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Abstract

This article considers the functions of the shareholders, particularly institutional investors, in corporate governance. Part 1 examines the current division of decision-making powers in the Anglo-American legal systems and its consequences; Part 2 discusses whether shifting power towards shareholders would really constitute an advantage for the firm as a whole; Part 3 looks more specifically at institutional investors, their capacity to take a leading role in running the company and the reasons for their apathy; and Part 4 seeks to address some of the regulatory reforms that should be considered in the UK and the United States of America, although it is argued that regulation is often prompted by the urge to respond to a crisis rather than by the actual need to re-think entirely the present allocation of powers.

Keywords

Division of power in companies, management power, shareholder primacy

Disciplines

Business Organizations Law

THE EXISTING DIVISION OF CORPORATE DECISION - MAKING POWER IN THE UK, USA AND EUROPE: A COMPARATIVE PERSPECTIVE

SHIDA GALLETTI*

Each economic crisis calls for reflection on the effectiveness of corporate governance and its ability to depict the advantages and disadvantages of a specific 'allocation of power within large economic organizations'.¹ In the UK and the US, although with some important differences, the decision-making power appears to rest mainly in the hands of the board of directors. Over the last decades, the attention of scholars and regulators has shifted to whether this constitutes the correct balancing of powers within the corporate body.

INTRODUCTION

The issue before academics and regulators is to determine the extent to which the shifting of decision-making power towards shareholders could lead to more efficient results for the company. In particular, shareholder empowerment calls for reflection on two important aspects. Firstly, it is contended that within the body of shareholders, institutional investors have the potential to assume a leading role given they are 'equity traders' and not merely 'liquidity investors',² although they currently lack incentive to do so. Secondly, shareholder empowerment in general begs two questions: what objectives would these residual claimants of the company be seeking, and would the pursuit of goals other than shareholder wealth maximization, if at all necessary, be possible in the light of such empowerment? It is argued that the current balancing of powers between shareholders and directors entails many advantages, and the shifting of decision-making power towards shareholders would lead to sub-optimal results for the company as a whole. Although shareholder wealth maximization remains the guiding principle in corporate decision making, directors, in contrast to shareholders, are better able to consider other considerations maximizing the efficiency of the firm.³

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¹ In fact, this may be one way of defining the very topic of corporate governance, as in the view of M Moore, 'Corporate Governance in the Shadow of the State' (Oxford, 2013), 14.

² The difference between these two categories of shareholders is emphasized by BS Sharfman, 'What's wrong with shareholders empowerment?' Keynote Speech: Journal of Corporation Law Spring Banquet, (March 8, 2012) 5.

³ As to the inefficiency of shareholder wealth maximization as a metric to establish the firm's achievements, see MM Blair, 'In the Best Interest of the Corporation: Directors' Duties in the Wake of the Global Financial Crisis' in T Clarke & D Branson, *The SAGE Handbook of Corporate Governance* (2012) 63.

If such criticisms are correct, why has the focus shifted to the function of shareholders? Such attention is far from being only an ‘Anglo-American’ concern, as demonstrated by the European Commission’s reflections on the role of shareholders’ engagement in the whole of Europe.⁴

This article considers the functions of the shareholders, particularly institutional investors, in corporate governance. Part 1 examines the current division of decision-making powers in the Anglo-American legal systems and its consequences; Part 2 discusses whether shifting power towards shareholders would really constitute an advantage for the firm as a whole; Part 3 looks more specifically at institutional investors, their capacity to take a leading role in running the company and the reasons for their apathy; and Part 4 seeks to address some of the regulatory reforms that should be considered in the UK and the United States of America, although it is argued that regulation is often prompted by the urge to respond to a crisis rather than by the actual need to re-think entirely the present allocation of powers.

MORE THAN MERE ‘AGENTS’: THE DIRECTORS’ DECISION-MAKING SUPREMACY AND SHAREHOLDERS’ RIGHTS

One of the most prominent features of Anglo-American corporate governance is that shareholder primacy has been advocated as a reaction to the separation between ‘ownership and control’ portrayed by Berle and Means,⁵ claiming that shareholders are principals on whose behalf the firm is administered and who have, and should have, ultimate control over the corporate enterprise.

The idea of shareholder primacy, however, has often been criticized as being incorrect from a legal standpoint. Such a concept has been rightfully regarded as a ‘misnomer’,⁶ given decision-making supremacy resides, in reality, in the board of directors. The rights of shareholders have been considered ‘remarkably limited both in theory and in practice.’⁷ More strongly, it has been advocated that ‘there is no such thing as shareholder primacy – it exists in neither law nor fact.’⁸

Shareholder primacy, therefore, merely describes the position of shareholders as ultimate beneficiaries of the accountability norms to which the board is subject, and their capacity to exercise *ex ante* or *ex post facto* rights to remedy directors’ misconduct.⁹ Instead, the board’s supremacy appears to stem from the underlying fundamental doctrines of corporate law necessary for the effective control of large and complex entities, and the interpretation of legal principles articulated

⁴ See ‘Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies’ European Commission COM (2012)740/2.

⁵ AA Berle & G Means, ‘The Modern Corporation and Private Property’ (1932) (revd 4th ed. 1968, New York: Harcourt, Brace & World) 3.

⁶ M Moore, ‘Shadow’, above n 1, 75.

⁷ MM Blair & LA Stout, ‘A Team Production Theory of Corporate Law’ (1999) 85 *Virginia Law Review* 252.

⁸ SM Bainbridge, ‘Director Primacy: The Means and Ends of Corporate Governance’ (2003) 97 *Northwestern University Law Review* 574.

⁹ Ex ante rights being stronger in the UK than ex post facto rights, given the more restricted capacity of shareholders to bring derivative actions as opposed to their US counterparts: M Moore, ‘Corporate Governance: Scope, Key Components and Regulatory Dynamics’ based on ‘National Report on Corporate Governance in the United Kingdom for the IACL’, Washington DC, 2010, 33, J Armour, ‘Enforcement strategies in UK Corporate Governance: A Roadmap and Empirical Assessment’ ECGI Working Paper n 106/2008, 54ff.

by the courts. Such supremacy can be further inferred from the limitations of the powers retained by shareholders.

As for the legal principles, both in the UK, under s 3 of the Model Articles, and in the US, under s 141(a) of the Delaware General Corporation Law (DGCL), directors are responsible for the management of the company and exercise all powers attributed to them subject to the articles or certificate of incorporation.

The normative background of the English rule empowering the board is constituted by the well-established theory of the firm as a 'nexus' of contracts, whereas its American equivalent stems from the so-called 'concession' theory. In the former system, the company's articles of association represent a covenant¹⁰ with which shareholders agreed to delegate executive powers to directors for reasons of commercial efficiency. In the latter system, the company's charter is vested with force of law by the sole act of incorporation, so that the division of decision-making power is granted directly from the State.

However, neither theoretical foundation is maintained in its purest form. On the one hand, the contractarian paradigm permeating UK corporate governance (originally from the American elaborations of scholars in the 1970s) should not be overestimated, given that the Companies Act itself is, to a great extent, mandatory and therefore not merely a freely-entered 'agreement' between shareholders and directors. On the other hand, the legal principle of s 141 of the DGCL is *prima facie* conceived not as a binding norm by the State but as a default rule, hence it would be reversible through autonomous contracting of the parties.¹¹ Its *de facto* mandatory nature derives from the impediments to changes of the certificate of incorporation which, after the formation of the company, may only be initiated by the board. Changes in the bylaws, however, though independently conceivable by the shareholders, may only be initiated if they do not contradict any provision of the charter of incorporation.¹²

In addition, the idea that s 141(a), according to which the board has general management power over the company, would allow a retaining of power by the shareholders has been excluded by some commentators¹³ and in practice.

The board's primacy is also inferred from the interpretation of the fundamental tenets of corporate law given by the judiciary, although it seems more favoured by the dicta of US judges. The management powers of the board have been recognized in the US from early years as being 'original and undelegated',¹⁴ whilst Justice Moore in the Supreme Court of Delaware, referring to the basic principle of s 141 (a) of the DGCL, stated that 'directors, rather than shareholders, manage the business and affairs of the corporation'.¹⁵ In the UK, the board primacy principle is explained in non-hierarchical terms. It is accepted that shareholders may not interfere with the power attributed to the board and their rights of intervention should follow precise procedures. Directors are not mere 'agents'¹⁶ of shareholders, nor are they 'servants'¹⁷ bound to obey their principals. The

¹⁰ *Companies Act 2006* s 33.

¹¹ D Kershaw, *Company Law in Context* (Oxford University Press, 2012) 214.

¹² Section 109 (b) DGCL.

¹³ LA Bebchuk as quoted in by D Kershaw, above n 11, 214.

¹⁴ *Hoyt v Thompson's Executor* [1859] 19 NY 207, 216 (Court of Appeals of New York).

¹⁵ *Aranson v Lewis* [1984] 473 A 2d 805 (Supreme Court of Delaware) 811.

¹⁶ *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame* [1906] 2 Ch 34 (CA).

¹⁷ *Gramophone and Typewriter Co v Stanley* [1908] 2 KB 89 (CA).

balancing of powers between directors and shareholders as set by the articles of association constitutes the agreement by which neither of the two components of the firm, acting as contracting equals, will ‘usurp the powers’¹⁸ vested in the other.

In both English and American company law, the managerial function of directors is not just a duty, but a ‘constitutional right’.¹⁹ Both systems have departed from the notion of shareholder primacy that would envisage shareholders as ultimate decision-makers for the company. They diverge, however, in the view of shareholders as holding something less than ‘primacy’, which at times has been called ‘sovereignty’,²⁰ over the affairs of the company.

In fact, English company law confers ‘sovereignty’ to shareholders as compensation for having agreed to an incomplete contract with the firm. Shareholders are thus entitled to a (restricted) level of involvement in firm decision-making. This is consistent with the view that all management powers prescribed by the covenant binding the board and the shareholders are subject to the collective will of the shareholders who are entitled to revoke them at any time.²¹

On the contrary, the American legislative framework carries the statutorily assigned prerogative of the board to its extreme, traditionally denying such powers to shareholders more easily than the English system. However, a number of significant reforms in the US have recently introduced measures that reinforce shareholder empowerment indirectly.²²

Therefore, the distinction between the US and UK jurisdictions rests on the rights of shareholders, which are permeate the law, and are enjoyed on a mandatory (and irremovable) basis in the UK,²³ whereas they are granted by default – and thus are unguaranteed and subject to alteration – under the United States law.²⁴

In both jurisdictions, the rights enjoyed by shareholders do not challenge the board’s decision-making supremacy. Their different content does, however, recall that powers of the board are conceived in England as originating from a covenant with the shareholders which is enshrined in the articles of association, while such powers are undelegated in the US.

For example, shareholders in the UK, as signatories of the articles in which they agree to designate powers to directors, are equally entitled to initiate constitutional amendments and limit the powers conferred.²⁵ In the US, changes in the charter of incorporation must be first proposed by the board, who has received its powers from the State in the act of incorporation.²⁶ UK shareholders, standing on equal footing with directors, enjoy a reserve instruction power, albeit not on actions already

¹⁸ *John Shaw & Sons v Shaw & Shaw* [1935] 2 KB 113.

¹⁹ M Moore, ‘Shadow’ above n 1, 26.

²⁰ M Moore & A Rebérioux, ‘Revitalizing the Institutional Roots of Anglo-American Corporate Governance’ (2011) 40 *Economy and Society* 93.

²¹ Model Article (DMA) 3.

²² Reference is made to the Rule 14a-8 by the Securities and Exchange Commission and its effects as described by M Moore, ‘Shadow’, above n 1, 132. See also sec 951 of the Dodd-Frank Act on the ‘say on pay’, and more on US reforms *infra*.

²³ So, for example, ss 21 and 338 CA 2006 on the right to bring constitutional amendments and sec 168 on the right to dismiss directors without cause, are mandatory.

²⁴ M Moore & A Rebérioux, above n 20, 98.

²⁵ *Companies Act 2006* (UK) ss 21, 338.

²⁶ Sec 242 (b) DGCL and Kershaw, above n 11.

undertaken by the board.²⁷ This is not the case in the US. Directors of UK Premium Listed companies are subject to annual re-election by shareholders,²⁸ who are able to choose their contracting parties and have concurrent authority to make appointments.²⁹ In the US, unless in cases of a proxy contest, shareholders are limited to vetoing the board's own nominees.³⁰ Shareholders in the UK have 'shot-gun' powers allowing them to dismiss board members without cause,³¹ a distinguishing feature from the US where the board is classified.³²

Another example of the board's supreme decision-making authority is that the control and payment of dividends to shareholders in the US rests with the board as a default rule,³³ while in the UK the power is vested in shareholders through ordinary resolution, although subject to the board's recommendation as to the amount.³⁴

Despite the differences, the distribution of powers in both legal systems seems to entrust shareholders with approval rights on decisions which are either vital for the life of the company or in which agency problems are more likely to arise. In other words, directors - the rightful and ordinary decision-makers in the company - may be incapable of properly performing these duties.³⁵ Shareholders are thus given powers to initiate, or at least veto, 'rules of the game' to amend the constitutional arrangement and 'game ending' decisions to merge or wind up the company.³⁶ Takeovers are common circumstances in which the powers of shareholders are to be protected against instrumentalisation by the board. There are firm restrictions on the defences that directors can employ to 'protect' the company in circumstances of pending takeover. The Takeovers Code forbids directors from taking any action that might frustrate the success of a takeover, once the bid is launched or anticipated, without seeking shareholders' consent.³⁷

Given such allocation of powers, one may wonder if it would be more appropriate to rebalance the powers granted to shareholders and whether such reallocation would better serve the interests of the company as a whole. While authors advocating directors' primacy maintain that the balance is struck correctly,³⁸ it is also necessary to consider recommendations of authors such as Blair and Stout. They warn the legal community against taking the 'shareholder primacy rhetoric'³⁹ too

²⁷ DMA 4.

²⁸ UK Corporate Governance Code (UKCGC) provision B 7.1.

²⁹ DMA 20.

³⁰ MM Blair - L A Stout, 'A Team Production Theory of Corporate Law', above n 7, 311.

³¹ Or threaten to do so. On the impediments in practice of the use of sec 168 CA 2006: MT Moore, 'National Report', above n 9, 17; A Keay, 'Company Directors Behaving Poorly: Disciplinary Options for Shareholders' (2007) *Journal of Business Law*, 8.

³² Sec 141 (k) DGCL.

³³ Sec 70 (a) DGCL.

³⁴ DMA 70 (2).

³⁵ R Kraakman, 'The Anatomy of Corporate Law: A Comparative and Functional Approach' in Kershaw, above n 11, 204.

³⁶ LA Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 *Harvard Law Review* 833.

³⁷ J Armour, above n 9, 44.

³⁸ SM Bainbridge, 'Shareholder Activism in the Obama Era' in F Scott Kieff & TA Paredes (eds), *Perspectives on Corporate Governance* (Cambridge University Press, 2010) 219.

³⁹ MM Blair & LA Stout, 'A Team Production Theory of Corporate Law', above n 7, 327.

seriously, suggesting that the success of such theory had fallen and risen throughout the nineteenth century according to social and economic conditions.⁴⁰

UPHOLDING SHAREHOLDER PRIMACY: WHAT ARE THE BENEFITS IN SHIFTING THE CURRENT BALANCE?

Those who argue for the re-allocation of power towards shareholders claim that enforcing control powers of shareholders would be a valid solution to agency problems.⁴¹ Such problems are best defined as the conflict of interest that arises when the agent's (the CEO's for instance) own interests differ from those of the principal (the shareholders).⁴² Various solutions were devised in order to overcome agency problems, such as tying the agent compensation directly to the benefits of the owner, letting shareholders intervene in order to make the CEO act correctly, or increasing the power of intervention and control by the shareholders by letting them bring in new managers.⁴³

Such emphasis on consequences of the separation of ownership and control, however, is increasingly criticized by commentators as 'excessive and misleading'.⁴⁴ In switching the debate to the advantages entailed in such separation and the value of centralized authority and accountability, it is argued that this condition should be exploited rather than fought.⁴⁵ Maintaining the present balance provides the advantage of having a central decision-maker, who is held accountable for decisions, and whose absence would make it harder for the shareholder body to reach decisions. Shareholders would likely lack sufficient information, suffer from '*rational apathy*' and be divided by their divergent interests. Their decisions would not be consistent with the overarching business plan as may be drafted by the board, but would be undermined by lack of any clear long-term vision. This might lead to disruptive '*cycles*' that would impede on corporate decision-making.⁴⁶ Contractarians argue that directors are held accountable by a series of market forces such as the capital and product market, the reputational market and the market for corporate control.

A reflection on the present debate and the possible advantages of shareholder primacy should move from the division traced by Professor Bainbridge, a leading advocate of director primacy in corporate governance who has dedicated numerous writings to the explanation of the law and economics of public companies.⁴⁷ Bainbridge has helpfully explained the concept of shareholder primacy by referring to two principles it entails: first, the objective of maximizing shareholder wealth, and, second, the objective of assigning to shareholders ultimate control over the firm. The first objective, which is not challenged by upholders of directors' primacy, has been challenged in recent years by legislation in both the UK and the US. This manifests a need to expand the traditional metric by which corporate performance is commonly measured. In the UK, the CA

⁴⁰ A Keay, 'Moving towards stakeholderism? Constituency statutes, enlightened shareholder value, and all that: much ado about little?' (2011) 22 *European Business Law Review* 4.

⁴¹ LA Bebchuk, above n 35, 69.

⁴² KJ Hopt, *Comparative Corporate Governance: The State of the Art and Emerging Research* (Oxford, 1998) 851.

⁴³ *Ibid.*

⁴⁴ MM Blair & LA Stout, 'A Team Production Theory of Corporate Law', above n 7, 328.

⁴⁵ M Moore & A Rebiérioux, above n 20, 85.

⁴⁶ See J Gordon as quoted by LA Bebchuk, above n 36, 58.

⁴⁷ On this topic see, for instance: 'Directory Primacy and Shareholder Disempowerment' 119 *Harvard Law Review* 1735 (2006), 'The Case for Limited Shareholder Voting Rights' 53 *UCLA Law Review* 601 (2006), 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 547.

2006 provided for an ‘enlightened shareholder value’ approach,⁴⁸ while the US witnessed the enactment of constituency statutes allowing directors to take into account an expanded group of interests.⁴⁹

The growing trend towards corporate social responsibility (CSR) represents a widespread recognition of the fact that, rather than rejecting shareholder wealth maximization, this should be coupled with the importance of stakeholders’ considerations. The result may thus lead to a richer, more socially-oriented notion of the corporate objective.⁵⁰ In this setting, shareholder wealth maximization still serves as the primary factor guiding the decisions of directors themselves. Section 172 CA, for instance, reveals its ‘hierarchical’ rather than pluralistic recognition of the interests at stake. Such developments indicate, however, that shareholder value alone may not serve as the greatest contribution to total social wealth. Considering that shareholder value can be increased without adding to social wealth, post-crisis reforms and academic literature recommend that directors should be focussing on maximizing ‘not just the value of the equity, but the sum of the values of all financial claims on the firm – debt, warrants and preferred stock, as well as equity’.⁵¹ Therefore, the directors’ mandate should not be limited to pursuing shareholder wealth maximization, but be instructed to act ‘in *the best interests of the corporation*’.⁵²

The second objective - shareholders’ ultimate control - calls for enhancement of several rights of shareholders. With specific reference to the US, empowering shareholders would render the replacement of directors more viable and further allow shareholders to initiate amendments, such as reincorporation decisions, which would lead states to compete for laws favouring shareholders. Directors should refrain from adopting anti-takeover measures when the takeover is given sufficient support by the shareholders themselves. Further, shareholders should be able to decide on termination of the company, and retain ‘*scaling down*’ decisions that currently rest in the board’s hands.⁵³

Such calls in the US are not completely novel. In 2009, opt-in rules were introduced to allow voluntary initiation by shareholders of the corporate ballot and nomination of their own candidates, as well as reimbursement for expenses incurred in launching the proxy contest.⁵⁴ A majority vote, rather than the traditional plurality voting, was introduced to elect directors.⁵⁵ Institutional investors have been increasingly successful in demanding the removal of anti-takeover mechanisms such as the poison pill and staggered boards.⁵⁶ Other important reforms, including the disclosure of executive compensation arrangements, have also taken place.⁵⁷

⁴⁸ Sec 172 CA 2006.

⁴⁹ A Keay, ‘Stakeholderism?’, above n 40, 8.

⁵⁰ For an overview on the concept of enlightened shareholder value, see A Keay, *The Enlightened Shareholder Value Principle and Corporate Governance*, (Oxford, 2012).

⁵¹ MC Jensen as quoted in MM Blair, ‘In the Best Interest of the Corporation: Directors’ Duties in the Wake of the Global Financial Crisis’ in T Clarke & D Branson, above n 3, 63.

⁵² WW Bratton & ML Wachter, ‘The Case against Shareholder Empowerment’ (2010) 158 *University of Pennsylvania Law Review*, p 712; *Model Business Corporation Act* par 8.30 (a) (2)).

⁵³ LA Bebchuk, above n 36, 57.

⁵⁴ Sec 112-113 DGCL.

⁵⁵ Sec 141(b) – 216 DGCL, *Model Business Corporation Act* (MBCA) 10.22.

⁵⁶ M Moore, ‘Shadow’ above n 1, 132.

⁵⁷ For a useful summary, see S M Bainbridge, ‘Shareholder Activism in the Obama Era’, above n 38, 217.

Calls for shareholder empowerment are probably part of the solution towards better corporate governance. This is why they were upheld in the years following the crisis and in many aspects addressed by subsequent reforms. However, what should be considered is whether it is reasonable to place excessive expectation on shareholders and anticipate them to act now as the solution when, according to some commentators, they were part of the problem for urging directors to take unnecessary risks to increase their share values.⁵⁸

Despite the possible limits on shareholders vis-à-vis directors in reinforcing efficient decision-making, even those who advocate enhanced shareholder supremacy seem to converge their expectations primarily on institutional investors.⁵⁹ UK corporate governance is established with the assumption of a strong relationship between companies and shareholders based on constructive engagement as well as 'exit' rights, a standard embraced in the UK Corporate Governance Code and the UK Stewardship Code.

THE PLEA TO INSTITUTIONAL INVESTORS AND THE CASE OF THE 'FLEETING' LANDLORDS

The reasons for the emphasis placed on institutional investors among the body of shareholders are well known. They are those who are seen as able to overcome some of the most common limits that individual shareholders in a highly dispersed market face. They possess greater stocks, and are thus presumably more incentivized to active engagement and to exert greater voting power. They also have greater access to information, and might be willing to monitor and exercise pressure on the board. These factors indicate that they might partially reverse the findings by Berle and Means, whereby control, as articulated by the two in the 1930s, had slipped from the hands of the owners to those of the directors.⁶⁰

The impact of institutional investors from the 1990s onwards has been controversial, with scholars giving conflicting evidence and opinions.⁶¹ It is suggested in the USA that the rise of institutional investing has influenced a variety of board decisions, including executive compensation schemes, anti-takeover norms, board composition and voting rights. For instance, the greater monitoring by institutional investors in recent years has led to a decrease in the adoption of anti-takeover devices such as poison pills and staggered boards, which are generally used by boards seeking to protect themselves from shareholders' pressure.⁶²

The rise of institutional investors in the United States is significant, and has increased steadily since the 1950s. The corporate landscape has seen a 10-fold increase in shares owned by professional investors: 61.5% of shares in 2005, compared to 6.1% at the beginning of 1950. Within the largest 1,000 US companies, institutional investors held 73% of shares in 2009, while the number of individual investors consequently dropped.⁶³

⁵⁸ WW Bratton & ML Wachter, above n 49, p 653 and also BR Cheffins, 'The Stewardship Code's Achilles' Heel', (2010) 73 *Modern Law Review* 1004, 1025.

⁵⁹ LA Bebchuk, above n 36, 42.

⁶⁰ M Useem, 'The Ascent of Shareholder Monitoring and Strategic Partnering: The Dual Functions of the Corporate Board' in T Clarke & D Branson, above n 3, 138.

⁶¹ A Keay, 'Behaving Poorly', above n 31, 5.

⁶² M Useem, above n 57, 143.

⁶³ Conference Board, 2010 Institutional Investment Report in M Useem, above n 57, 138.

In the UK, although mainly adopting a ‘defensive’ approach, the growth of institutional holdings gave rise to an increase in the frequency of voting in listed companies, standing at 68% in 2010. This can also be explained by a series of governmental and industrial recommendations encouraging institutional shareholder engagement.⁶⁴

However, other scholars suggest that, in practice, the efforts exerted by institutional investors in monitoring, ‘voicing’, and coordinating activities have been relatively modest, but most importantly, ‘no strong evidence’ was found as to a ‘correlation between firm performance and percentage of shares owned by institutions’.⁶⁵

In brief, institutions are as indifferent as other shareholders. They are likely to get involved only when long-term inefficiencies occur as a result of monitoring costs and coordinating shareholders. Free-riding is likely to ensue, since institutional activism is costly to produce.⁶⁶

It is suggested, however, that institutional investors are not one homogeneous block. Various investors adopt differing approaches to engaging in corporate governance. Aguilera, Kabbach de Castro and i Cladera argue that, considering prominent institutional investors, mutual funds are generally far less committed to activism than pension funds. This is partially because mutual funds must differentiate their products by being able to assemble different portfolios to those of competitors. They are, therefore, more willing to adopt a ‘buy and sell’ strategy rather than engaging actively in the assessment of decisions taken within firms.⁶⁷

On the other hand, pension funds would at least theoretically be more interested in nurturing long-term relations with firms, given their clients are more concerned with the profits to be made in the long run rather than short term.

A study of the actual weight of different components within the institutional investors arena could be useful, considering that even commentators who have been critical about their role admit that pension funds and hedge funds may be exceptions to the otherwise passivism of professional shareholders.⁶⁸ In the UK, institutional investors are predominantly pension funds and insurance companies. Together they count for 13.7% in 2010, while individual investors decreased from 54% in 1963 to 11.5% in 2010.⁶⁹ Mutual funds (‘unit trusts’) are also significant, although not in the same proportion as in the US.

The origin of investors has also rapidly changed from domestic to ever expanding foreign investments. This has led to further impediments to a potential active role held by institutional investors. Borrowing Lord Myners’ metaphor, today they might not only be ‘*absentee landlords*’ but ‘*fleeting landlords*’, given their ever-decreasing domestic presence. In 2010, the percentage of foreign holdings in the UK was 41.2%.

⁶⁴ M Moore, ‘National’, above n 9, 15.

⁶⁵ BS Black, as quoted in S M Bainbridge, ‘Shareholder Activism in the Obama Era’, above n 38, 226.

⁶⁶ Ibid, 229.

⁶⁷ R V Aguilera, L R K de Castro, RC i Cladera, *Uncertainty and corporate ownership: Evidence from Emerging Markets* (Madrid, 2011).

⁶⁸ Ibid 227.

⁶⁹ *Kay Review* (July 2012).

Such figures should not be exaggerated however, as warned by the Kay Review, since it includes holdings where management is run in the UK, although the parent company is US based and asset managers may be acting for UK clients.⁷⁰

Leaving foreign investors aside, other important unintended consequences of the growth in institutional investing also place significant pressure on directors to focus on short-term returns.⁷¹ There are concerns over insufficient expertise by institutional investors as opposed to directors. More importantly, it is accepted that the structure of institutional investors leads to increasing financial intermediation, where the distance between the company and the end investor is such that the leading role is played by fund managers who are more prone to trading rather than acting as real ‘owners’.⁷² It is no surprise, then, that the natural focus of fund managers on immediate returns may result in poor long-term management, in contrast to the true ‘owners’ who would instead be focused on future performance. As such, the institutional investor will be ineffective, and potentially even detrimental, where it influences the governance of the company.

For this reason, since the Walker Report, emphasis has been put on the need to ensure that the fund manager’s business project is disclosed, to enable shareholders to place an informed mandate.⁷³

The attention to institutional investors is not new. It was first proposed by the Cadbury Report in 1992, then tackled in the Stewardship Code issued by the ISC (Institutional Shareholders Committee), and finalized in the Code issued by the FRC (Financial Reporting Council). Doubt was cast upon its effectiveness to foster shareholders’ engagement, *inter alia*, because of its ‘compliance or explain’ structure. The role that could be played, and to some extent has been played, by institutional investors is considerable, given all of the above limitations. It seems reasonable that recent regulatory responses view these participants in the firm’s structure as those who could balance and monitor the present division on decision-making powers.

REGULATORY RESPONSES TO EFFICIENT CORPORATE GOVERNANCE

Regulation tends to follow the business cycle.⁷⁴ In moments of crisis and collapse, regulation should take up the role of filling the gaps so that such events would not reoccur. In times of economic boom and wealth, there is less of an impetus for renewal and improvement of the corporate system.

As a response to the global financial crisis in 2008, governments worldwide are taking a leading role in remedying the existing problems.

Yet in one of the first studies immediately after the crisis, Cheffins noticed how the firms that failed in 2008 had relatively well functioning corporate governance.⁷⁵ Adams and Erkens, Hung and Matos⁷⁶ found that companies which had more independent directors and institutional shareholders did not necessarily cope better with the crisis. These findings raise the issue of whether

⁷⁰ *Kay Review*, 31.

⁷¹ Trade in equity markets being at high speeds and with an average holding period of less than 8 months. See R Barker, UCL lecture slides, 1 March 2013.

⁷² BR Cheffins, above n 55, 1005.

⁷³ A Klettner, ‘Corporate Governance and the Global Financial Crisis: The Regulatory Response’ in T Clarke & D Branson, above n 3, 570.

⁷⁴ *Ibid* 556.

⁷⁵ As quoted in Klettner, above n 73, 557.

⁷⁶ As quoted in A Klettner, 558.

the pursuit of shareholder activism, together with the increased functions of independent directors, would really serve to avoid future crisis. Leaving aside the monitoring function of independent directors, whether shareholder activism and the primary function played by shareholder value should be upheld calls for serious consideration.

Some authors suggest that it may have been the search for shareholder value on behalf of investors which principally drove the global financial crisis, as companies incessantly tried to achieve higher returns for their shareholders.

In the UK, the financial crisis gave rise to a series of reviews such as the Walker Review in 2009, which sought to examine some of the most apparent weaknesses in corporate governance, including board composition and performance and shareholder engagement. Among its recommendations, it called for the FRC to prepare a formal Stewardship Code aimed at improving the engagement of institutional investors. Subsequently, the UK Code of Corporate Governance, issued by the FRC in a revised version in 2010, was directed towards improving board effectiveness and performance.

Shareholder engagement has been one of the main focusses of post-crisis reforms in the UK and the US, along with executive compensation, risk management and shareholder engagement. However, as much as good structure and process appears to play a decisive role, some scholars still find that there is a degree of ‘magic’ involved in reaching the ‘optimal conditions for good decision-making’.⁷⁷ In other words, some elements such as trust, honesty, constructive debate, flow of information and the skills required to interpret such flow are still difficult to depict and put in any binding or voluntary legislative form.

The way forward, therefore, is to develop best practices. The recent Cox Review interestingly points out the diminishing meaningful dialogue between listed companies and shareholders, an integral part of the Stewardship Code. It also recommends an adoption of clear descriptions of long-term strategies.⁷⁸ The recommendations, however, are not limited to ‘*best practices*’ but also address the need for strong government actions, at least with the means to foster long-term shareholding - legislative action should intervene in distinguishing speculation and investment.

CONCLUSION

The role of shareholders as ‘stewards’ of the company is a key component of effective corporate governance not only in the UK, but also in the rest of Europe, where the model in place depends, *inter alia*, ‘on checks and balances between the different organs and different stakeholders’.⁷⁹ Its importance is observed in many recent reforms in the US, where perhaps the imbalance towards directors is more apparent. While legislators and regulators should rightfully find ways to engage shareholders and prevent directors from becoming absolute monarchs, the present allocation of decision-making powers should not be held unsatisfactory *per se*. The primacy of the board does not by itself lead to negative results, and indeed entails some recognized advantages linked to the value of centralized authority. Apart from shareholders, a decisive role is to be played in this context by the gatekeepers: accountants, lawyers, auditors and rating agencies.

⁷⁷ Ibid 579.

⁷⁸ *Cox Review* (26 February 2013) 41.

⁷⁹ EU Action Plan, above n 4, 8.

In all legal systems, the decision-making power held by directors should not be viewed as the sole scapegoat for past and future failures. Rather, the advantages of a more clearly defined division of labour should be upheld, thus acknowledging the ability of directors to make decisions and be held accountable for them.