrow the circumstances in which collaboration between activist shareholders will trigger a mandatory offer. In particular, since a 'concert party' can only exist if *inter alia* the relevant shareholders requisition a general meeting to consider a 'board control-seeking' resolution or threaten to do so, it follows that the concept of a concert party cannot normally be relevant to private engagement with the company nor to agreements between the shareholders to vote in the same way on a particular resolution at a general meeting.

The second development is the FSA clarification relating to ownership disclosure and changes in control in authorized financial institutions.[76] The essence of the FSA's clarification is to limit the need to aggregate the voting power of shareholders to circumstances in which there is an agreement obliging them to adopt a lasting common

71 Curtiss and others (n 48).

72 Under Rule 9 of the Takeover Code.

73 In many cases an institutional investor would not have the financial resources to make a bid and even if it did would likely place itself in breach of its investment mandate and FSA regulatory obligations.

74 See eg Brav and others (n 32).

75 See Takeover Panel Practice Statement 26. As the Panel notes in that Statement (at 1.7) 'The current provisions of the Code regarding collective shareholder action were introduced into the Code following consultation in 2002, with the specific aim of assisting normal shareholder action'.

76 See FSA letter to the IMA Chairman (n 49).

policy towards the management of the issuer through the exercise of their voting rights.[77] However, to understand why a relaxation of ownership-disclosure requirements promotes shareholder collaboration requires reference to co-ordination problems and preferences for covert ownership and action, since ownership disclosure is more commonly associated with the potential to enhance collaboration by revealing the identities of potential collaborators.[78] Co-ordination problems arise from the need to ensure that timely reporting of changes to the aggregated holding of the concert party will be possible, encompassing different funds within each group that form part of the aggregation. That may involve significant time and cost. Preferences for covert ownership and action can be explained by reference to circumstances in which a coalition engages in activism that falls short of seeking control: in those circumstances, it is likely that more of the benefits of activism can be captured through covert action by the coalition since, as already mentioned, disclosure of activist shareholdings may lead to a rise in the share price. Thus, although it may to some extent appear perverse, it seems clear that relaxation of the 'concert party' rules relating to ownership disclosure (and authorization in the case of financial institutions) does have the capacity to facilitate collaboration between shareholders.

Coalition formation

The collective action problem associated with the creation of a coalition depends on its objectives. A coalition that aims simply to engage with the board and to exercise influence might comprise just two or three significant shareholders, whereas a coalition that seeks to pass a resolution at a meeting (eg to remove a director) will generally require a larger number of participants.[79] Moreover, since the relative voting power of large shareholders declines as voting engagement increases (as it has done in the UK in recent years[80]), it becomes more difficult to assemble any form of coalition in those circumstances.

The practical difficulty of assembling a coalition, combined with the regulatory constraints and preference for private action mean that public information about coalitions is relatively sparse. Research into the practices of British institutional investors in the 1990s found that coalitions were formed only in crisis situations.[81] That impression was confirmed by two subsequent studies.[82] While both the regulatory approach and attitudes towards activism and collaboration have changed since then, there remains relatively little evidence of coalition formation, although more recent research suggests

77 While the FSA does not use the term, such agreements are more commonly referred to as 'shareholders' agreements' in other contexts.

78 See generally, M Schouten, 'The Case for Mandatory Ownership Disclosure' <http://ssrn.com/abstract=1327114> accessed 13 August 2010.

79 See M Goergen and L Renneboog 'Strong Managers and Passive Institutional Investors in the UK' in F Barca and M Becht (eds) *The Corporate Control of Europe* (OUP, Oxford 2001), finding that on average a coalition of eight shareholders would be required to secure the majority vote required to pass an ordinary resolution.

80 'Shareholders Making Greater Use of Their Voting Rights' *The Financial Times* (15 November 2006).

81 Black and Coffee (n 47).

82 Franks and others (n 38); R Crespi-Cladera and L Reneboog (2000) 'United We Stand: Corporate Monitoring by Shareholder Coalitions in the UK' <http://ssrn.com/abstract=276656> accessed 13 August 2010, finding little evidence of coalitions. Both studies found that the most effective coalitions were typically formed by directors as a response to the threat of removal.

that collaboration may have increased. A recent study comparing shareholder-sponsored resolutions in the UK found that 42 per cent of proposals were sponsored by institutional investors and that the median shareholding of the sponsor was 10.1 per cent:[83] thus, it seems fair to conclude that sponsors of such resolutions would engage in some form of collaboration to ensure that their proposal was likely to secure a majority vote. Nevertheless, since these resolutions are aimed primarily at relatively small companies, the broader picture as regards coalitions formed to engage with larger companies remains obscure. A recent survey of investors in companies in the USA and The Netherlands found that a majority of investors (59 per cent) were willing to consider collaboration,[84] but it remains unclear how far that is translated into action and the extent to which it is relevant to the UK context.

5. The Stewardship Code in operation

Scope of the Code

The Code is addressed in the first instance to fund managers, who will in due course become subject to an FSA 'comply or explain' disclosure requirement in a similar manner to that already applicable to the Combined Code. However, the FRC guidance on the implementation of the Code 'encourages all institutional investors to report if and how they have applied the Code, on the same basis as asset managers'.[85] The guidance also notes that a statement regarding application of the Code should form part of the Statement of Investment Principles of pension funds.[86] Proxy voting agencies are not expressly within the scope of the Code but are brought within its ambit in two ways: first, under Principle 1, institutional investors should disclose how they use such services; and second, the FRC guidance encourages proxy voting and other advisory agents to disclose how they have applied aspects of the Code that are relevant to their activities. Overseas investors are not within the scope of the Code but the FRC hopes that they will commit to the Code even if, in practice, UK-based investors take the lead in engagement.

Compliance

Like its predecessor, the Code applies to institutional investors on a 'comply or explain' basis. In reporting terms this entails providing a statement on the institution's website that contains:

- a description of how the principles of the Code have been applied;
- disclosure of the specific information listed under Principles 1, 5, 6 and 7; or
- an explanation if these elements of the Code have not been complied with.

As with the Combined Code, that approach is intended to permit flexibility, so that institutional investors subject to the Code can, in appropriate circumstances, choose not

83 Buchanan and others (n 37) Table 5.
84 McCahery and others (n 35).
85 FRC, 'Implementation of the UK Stewardship Code' <http://www.frc.org.uk> at para 21, accessed 13 August 2010.
86 Ibid para 23.

to comply and explain why. Underlying that approach in the context of the Combined Code are a number of assumptions: that there are objective standards against which compliance can be assessed; that 'comply or explain' is underpinned by a legal obligation to disclose which option has been chosen and in the latter case to provide an explanation and that a liquid market in the shares of issuers subject to the Combined Code provides investors with a disciplinary mechanism that is readily accessible. The Stewardship Code, by contrast, faces the difficulty that these characteristics are not replicated within its framework.[87] As regards the standards against which compliance will be assessed, it is notable that the Stewardship Code leaves it to institutional investors to determine their own policy on stewardship responsibilities (Principle 1), conflicts of interest (Principle 2), intervention (Principle 4), collective action (Principle 5) and voting (Principle 6). This stands in contrast to the Combined Code which sets objective standards for matters such as the structure and composition of the Board and thereby sets a common framework against which 'comply or explain' operates. The credibility of a 'comply or explain' obligation set against self-selected standards is therefore open to question.[88] Second, the limited nature of the legal obligation for disclosing whether a firm subject to the Code has 'complied or explained' potentially undermines the scope of application of the Code and its status as an industry-wide standard. While the FSA can set such a requirement for fund managers acting under existing powers, it would not apply directly to pension funds, overseas investors or agents employed by institutional investors. Third, the nature and duration of fund management mandates does not lend itself easily to disciplinary action by underlying investors who are dissatisfied either with the fact of non-compliance or the quality of explanations. It is difficult to see what form of disciplinary action is open to underlying investors: they certainly cannot 'exit' fund management contracts in the way that they can sell shares and so 'comply or explain' in the Stewardship Code context would not carry the same threat as in the Combined Code context. Of course, it might be argued that stewardship or governance issues would always be trumped in either context by good performance (operational for the Combined Code and portfolio for the Stewardship Code) and there is some evidence to support that view:[89] however, that approach understates the need for a credible threat against the (inevitably) larger cohort of average or underperforming companies or institutional investors. Given these difficulties, it may well be that the clients of institutional investors subject to the Code will take the view that the outcomes of activism and collaboration are more important than the process. While the outcomes of such initiatives are difficult to observe, they are captured (along with other characteristics such as fund management style and stock-picking ability) in the alpha of a fund, which measures the extent to which

87 Differences between Combined Code and Stewardship Code compliance were one of the main points made by the IMA in its response to the FRC consultation on the Stewardship Code.

88 See 'Investors Raise Fears on Stewardship Code' *The Financial Times* (15 April 2010), highlighting the fear that the Stewardship Code will become a mere compliance exercise.

89 See I MacNeil and X Li, 'Comply or Explain: Market Discipline and Non-Compliance with the Combined Code' (2006) 14 CG 486–96.

return in a fund can be attributed to factors other than market movements (such as stock selection, market timing and activism).[90] While it would be wrong to suggest that alpha can operate as a functional substitute for the Stewardship Code in facilitating activism and collaboration, it is probably correct to conclude that it represents the best (or at least the most accessible) measure of outcomes, which is ultimately the best way to assess the appropriateness and benefits of activism and collaboration.

Independent verification of engagement and voting processes

The forerunner to the Code contained a recommendation that institutional investors signing up to the Code should consider obtaining an independent audit opinion on their engagement and voting processes and that this assurance should be publicly disclosed. That form of reporting to clients already takes place in connection with voting and therefore the issue at this stage is whether it should be extended to cover the process of engagement with portfolio companies (and to require it for voting if not already in place). Responses to the FRC consultation on the Stewardship Code attracted differing views on the issue. The ABI and Investment Management Association (IMA) were broadly in favour of assurance being applied to the process of engagement but not outcomes, whereas the AIC[91] opposed verification on the basis that verification could not capture outcomes and would therefore 'reduce engagement practices to a box-ticking exercise'. The final version of the Code retained the original ISC recommendation. However, since the recommendation is simply in the form that institutional investors should consider independent verification, there seems to be no substantial barrier to explaining that verification has been considered but rejected.

Monitoring and review

Both in origin and development, the Code has been an industry-sponsored initiative. The original statement on 'The Responsibilities of Institutional Shareholders in the UK' was published by the ISC in 1991. Following the recommendations of the Myners Report in 2001 on incorporating shareholders' activism into fund-management mandates, the ISC developed best-practice guidance for the investment industry by way of its 2002 Statement of Principles on the responsibilities of institutional shareholders and their agents in respect of investee companies. The statement was reviewed and reissued in 2004 and 2007 and was published in the form of a Code in November 2009. The IMA has undertaken monitoring of adherence to the Code since 2003.[92] However, as noted by the IMA in its submission to the FRC consultation, 'The FSA's and FRC's involvement brings the Code out of the realm of voluntary industry guidance into the regulatory framework'. That development, viewed in the context of the history of the Code, inevitably creates some tension as to who should assume responsibility for monitoring of public reporting associated with the Code and review of the content of the Code. Responses from the

90 For more detail, see J Rutterford, *An Introduction to Stock Exchange Investment* 3rd ed (Palgrave 2007) 435.

91 Association of Investment Companies.

92 See the IMA Survey (n 11), covering institutional investors accounting for 68 per cent of funds invested in UK equities.

industry bodies indicated a preference for retaining the role of the IMA in monitoring adherence to the Code. While the transfer of the Code to the FRC in itself implies a significant role for it in the review process, the ABI argued that this should be an oversight role, with the ISC remaining responsible for the content and development of the Code.

The FRC guidance issued with the final version of the Code makes clear that the IMA's role in monitoring compliance with the Code will continue on an interim basis to monitor adherence to the Code. This is stated to be 'without prejudice to the approach that may be followed in future years'. However, the creation by the ISC of the Institutional Investor Council with a focus on promoting the Code and facilitating engagement suggests that monitoring would sit more comfortably within the FRC, not least since the FRC has already secured responsibility for review of the Code. That division provides a clearer demarcation between industry responsibility for the operation of the Code and FRC responsibility for the quasi-regulatory functions of monitoring adherence and review.

6. Conclusions

The Stewardship Code places its forerunner the ISC Code within a quasi-regulatory framework but makes few substantive changes. While there is now a more clearly demarcated institutional structure around engagement and collaboration, it remains to be seen whether it will make a significant contribution to outcomes. Neither the Code nor the institutional structure has any intrinsic value, since engagement and collaboration must ultimately be judged by their contribution to long-term value. However, as it seems clear that there are benefits to be gained from engagement and collaboration in appropriate cases, the facilitation role of the Code is likely to be important. It is, however, less clear if 'comply or explain' can operate effectively in this arena. The problems encountered in that regard in the sphere of the Combined Code are likely to be even more severe in the context of the Stewardship Code since it lacks the objective focus of the Combined Code. Thus, the better approach may be to regard the primary role of the Stewardship Code as underpinning the Combined Code rather than a separate initiative in its own right. On that view, however, the benefit of another layer of 'comply or explain' reporting remains questionable.