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Understanding and Augmenting Institutional Shareholder Activism: A Comparative Study of the UK and China

BO GONG

A Thesis Submitted for the Degree of Doctor of Philosophy

Durham University
Durham Law School

May 2011

Abstract

Institutional shareholder participation has long been considered as vital to good corporate governance in the UK, and increasingly recognized as, at least potentially, an important part of Chinese corporate governance too. But its potential does not yet seem to have been realised. The reasons for that are undoubtedly complex, and this thesis seeks to understand that complexity, and to offer some (modest) proposals to promote greater shareholder engagement.

At the core of the thesis' explanation of shareholder activism is the model it seeks to develop to explore the factors that determine institutional shareholders' propensity for activism. This model is built up in several stages, running across the whole thesis. The first 'setup' stage is composed of a two-step analysis. It first elaborates the collective benefits of activism as a means of achieving managerial accountability. The second step switches to the individual level of analysis, asking whether and when shareholder activism is individually rational i.e. rational for any individual shareholder. The thesis considers two inquires as essential to determine engagement for individual institutional investors: whether the temptation to free-ride that faces an individual shareholder can be overcome and whether a shareholder's individual benefits from action exceed its individual costs.

The model suggests that, in working out the strength of the temptation to free-ride, and the balancing of costs against benefits – much will depend upon the governance or regulatory environment, upon the type of institutional shareholder concerned, and upon the form of activism being undertaken. This thesis adds in as much empirical knowledge as can reasonably be currently gathered about these three variables both for the UK and for China.

The application of the model explains the remarkable contrast in respect of the level of institutional shareholder involvement between the UK and China. The small presence of institutional investment and the lack of awareness of the importance of institutional shareholder activism are considered as two of the most relevant contributory factors to the comparatively passive institutional shareholder involvement in China. Moreover, besides working as an explanatory model, identifying those factors which contribute most significantly to the form and level of

shareholder activism, the model also allows prescriptions to be developed for improving the environment for shareholder activism primarily (although not exclusively) in China.

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Abbreviations

ABI	Association of British Insurers
CA 2006	Companies Act 2006 (UK)
CL 2005	Company Law 2005 (China)
CSRC	Chinese Securities Regulatory Commission
GDP	Gross Domestic Product
FSA	Financial Services Authority
IPO	Initial Public Offering
IMA	Investment Management Association
ISC	Institutional Shareholders' Committee
JSC	Joint Stock Company
LLC	Limited Liability Company
MOF	Ministry of Finance (Chinese)
NAPF	National Association of Pension Funds Ltd.
NSSF	National Social Security Fund
OECD	Organization for Economic Co-operation and Development
PIRC	Pensions & Investment Research Consultants Ltd.
QFII	Qualified Foreign Institutional Investor
RMB	Renminbi (Chinese yuan)
SIF	Securities Investment Fund
SL 2005	Securities Law 2005 (China)
SOE	State Owned Enterprises
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
UK	United Kingdom
US	United States of America

Part I A Model for Shareholder Activism: In Outline

Introduction

0.1 Research Background

The ultimate goal of the thesis is to offer a comparative analysis of the UK and China in respect of shareholder activism.

Institutional shareholder activism[1] appears to have come of age, both within the UK and China. In the past few years, institutional shareholders – those who pool large sums of money from clients and invest those sums in securities, real property and other investment assets for their clients,[2] seemed to have begun to work in an effort to strengthen their voice within the corporation by seeking to enhance managerial accountability.

In the UK, the failed acquisition of AIA Insurance by Prudential Insurance, for example, is reported to have prompted some of its own institutional shareholders to have sought the replacement of its chairman.[3] Other recent high-profile examples of shareholder activism in large UK companies have included HSBC (by Knight Vinke Asset Management lobbying for changes to HSBC's strategy and management structure),[4] Vodafone (by Efficient Capital Structures lobbying for a change in

[1] We shall have to say much more to define shareholder activism below, including developing a typology of activism. For now, however, we might describe it as 'the use of power by an investor either to influence the processes or outcomes of a given portfolio firm or to evoke large-scale change in processes or outcomes across multiple firms through the symbolic targeting of one or more portfolio firms', see L V Ryan and M Schneider, 'The Antecedents of Institutional Investor Activism' (2002) 27 Academy of Management Review 554, 555. I will look at the term of 'shareholder activism' in more detailed in Chapter 3.

[2] P Davis and B Steil, *Institutional Investors* (MIT Press, Cambridge, Mass 2001) 12. A fuller treatment of the organizations that are typically included in the class of institutional shareholders is provided in Chapter 3.2. below.

[3] P Davies and K Burgess, 'Pru Investors Turn Focus on McGrath', *Financial Times* (London 16 June 2010) <http://www.ft.com/cms/s/0/987c085e-7984-11df-b063-00144feabdc0.html> accessed 23 June 2010.

[4] The process of how Knightvinke engaged with the HSBC is disclosed on its website: <http://www.knightvinke.com/track_record/> accessed 21 June 2010.

strategy),[5] Marks and Spencer (by its own institutional investors lobbying for the separation of CEO and board chairman roles).[6]

In China, there is also a growing trend for institutional shareholders in listed companies to make their voice known. Recent notable cases of shareholder activism have included China Merchants Bank (by eight funds lobbying for withdrawal of a new share plan),[7] Vanke (by 23 funds lobbying for altering of article)[8] and Shanghai 3F New Materials (by institutional investors lobbying for a fair share structure reform scheme).[9]

However, it must be admitted that the full potential for shareholder activism has not been realized. Against the examples of activism described above, we must acknowledge that some British institutional investors have rightly been criticized as behaving as 'absentee landlords' of their investee companies.[10] The recent banking crisis has exposed the passivity of some institutional shareholders – many of whom appear to have chosen to sell their stakes in the banks rather than intervene or challenge the board when they realised the strategies followed by the banks were excessively risky.[11] Institutional shareholders' role to scrutinise and monitor the decisions of boards and executive management in the banking sector is considered as

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[5] E Judge, 'Auction Rekindles Fears over Vodafone's US Strategy', *Timesonline* (26 January 2008), <http://business.timesonline.co.uk/tol/business/industry_sectors/telecoms/article3254338.ece> accessed at 12 June 2009.

[6] K Burgess, 'Questions Raised over Combined Role Move', *Financial Times* (London 10 March 2008) <http://www.ft.com/cms/s/0/9175be7c-eef0-11dc-97ec-0000779fd2ac.html> accessed 10 September 2009.

[7] P Wang, 'Jijin Fandui Zhaohang Faxing Baiyi Kezhuanzai Rongzi' [Funds Disagreed China Merchant Bank's Bond Offer Plan] Zhongguo Zhengquan Bao [Chinese securities journal] (29 September 2003).

[8] M Jin, 'Jijin Gaodiao Banyan 'Jiji Touzizhe'' [Funds Acted as 'Active investors'], Zhongguo Zhengquan Bao [China Securities News] (9 May 2005).

[9] See, for example, 'San'aifu Gugai Liuchan, Farengu Jiezheng Renu Jijin' [3FShare Structure Reform Miscarried, Legal Person Share Problem Annoyed the Funds], *21 Shiji Jingji Baodao [21st Century Economic News]* (19 December 2005); 'San'aifu Gugai Yaozhe, Yinhua Jijin Pilu Yuanyin' [Yinhua Fund Explained Why 3F Share Structure Reform Aborted], *Shanghai Zhengquan Bao [Shanghai Securities News]* (15 December 2005). Share structure reform in China will be introduced in Chapter 9.

[10] Lord Myners, Speech to the NAPF Investment Conference in Edinburgh on March 12, 2009, available at < www.hm-treasury.gov.uk/speech_fsst_120309.htm> accessed 14 July 2009.

[11] Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City*, Ninth Report of session 2008-9, 64.

a failure, resulting in the phenomenon of 'ownerless corporations', as described by Lord Myners.[12] Similarly, some institutional shareholders have not played a contributory role in monitoring corporate managers in Chinese listed companies, as reported in a survey conducted by the Shanghai Stock Exchange in 2007.[13]

The reality regarding whether there is truly an increase in institutional shareholder involvement appears to be mixed. But it at least suggests that shareholder action is not widely practiced by every individual institutional investor. Appreciating this complexity requires us to ask the central question that will be addressed in this thesis: Why and when institutional shareholder activism is likely to occur? The exploration of these issues is timely and vital to both the UK and China.

Firstly, the concept of active institutional share ownership has become central to the regulatory framework for the governance of listed companies. Policymakers in both countries view institutional shareholder engagement as a means of improving corporate governance practice in listed companies and have issued a variety of guidelines to promote greater institutional shareholder monitoring. A recent groundbreaking movement in the UK framework is the newly-issued 'Stewardship Code.' In July 2010, the Financial Reporting Council (FRC), a regulatory body that oversees corporate governance standards in the UK, launched the world's first 'Stewardship Code', to require UK institutional investors to engage with the companies in which they invest.

The FRC's Stewardship Code, which sits alongside the UK's newly revised Corporate Governance Code[14] for companies, comes off the back of the Government-commissioned Walker Review into corporate governance during the

[12] Ibid, 65.
[13] Shanghai Stock Exchange, *China Corporate Governance Report 2007*, 36, available at <http://static.sse.com.cn/sseportal/webapp/datapresent/SSEDisquisitionAndPublicationAct> accessed 14 December 2009.
[14] The UK Corporate Governance Code is available at <http://www.frc.org.uk/corporate/ukcgcode.cfm> accessed 12 March 2010. The UK Corporate Governance Code, which updates the previous 'Combined Code on Corporate Governance', grew out of: Financial Reporting Council, Financial Reporting Council, '2009 Review of the Combined Code: Final Report' < http://www.frc.org.uk/corporate/reviewCombined.cfm > accessed 10 March 2010, 3.76.

financial crisis.[15] The Stewardship Code sets out the best practice for institutional investors in their stewardship of UK listed companies with a view to

> 'enhancing the quality of engagement between institutional investors and companies to help improve long-term returns to shareholder and the efficient exercise of governance responsibilities.'[16]

Unlike previous codes which were voluntary in nature, the Stewardship Code has a more mandatory weight on institutions. UK institutional investors must abide by the Code to make public disclosure of their voting and engagement activity, or explain why they do not comply with the Code.[17]

Similar pressures are starting to build in China. China's own Code of Corporate Governance, issued in 2002, is mandatory for Chinese listed companies. It explicitly states:

> 'Institutional shareholders shall play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes.'[18]

In the recent 'split share reform',[19] institutional investors are expected by the Government to 'take active part in the share reform, and defend the rights of investors, especially public investors, as well as sustained development of the market.'[20]

Secondly, corporate governance is of critical importance to a country's financial market stability and economic growth, because it helps to provide a degree of confidence and credibility that is necessary for the proper functioning of a market

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[15] D Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations' (2009) <http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 16 January 2010, Recommendation 16.
[16] Stewardship Code, Preface.
[17] The implementation of the Stewardship Code in practice remains to be seen. For a good evaluation on aspects of the Code in operation, See I Macneil, 'Activism and Collaboration Among Shareholders in UK Listed Companies' (2010) Capital Markets Law Journal 1, 17-20.
[18] Code of Corporate Governance for Listed Companies s 11.
[19] For an account of this reform, see infra; Chapter 6.
[20] Guidance Opinions on the Split Share Structure Reform of Listed Companies, issued by the China Securities Regulatory Commission in September 2005, s 14. It will be discussed in Chapter 6.

economy.[21] The significance of studying the role of institutional shareholders in corporate governance lies in the fact that (a) institutional investors collectively hold a very large portion of the equities of the UK listed company sector, and an important, growing increase of Chinese securities; and (b) domestic listed companies, in turn, account for a vital part of the economy in both the UK and China.

With regard to (a), institutional ownership of the listed UK equity market has increased substantially since the 1960s. While in 1963, individual investors owned 54% of shares, and institutions owned 24%, by 2008, there is a dramatic reverse: the level of share ownership by individuals dropped to only 10%, and accordingly, institutional ownership accounted for 40% of UK equities.[22] The proportion of the listed China equity market owned by institutions has also increased enormously, although not to the extent seen in the UK mainly due to the presence of non-tradable shares in Chinese listed companies. By 2009, institutional ownership accounted for more than half of tradable Chinese equities.[23] With the on-going split share reform, institutional shareholder will be likely to replace the State or local governments to become major shareholders in many listed companies and thus, their significance is far-reaching in the future.

Regarding (b), there were 2,179 domestic companies listed on the London Stock Exchange by 2009, with a combined market capitalization of £1.8 trillion, equally more than 128% of UK's GDP.[24] In China, there were 1,700 companies listed on its domestic stock exchanges, with a total domestic market capitalization of RMB 23 trillion (roughly £2.3 trillion), accounted for more than 101% of Chinese GDP.[25]

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[21] OECD, *OECD Principles of Corporate Governance* (OECD, Paris 2004) Preamble.
[22] Office for National Statistics, 'Share Ownership Survey 2008' <http://www.statistics.gov.uk/pdfdir/share0110.pdf> accessed 17 August 2010. For a full analysis of UK institutional share ownership, see Chapter 3.1.
[23] See a detailed analysis in Chapter7.1.
[24] World Bank, *Listed Domestic Companies, Total and Market Capitalization of Listed Companies (% of GDP),* <http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS/countries/1w-CN?display=default> accessed 12 August 2010.
[25] Ibid.

As institutional investors become increasingly powerful in the corporate arena, it will be accordingly critical for both researchers and practitioners to understand the heterogeneity of this enormous investor class.

0.2 Research Questions

The questions that the thesis intends to examine are:

1. Is activism by shareholders rational? What factors determine the extent of institutional shareholder activism? Can these factors be ordered so they form a coherent model of shareholder activism?
2. What empirical evidence is there about the strength of these factors in the UK and China?
3. What can be done to overcome factors that weigh against institutional shareholder activism, or to strengthen factors that encourage more shareholder activism?
4. Comparatively, questions 1, 2 and 3 will be addressed for both the UK and China.

0.3 Research Design and Structure

Clearly, at the core of these four research questions is the model of activism that the thesis develops (and then seeks to 'prove' by reference to the current empirical extent of activism in the UK and China). Developing this model has been an admittedly complex and difficult task, reflecting the complexity of understanding shareholder activism itself. The model is built up in three stages, running across several of the chapters of the thesis, and it will accordingly be useful to foreshadow the way the argument will develop.

Chapter 1 seeks to offer a framework showing the factors that explain when shareholder activism will occur. At this first, 'framework', stage, the analysis involves two moves. The first is to explain how *collective* action by shareholders can be beneficial (to shareholders). In doing so, it in part notes the positive benefits of

activism, in part rejects some of the counter arguments against activism and in part looks at the empirical evidence on the collective benefit of activism. The second move is to explain whether, and when, this collective benefit might be translated into *individually rational* activism by shareholders. In other words, it intends to show how individual shareholders might go about deciding whether they ought, individually, to be active. This chapter suggests that the move from *collectively* beneficial activism to *individually* rational activism involves a two-step analysis. The first step is to determine whether the free-riding problem that faces any collective action can be overcome. This thesis suggests four factors that can, in some circumstances, undermine the likelihood of free-riding. They are: the decisiveness of large individual institutional holdings, the possibility of concerted action, what I shall call 'in process' benefits and a normative obligation to act.

If free-riding can be avoided, the second step involves a *calculation*: are the institution's individual benefits likely to exceed its individual costs? This chapter suggests that the benefits include the shareholder's share of the total gains to the corporation from the activism in question, plus any individual 'in process' benefits it secures through its own activism. It also offers a classification of 'costs' based on direct costs and indirect costs. Chapter 1 notes that the precise functioning of these factors – the impact they have on the decision-making process of any given institutional shareholder will – depend upon the *type* of institutional shareholder concerned and the *form* of activism they take.

Subsequent chapters (4 onwards) will then develop this model, but before doing so, it is essential to attend to some background information necessary for this analysis to make sense. Chapter 2 therefore provides an overview of some fundamental elements of UK listed companies and the corporate governance framework that is crucial for understanding the micro-environment of shareholder activism. It is followed by Chapter 3 which outlines and surveys the extent and features of major market participants in the UK institutional investment landscape. With this grasp on the

reality of UK corporate governance and institutional investment, Chapter 4 takes a more theoretical turn to develop the model established in Chapter 1. It enriches the model of activism by 'feeding in' some of the relevant findings about the type of institutional shareholders involved in the activism. (It is worth nothing here that since Chinese institutions share many of the same features as the UK institutions, concerning the way they manage investment, some findings in Chapter 4 can also be applied in the Chinese landscape, although I will subsequently note in Chapter 9 when differences are observed.)

Chapter 5 intends to 'prove' the explanatory model of activism developed in Chapter 1 by adding in empirical material in respect of shareholder activism in the UK. The first section identifies a typology of shareholder activism, including private meetings, proxy voting, submitting proposals, and derivative actions. It then explores the current extent and level of each form of activity that has taken place in the UK. Based on such empirical evidence, Chapter 5 applies the model to show how factors contained in the model are 'in play' when they come to different types of activism. It concludes with a list of recommended reforms for more active shareholder engagement in the UK.

Chapters 6 to 9 move the thesis on to research on shareholder activism in China, which are conducted under a similar structure to that is used in the previous study of the UK. Chapter 6 lays the background knowledge of the Chinese corporate governance system and Chapter 7 explores the extent and features of Chinese institutional investors.

In order to explore the level of shareholder activism in China, Chapter 8 presents an empirical study I undertook of a total sample of 30 Chinese listed companies. After outlining the overall approach taken in the empirical study, this chapter surveys and analyzes the research results according to the 'typology of activism' developed in Chapter 5 (namely, private meetings, submitting proposals, proxy voting and derivative actions). The study finds that Chinese institutional shareholders have presented a much lower level of activism in corporate governance than their UK

counterparts. To ‘prove’, in relation to China, the model established in Chapter 1, Chapter 9 puts these empirical findings into the activism model to show how all this empirical knowledge is consistent with the predictions of the theoretical model.

Building upon the discussion in previous chapters, Chapter 10 ties the threads of this study together and offers policy implications for China. It begins with a brief discussion to justify why and how this thesis deals with the issue of borrowing a country’s experience by another. By comparatively indentifying how these factors driving activism play out differently between the UK and China, the analysis of Chapter 10 moves up to the essential questions of what China can learn from the UK’ s approaches and how these proposals can be implemented in China.

The Conclusion of the thesis provides a summary of research findings and offers avenues for future research.

0.4 Research Method

0.4.1 Library Search

This thesis is conducted primarily through a library-based research approach. It consists of the literature review from diverse sources, such as books, journals, magazines, newspapers, and websites of both Western and Chinese origin. It involves a process more complicated than accumulation of the materials; furthermore, it also integrates different arguments systematically and develops new thoughts about the theories in a creative way.

A note on sources: Late appearance of the Stewardship Code – the thesis tried to include its norms and applications in analysis, but unfortunately, little has been written about it so far[26] and no empirical evidence on its effectiveness.

[26] There are exceptions, for example, see Macneil (n 17); Brian R Cheffins, ‘The Stewardship Code’s Achilles’ Heel’, 73 The Modern Law Review 1004; A Reisberg, ‘The Notion of Stewardship from a

0.4.2 Empirical Study

In the UK, there is considerable evidence available for the investigation concerning the level of institutional shareholder participation in listed companies. However, in the Chinese context, despite institutional investment having gained increased popularity over the last few years, empirical evidence exploring the role of institutional shareholder in corporate governance is rare. To fill the gap, this thesis employs an empirical research method to probe the level of shareholder activism in China.

The study aims to achieve a twofold purpose. First, it intends to provide empirical evidence on the overall level of shareholder activism in Chinese listed companies. Secondly, the study compares data between companies with different levels of institutional share ownership and corporate governance standards, with an interest in how and to what extent shareholder activism varies between these different types of company.

For the research purposes above, a total of 30 companies were selected from the Chinese top 100 largest listed companies as the sample. The study selected the top 10 Chinese listed companies with largest investment funds' shareholding (categorized as Group A);[27] the top 10 companies which scored with best corporate governance performance (categorized as Group B);[28] 10 companies were randomly selected from the top 100 listed companies which are excluded by Group A and Group B (categorized as Group C).

Company Law Perspective: Re-Defined and Re-Assessed in Light of the Recent Financial Crisis?', available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1661011, accessed 10 March 2011.

[27] The largest institutional holding in Chinese listed companies by the end of 2009 is summarized by Hexun.com, a large financial securities website in China. The data only covers the proportion of securities investment funds (SIF)' holdings and the actual holding of total institutions is estimated higher than this data. However, since SIF' investment accounts for about 80% of all institutional assets, this ranking could still reflect the shareholding of institutions in Chinese listed companies.

[28] The assessment of corporate governance is conducted by Institute of World Economic and Political in Chinese Academy of Social Science in its 2009 nia Zhongguo Shangshi Gongsi 100 qiang gongsi zhili pInjia [Corporate Governance Assessment Report on the Top 100 Chinese Listed Companies for 2009],available at http://www.iwep.org.cn/, accessed 14 September 2009. The assessment is based on six criteria: rights of shareholders, equitable treatment of shareholders, role of stakeholders, disclosure and transparency, board responsibility, and supervisory board responsibility.

The data required for the present study were hand-collected from companies' websites, annual reports, quarterly announcements, as well as the announcements of the relevant governmental-institutions and stock exchanges. Through an analysis of data obtained, the study provides valuable evidence on the extent to which institutional shareholder in China monitor their portfolio companies.

0.4.3 Comparative Study

The thesis develops a comparative study between the UK and China in order to (1) explore the current level of institutional monitoring activities, survey developments and identify challenges institutions face in each country; and (2) observe and explain the differences and similarities between these two countries and explore whether the future development of institutional shareholder activism in China can be inspired by the UK's experiences.

The comparison between the UK and China is chosen based on the following considerations. First, the level of institutional shareholder engagement in UK listed companies has shown to be higher than of other countries. A survey on the implementation of the United Nation Principle for Responsible Investment, found that UK asset owners presented higher scores than peers from other countries and the total number of engagements reported by UK signatories far exceeded that of other countries.[29] Partly because of the higher level of institutional shareholder engagement, UK enjoys the reputation of being a leader in the area of corporate governance, scored as the top of 49 studies countries by a survey conducted by the World Bank.[30] By contrast, as we will see later, institutional shareholder activism is still relatively a new and rare phenomenon in China and Chinese corporate governance systems only ranked 44 out of 49 studied counties. Given the remarkable differences above, it is

[29] Report on implementation of the UN Principles for Responsible Investment cited in FRC (n 14) 3.73.

[30] World Economic Forum in 2003, results cited in Q Liu, 'Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants' (2006) 52 CESifo Economic Studies 415,452.

therefore interesting for us to inquiry what factors contribute to a more active role that institutional shareholders are currently playing in the corporate governance of investee companies in the UK.

The exploration of this issue is critical to the future development of Chinese corporate governance. In a system of concentrated shareholding such as China's, the purposes of institutional shareholder engagement is two-fold. The first and foremost task is to act 'in a supervisory capacity' to ensure effective monitoring and disciplining of controlling shareholders.[31] Second, as the same role that institutional investors play in the UK, they are expected to hold the board accounts. This role will become increasingly important in China when current concentrated share ownership is gradually diluted by virtue of the on-going program of split share reform in China.

For the above reasons, an in-depth survey on the UK's approaches to ensure greater institutional shareholder engagement will merit the attention of Chinese legislators and academics who wish to learn more about how shareholder involvement can be promoted. The shareholders' activism taking place and efforts made by the Government and academics in the UK would stand out as valuable experience to inspire the future development of shareholder engagement in China.

The second reason for the UK-China comparative study lies in the fact that the extent of shareholder involvement in the UK is not perfectly satisfactory as a result of a variety of economic and regulatory obstacles. As institutional shareholder activism is in its infant stage in China, identification of challenges UK institutions currently face would caution Chinese institutions that similar problems might emerge in future.

While good reasons exist for considering a comparative analysis on how institutional shareholders' activities take place in the UK and China, the presence of differing culture, legal systems and market conditions must be considered. The thesis therefore carefully takes these differences into account when measuring institutional

[31] B Cheffins, 'Current Trends in Corporate Governance: Going from London to Milan via Toronto ' (1999) 10 Duke Journal of Comparative and International Law 5, 40.

shareholder activism in these two countries. The potential risks involved in a comparative study will also be addressed in Chapter 10.

Chapter 1 A Theoretical Framework for Shareholder Activism

This chapter addresses what is really the most fundamental, core, question in my thesis: is activism by shareholders rational? I wish (unsurprisingly) to answer this affirmatively. And to develop this positive assessment of shareholder activism, I need to move in two stages. The first stage seeks to show that shareholder activism is *collectively* beneficial: it is part of a good corporate governance system that generates greater collective benefits than the (collective) costs it creates. The second move switches from the collective to the individual level of analysis. I wish to show the circumstances in which it is now, and could (with an appropriate regulatory framework) even more often be, in the *individual* interest of (at least many) individual institutional shareholders to engage in activism.

1.1 Is Collective Action by Shareholders Beneficial?

Is, then, shareholder activism collectively beneficial; are the collective benefits of some bout of activism likely to be greater than the collective costs? Or is the management of companies best left to managers, with minimal interference by shareholders? This clearly goes to the heart of the question whether shareholder activism is something to be encouraged and celebrated. In this section, I shall attempt to argue that activism can be beneficial to companies and therefore to their shareholders. I shall do so by confronting the arguments of those who criticize shareholder activism.

The starting point suggesting that shareholder activism can be beneficial is the *agency problem* stemming from a divergence between the interests of shareholders and

managers inherent in the corporate form of firm organization. This problem is well explained by Fischel:

> 'As residual claimants on the firm's income stream, shareholders want their agents-the firm's managers-to maximize wealth. Because managers cannot capture all of the gains if they are successful, and will not suffer all of the losses should the venture flop, they have less incentives to maximize wealth than if they themselves were the principals. Rather, managers have an incentive to consume excess leisure, perquisites and in general be less dedicated to the goal of wealth maximization than they would be if they were not simply agents.'[1]

The agency problem imposes, in economic terms, 'agency costs' on shareholders.[2] Kershaw suggests that agency costs comprise of 'direct transfers of value', such as self-dealing, senior management remuneration, and 'indirect agency costs', including shirking and incompetence.[3] Shareholder activism is collectively beneficial, then, insofar as it reduces agency costs by monitoring the agent's actions to ensure that he does not misbehave and to sanction him if he does, in both the UK and China.

In addition, institutional shareholder activism in Chinese listed companies provides a source of discipline on the controlling shareholders, ensuring that they are acting in the best interest of the minority shareholders. As one will see in following chapters, in contrast to the UK's 'outsider/arm's-length' system,[4] China has a 'insider/control-

[1] D R Fischel, 'The Corporate Governance Movement' (1982) 35 Vanderbilt Law Review 1259, 1262-3. This problem is also pointed out by Adam Smith in A Smith, *The Wealth of Nations* (Everyman, London 1977) 700.

[2] M C Jensen and W H Meckling, 'Theory of the firm: Managerial behavior, agency costs, and ownership structure' (1976) 2 Journal of Finance Economics 305, 308-9.

[3] D Kershaw, *Company Law in Context* (Oxford University Press, Oxford 2009) 169-71.

[4] A 'outsider/arm's-length' system suggests that the listed company has a widely dispersed share ownership and is run by a small group of managers who typically own no more than a small portion of the corporations' shares. For a discussion, see C Mayer, 'Financial Systems and Corporate Governance: A Review of the International Evidence' (1998) 154 Journal of Institutional and Theoretical Economics 144, 145-47, 159-60. There is a massive literature examining the ownership structure of UK listed

oriented' system of ownership and control, where listed companies typically have a 'block holder' – the *State,* which owns a sufficiently sizeable fraction of the voting shares to exercise considerable control over management.[5] As a result, apart from contributing towards managerial accountability, institutional shareholder activism can also achieve the benefit of reducing the majority-minority agency costs.

1.1.1 A Controversial Question Side-stepped

Having introduced the fundamental issue of agency costs, I must now note, but leave aside, one argument against the benefits of activism. This argument is put by some proponents of what is variously termed 'stakeholding', or 'corporate social responsibility'.[6] For these critics of shareholder activism, the objective of the company should not be understood in terms of single-minded loyalty to the interests of shareholders (by maximizing the profits available for distribution to shareholders, maximizing the wealth of shareholders, or so on). Rather, the very objective of the company is to be understood as involving some *balancing* of the interests of shareholders with the interests of a company's other stakeholders, or with the company's obligations to operate in a socially responsible way. And on this view of a company's objectives, the disadvantage of collective shareholder action is not that it may harm the interests of shareholders. Rather, it may sadly be all too effective in improving the position of shareholders, but it is likely as a result to harm the position

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companies, Cheffins provides a good summary in B Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press, Oxford 2008) 11-6.

[5] It is important to make clear here, that the state does not fall into the category of institutional investor. The role of the state in a company is significantly different from that of an institutional investor. They have very different objectives to each other. Institutional investors are normally bound by various fiduciary duty towards their clients while the state is not but it is always oriented by political purposes. For a fuller discussion of the ownership structure of Chinese listed companies, see Chapter 6.

[6] There is a rich literature discussing the stakeholding theory. Generally, see articles in D McBarnet, A Voiculescu and T Campbell (eds), *The New Corporate Accountability:Corporate Social Responsibility and the Law* (Cambridge University Press, New York 2007); A Crane and others (eds), *The Oxford Handbook of Corporate Social Responsibility* (Oxford University Press, New York 2008).

of the company's stakeholders, or to undermine the prospects of a company acting in a sufficiently socially responsible manner.

In this thesis, I am, however, *assuming* that the objective of those running companies is indeed to 'promote the success of the company for the benefit of its member' (as section 172 of the Companies Act 2006 puts it).[7] I accept that this view is not, as the previous paragraph acknowledges, universally held. However, due to constraints of space I shall not endeavour here to defend this (orthodox) view of the company, but will take it simply as an assumption for the arguments that I *do* wish to deal with.

So, what arguments against shareholder activism are put by those of its critics who nevertheless share my assumption that the purpose of companies is indeed to promote the interests of the company's members?

1.1.2 Objections to Shareholder Activism

Among other things, I shall consider claims that shareholder activism is detrimental to corporate value because of undermining board authority, because of information asymmetry and shareholders' the lack of expertise, because of shareholder short-termism and the special interests by which shareholders might be motivated; that other corporate governance mechanisms provide sufficient accountability; and that there is not sufficient empirical evidence supporting shareholder activism. After reviewing all these claims, I conclude that they do not, individually or collectively, form a sound basis against institutional shareholder activism.

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[7] For a general discussion of section 172 of CA 2006, See J Loughrey, A Keay and L Cerioni, 'Legal Practitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance' (2008) 8 Journal of Corporate Law Studies 79; P Omar, 'In the Wake of the Companies Act 2006: An Assessment of the Potential Impact of Reforms to Company Law' (2009) 20 International Company and Commercial Law Review 44; A Keay, *Directors' Duties* (Jordan, Bristol, 2009) 118-20; A Keay, 'The Duty to Promote the Success of the Company: Is it Fit for Purpose?' < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1662411> accessed 3 September 2010.

1.1.2.1 Adverse Effects on Shareholder Value (Damaging the Effectiveness of Central Board System)

1.1.2.1.1 Director Primacy Model

In a series of articles e.g. *Director Primacy: the Means and Ends of Corporate Governance,* [8] and one recent challenging monograph: *The New Corporate Governance in Theory and Practice,*[9] Bainbridge applies Arrow's theory in T*he Limits of Organization*[10] to argue the necessity of a centre of power capable of exercising fiat within the corporation. A central authority is often the only way to process information and to make collective decision for many thousands of members within a large organization.[11] Bainbridge therefore contends that the decision-making authority of a corporation shall be vested in a single, central organ – the board.[12] Bainbridge also agrees with Arrow that there is a need to maintain a trade-off between authority and accountability in an effective organization.[13] However, while he proposes a variety of mechanisms, including self-regulation, board internal dynamics and the use of market mechanism, as means of ensuring managerial accountability, he rejects the idea that shareholder activism should play a role.[14]

Bainbridge views shareholder activism as being detrimental to the board's authority. Encouraging shareholders to 'review management decisions, step in when

[8] S M Bainbridge, 'Director Primacy: the Means and Ends of Corporate Governance' (2003) 97 Northwestern University Law Review 547.
[9] S M Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press, Oxford 2008).
[10] K J Arrow, *The Limits of Organization* (Norton, New York 1974).
[11] Ibid, 68-69; Bainbridge, 'Director Primacy: the Means and Ends of Corporate Governance' , 557-58.
[12] S M Bainbridge, *The New Corporate Governance in Theory and Practice,* (n 9) 10; Also See S M Bainbridge, *Corporation Law and Economics* (Foundation Press, New York 2002)
[13] S M Bainbridge, 'Shareholder Activism and Institutional Investors' (2005) UCLA School of Law, Law-Econ Research Paper No. 05-20 <http://ssrn.com/paper=796227> accessed 13 December 2008
[14] S M Bainbridge, *The New Corporate Governance in Theory and Practice,* (n 9) 100-04, 55, 112, 113, 123, 151-52, 197-98.

management performance falters, and exercise voting control to effect a change in policy or personnel' will 'shift some portion of the board's authority to them' and ultimately undermine the optimality of the 'director primacy model'.[15]

Might shareholder activism damage board authority as Bainbridge fears? No. Shareholders do, and indeed should, have some ability to intervene in corporate management. The scope of power they have, however, is limited. As argued by Mcdonnell when he considers Bainbridge's director primacy model, shareholders would, as a matter of law, have restrained power to interrupt board authority.[16] Most of them only get one chance a year to question the board at the annual shareholders' meeting, and the agenda of that meeting is often usually controlled by the board. It is beyond the shareholders' legal power to intervene on most particular business decisions, and that will continue to be so even though shareholder are more actively participating in activism.[17] Instead, the board, if they want, can step in to make every decision within the corporation. Hence, shareholder activism helps to achieve board accountability but does not result in the board losing a substantial amount of its authority that Bainbridge fears. It therefore fits quite well with Arrow's position.

One way of examining the objections examined in the following sections is that, if they were correct, it would not be necessary for shares to be attached with votes at all. People who agree that it is important to let shareholders have a say on their own assets are unlikely to accept Bainbridge's objections set out above.

In addition to retaining authority, Bainbridge has two other subsidiary (and, I would suggest, less original) reasons to support his objections to shareholder activism. He

[15] S M Bainbridge, *The New Corporate Governance in Theory and Practice*, (n 9) 234.
[16] B H.McDonnell, 'Profeesor Bainbridge and the Arrowian Moment: A Review of *The New Corporate Governance in Theory and Practice*' (2009) 34 Delaware Journal of Corporate Law 139, 164-166.
[17] Ibid, 165.

claims that some investors may misuse their power to advance their private interests which conflict with those of other shareholders. And he also argues that a variety of other mechanisms (instead of shareholder activism) will sufficiently hold the board accountable. These two points will be discussed separately in sections 1.1.2.1.4 and 1.1.2.2 below.

The following section will first deal with a common argument against shareholder activism: information asymmetry and lack of expertise.

1.1.2.1.2 Information Asymmetry and Lack of Expertise

A main objection to shareholder activism is grounded on the informational and competence disadvantages that shareholders are likely to have vis-à-vis management.[18] Opponents contend that, firstly, unlike managers, shareholders neither have time to gather information nor have full access to inside information of a corporation or business; and secondly, if they gained information, they do not specialize in making 'sound decisions on either operational or policy questions.'[19] The argument goes, by virtue of those constraints, shareholder could make poor and wrong choices that might be detrimental to the interests of the company.[20] However, as the following counterarguments suggest, this viewpoint does not obviate the strong need for institutional shareholder engagement.

First, whether information is sufficient for a shareholder should be judged by the way he intends to use it. It is essential to bear in mind the objective or form that activism might take. Much activism will be concerned *not* with management of the company

[18] M Lipton and S A Rosenblum, 'A New System of Corporate Governance: the Quinquennial Election of Directors' (1991) 58 University of Chicago Law Review 187.
[19] S M Bainbridge, 'Shareholder Activism and Institutional Investors', (n 13) 6.
[20] J N Gordon, 'Shareholder Initiative and Delegation: A Social Choice and Game Theoretic Approach to Corporate Law ' (1991) 60 University of Cincinnati Law Review 347, 353-55.

but with its internal *governance arrangement*. Making a decision as to whether a governance arrangement is problematic commonly does not turn on company specific, inside information or professional ability. Consider, for example, the decision whether to separate the role of CEO from the chairman in a board structure. For UK investors, it is already a recommendation set out in the UK Corporate Governance Code.[21] Any company which does not adopt such a practice will be easily viewed as not-in-compliance with the Code. If the company offers an explanation, shareholders will determine whether the reasons given by the board of directors are acceptable and such decisions are unlikely to rely on inside information that corporate managers have but shareholders lack.

Even if shareholders gathered relevant information they need, the second argument mentioned above contends they lack expertise to process and respond to the information they obtain. This difficulty may be an obstacle to activism by individual, small shareholders. However, it is less of a problem for institutional shareholders who are professionally trained or equipped with specialists in corporate governance so as to detect and respond to managerial hazards more quickly and efficiently when the company's performance lags.[22]

In some cases, institutional shareholders devoting resources to specific concerns will be in even better positions to deal with governance issues than companies' executives. They encounter similar questions in many companies, and they will soon gain experience how to address such questions. Consider one example, to which I shall return in detail later, drawn from shareholders' 'Say on Pay'.[23] Davis found that

[21] A.2 of the UK Corporate Governance Code provides that 'the roles of chairman and chief executive should not be exercised by the same individual.'
[22] See Chapter 3.4.
[23] Chapter 5.2.2.2.3 will look at this issue in more detail.

feedback from those institutions helps management to modify their plan, for example, in the remuneration report, 'to revise plans, better anticipate and perhaps pre-empt resistance, and/or manage risks of opposition'.[24] They are, as reported by Grundfest, also *better* able to identify a sub-optimal governance structure than are incumbent boards.[25]

In addition, however, the question is *not* whether managers or shareholders have information advantages. The fact that management might sometimes have superior information does not necessarily suggest they also have sufficient incentives to make the right decision, given the divergence of interests between the manager and shareholders. By virtue of the agency problem, without shareholder monitoring, decision-making that is left to a small group, even if it has information advantage, might be poorer if that informational advantage is outweighed by weaker (or self-interested) incentives. Suppose, the argument that shareholders might make poor decisions is right, it may still be far less detrimental than misconduct of self-interested directors because the board can intervene in any particular management decision much more easily than can shareholders.

1.1.2.1.3 Short-termism

Shareholder activism might also be opposed on the ground of short-term horizons. The danger of short-termism is that some shareholders interested in gaining the

[24] S Davis, 'Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable' (2007) Millstein Center for Corporate Governance, Yale School of Managment <http://millstein.som.yale.edu/Davis_Say_on_Pay_Policy_Briefing.pdf> accessed 16 September 2009

[25] J A Grundfest, 'Advice and Consent: An Alternative Mechanism for Shareholder Participation in the Nomination and Election of Corporate Directors' (2003) Stanford Law and Economics Olin Working Paper No. 274 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=481021> accessed 12 May 2010 It is worth noting that Grundfest contends that institutional investors have a comparative advantage in identifying suboptimal governance structures, but that incumbent boards have a comparative advantage in rectifying those shortcomings, provided that the incumbents concur that the shortcomings are material.

maximum possible return in the shortest possible time might produce changes that are harmful to the long-term value of the corporation.[26] Again, however, several counter-arguments can be put.

Firstly, this contention that institutional shareholders are inevitably short-term investors is not supported by the evidence available. A study conducted by McConnell and Servaes found that the percentage of institutional ownership is positively related to a firm's Tobin's Q (ratio of market value to book value of a firm). It suggests that institutions are predominantly owners of firms with high-growth, low dividend where the investment payoff is far in the future.[27] Brav *et al.* also found that activist hedge funds[28] continue to hold for relatively long periods of time after an undervalued targeted company's share were restored, indicating that their activism is long-term in nature.[29]

Secondly, Black suggests, surely plausibly, that short-term institutions are the least likely to engage in monitoring, because the return from improvement is often long-term.[30] So, for example, one of the goals of much of the activism is to increase the independence of the board. Although it is likely to appoint more independent directors in a relatively short time, the increased value from such activism takes time to be realized.

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[26] S M Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119 Harvard Law Review 1735, 1754-55; R Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered' (1993) 93 Columbia Law Review 93 .

[27] J J McConnell and H Servaes, 'Additional Evidence on Equity Ownership and Corporate Value' (1990) 27 Journal of Financial Economics 595.

[28] Hedge funds will be introduced in Chapter 3.2.4.

[29] A Brav and others, 'Hedge Fund Activism, Corporate Governance, and Firm Performance ' (2008) 63 Journal of Finance 1729, 1766.

[30] B Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 UCLA Law Review 811, 863.

Thirdly, as Macey puts it, rational institutional shareholders will support any long-term value-enhancing decisions by companies even if those decisions will take many years for companies to receive payoff because '*the expected future cash flows*' will have an immediate impact on company's share price.[31] The expected future cash flows will be discounted to present value by the market and reflected in a company's current share prices.

1.1.2.1.4 Special Interests

Opponents of shareholder activism question whether some investors will act in the best interests of the corporation, or will instead advance their particular self-interests.[32] Some shareholders, it might be argued, have their special interests, such as social, environmental, or others at play and might consequently favor changes that serve their own agenda but not the long-term corporate value.[33] This concern, however, does not undermine the strong case for shareholder activism.

Considering this argument we should repeatedly bear in mind that all resolutions shall be approved with a minimum 50% of votes cast at shareholders' meetings. Most shareholders will embrace issues that enhance the overall value of the corporation, or those which a broad range of shareholders otherwise find important.[34] Changes proposed by investors who seek to advance their own self-interests are not likely to gain the support of other non-special shareholders.[35]

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[31] J Macey, *Corporate Governance:Promises Kept, Promises Broken* (Princeton University Press, Princeton, N.J. 2008) 266. A point is important to be noted here. This thesis is not suggesting that share market perfectly/fully values future improvements, only that it sometimes does so.

[32] M Lipton and S Rosenblum, 'Election Contests in the Company's Proxy, An Idea Whose Time Has Not Come' (2003) 59 Business Lawyer 67, 82-83.

[33] Bainbridge, 'Director Primacy and Shareholder Disempowerment' (n 26) 1754; Bainbridge, *The New Corporate Governance in Theory and Practice* (n 9) 202-09.

[34] S J Schwab and R S Thomas, 'Realigning Corporate Governance: Shareholder Activism by Labor Unions ' (1998) 96 Michigan Law Review 1018, 1041-42.

[35] Schwab and Thomas, ibid, 1035-36 (noting that labor initiative cannot succeed without the support

The mutual checks and balances amongst shareholders could work more strongly in the institutional shareholder community since it is relatively small and closed. Short and Keasey, for example, found that institutional investors in the UK form a highly concentrated network, often operating in the 'confines of the (London) Square Mile with a well-developed history of relationships and communication'.[36] Institutional investors may therefore know a lot about one other. Black compared shareholder voting to a repeated game without a final period and those players who cheat will invite retaliation, which creates incentives not to cheat.[37] Another likely reason for a stronger mutual monitoring amongst institutional investors lies in the professional ability they own. They are enabled to make efficient and quick judgments on others' proposal whether it is in the best interests of the corporation.

Indeed, a similar point has been raised by Bainbridge himself, but in relation to directors, when he argues that board members will monitor each other.[38] He contends that mutual monitoring among board members, 'enforced through peer pressure and reputational sanctions', will provide important constraints on behavior, making it much harder for a director to pursue self-dealing when she is part of a group.[39] Whilst resisting some of the other arguments Bainbridge puts forward, this point seems correct. And, crucially, it can be applied to the group of institutional shareholders. For the reasons above, institutional investors may impose some discipline on each other.

It must, to be sure, be conceded that if many shareholders do not vote their shares at the meeting, the self-interested shareholders might win their proposals. However, this

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of other shareholders); also L A Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 Harvard Law Review 833, 883.

[36] H Short and K Keasey, 'Institutional Shareholders and Corporate Governance' in K Keasey and M Wright, *Corporate Governance: Responsibilities, Risks and Remuneration* (Wiley, Chichester; New York 1997) 23, 34.

[37] Black (n 30) 861.

[38] Bainbridge, *The New Corporate Governance in Theory and Practice* (n 9) 100-04.

[39] Ibid.

issue is better addressed not through discouraging all activism, but instead through encouraging more voting to ensure that the collective interests of shareholders prevail.

Moreover, even accepting that some funds do sometimes have different special interest concerns, often their interests will *not conflict* with those of other shareholders. In the UK and China, as we will see later, institutional investors have often been focused on questions of procedure and/corporate governance, such as pay for performance, independent directors, board structure and compliance of corporate governance codes. In the US, Bebchuk and Mcdonnel found that the types of proposal that were most common and received the highest percentage of votes were those calling for de-staggering the board, pay for performance and independent board chairs.[40] Thus, broad corporate concerns, as opposed to personal interests, are prominent in institutional shareholders' agendas for engagement. It seems hard to see that these issues would lean heavily to special shareholder interest.

Finally, although, as we shall concede, shareholders do suffer weaknesses as controller of executives, nevertheless it is crucial to note that they do enjoy one overwhelming advantage in their favor: they have the strongest incentives to exercise effective control. If anyone has an interest to make decisions that would always be at the best interests of shareholders, the shareholders, by definition, do.

1.1.2.2 Other Corporate Governance Devices Provide Sufficient Accountability

Some opponents of shareholder activism believe that institutional shareholder monitoring is not necessary because there are sufficient alternative, and effective,

[40] L A Bebchuk, The Case For Increasing Shareholder Power, (n 35) 884; McDonnell, (n 16) 178.

mechanisms to ensure the board's faithfulness.[41] These alternative mechanisms include: 1 market forces such as the market for corporate control; 2 executive remuneration; 3 monitoring by non-executive directors; and 4 independent audit of the preparation of financial statements.

These mechanisms all pose some constraints on the agency problem. However, as I shall argue below, they all have their own weaknesses and thereby individually, and collectively, they fail to build a perfect monitoring framework on the board. As such, there is much need for shareholder monitoring. Black has eloquently explained this point:

> 'The case for institutional oversight, broadly speaking, is that (other mechanisms, such as) …….corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available.'[42]

The general point I wish to make here is that shareholder activism can and should be viewed as one strand in the web of mechanisms to constrain agency conflicts, rather than arguing that shareholder activism is alone sufficient, or even necessarily superior, to the others. It fits into a broad range of monitoring devices as mentioned above and, *complements* and *strengthens* those mechanisms to reduce the divergence between the interests of managers and shareholders. As we will see in later chapters, monitoring by institutional investors is already a significant element to facilitate other devices, such as remuneration and board structure, and a growing but less significant part of the Chinese scene.

[41] Bainbridge, 'Director Primacy and Shareholder Disempowerment' (n 26) 1741.
[42] Black, Agents Watching Agents (n 30) 815.

1.1.2.2.1 A Summary of Alternative Monitoring Mechanisms

In order to understand the necessity of shareholder activism, it is important to consider both the advantages and limits of these mechanisms, and also how shareholder activism can, in fact, itself actually strengthen each of them.[43] It is worth emphasizing that the discussion here is relatively brief; my intention is to summarise the limits of these alternative mechanisms and to point the reader to further relevant literature, rather than providing an exhaustive analysis of their precise effectiveness.

1. The Market for Corporate Control

Many economists and scholars accord an essential role to the market for corporate control in enhancing managerial accountability.[44] The theory believes that the threat of takeover can provide management with an incentive to perform diligent on the behalf of shareholders. The incumbent management who do not actively seek to maximize shareholder-return will fail in the market and be replaced by others through a hostile takeover.[45]

While the market for corporate control can be seen as a disciplinary instrument to reduce agency costs, it is, nonetheless, imperfect and has become increasingly weak in recent years.[46] Takeovers occur only for companies that perform quite badly – a situation that leaves a lot of room for 'slacking off in board performance'.[47] Coffee

[43] For an extensive study on corporate governance, see, A Shleifer and R Vishny, 'A Survey of Corporate Governance' (1997) 52 Journal of Finance 737.
[44] H G Manne, 'Mergers and the Market for Corporate Control' (1965) 73 Journal of Political Economy 110, 112; see also F H Easterbook and D R Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 Harvard Law Review 1161, 1169.
[45] E F Fama, 'Agency Problem and the Theory of the Firm' (1980) 88 Journal of Political Economy 288.
[46] S Sudarsanam, *Creating Value Through Merger and Acquisitions: The Challenges, an Integrated and International Perspective* (FT Prentice Hall, Harlow 2003); J Barnard, 'Narcissism, Over-Optimism, Fear, Anger, and Depression: The Interior Lives of Corporate Leaders' (2008) 77 University of Cincinnati Law Review 405.
[47] L A Bebchuk, 'The Myth of the Shareholder Franchise ' (2007) 93 Virginia Law Review 675, 714.

observes that 'the hostile bidder, as an external monitor, is unlikely to be the first to detect or respond to managerial inefficiency.'[48] Moreover, it is a very expensive way of changing management, either mounting a takeover or defending against it, and thus results in controversy about whether this mechanism is in fact beneficial for the economy and shareholders.[49] Furthermore, as evidenced in the recent financial crisis, the market is not always reliable, for it encouraged managers to make irrational risk-taking decisions.[50] Also there is much empirical evidence that doubts how far corporate performance improves after takeovers.[51]

Last but not least, in any case in a market like China, the hostile takeover has rarely been an effective mechanism for corporate governance because of the over-concentration of share ownership in most listed companies.[52]

2. Remuneration

Properly designed remuneration such as the use of profit related pay and equity-based compensation can help to align the management's interests with those of

[48] J Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1202.
[49] See generally A Peacock and G Bannock, *Corporate Takeovers and the Public Interest:report of an inquiry conducted for the Joseph Rowntree Foundation by the David Hume Institute* (Aberdeen University Press, Aberdeen 1991); L Stout, 'Do Antitakeover Defenses Decrease Shareholder Wealth-The Ex Post/Ex Ante Valuation Problem' (2002) 55 Stanford Law Review 845; J Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (2007) 59 Stanford Law Review 1465, 1522.
[50] R Tomasic, 'Corporate Rescue, Governance and Risk Taking in Northern Rock: Part 2' (2008) 29 Company Lawyer 330.
[51] A Singh, Singh, Alaka and B Weisse, 'Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging Markets' (2002) Centre for Business Research, University of Cambridge Working Paper No. 250 <http://www.cbr.cam.ac.uk/pdf/WP250.pdf> accessed 25 March 2010, 29; J Franks and C Mayer, 'Hostile Takeovers in the UK and the Correction of Managerial Failure' (1996) 40 Journal of Financial Economics 163; W Schwert, 'Hostility in Takeovers: In the Eyes of the Beholder?' (2000) 55 Journal of Finance 2599 (The same conclusion was made in respect of the USA).
[52] H Huang, 'China's Takeover Law: A Comparative Analysis and Proposals for Reform' (2005) 30 Delaware Journal of Corporate Law 145, 153; J Chiou and Y Lin, 'The Structure of Corporate Ownership: A Comparison of China and Taiwan's Security Markets' (2005) 6 Journal of American Academy of Business 123; Lay-hong Tan and J Wang, 'Modelling An Effective Corporate Governance System for China's Listed State-owned Enterprises: Issues and Challenges in A Transitional Economy' 7 Journal of Corporate Law Studies (2007) 143, 153.

shareholders.[53] However, concerns about excesses in executive remuneration and the 'insufficient sensitivity of management' compensation to performance' have cast doubt on the effectiveness of remuneration to discipline management.[54]

First, Bebchuk and Fried observed that most highly compensated managers have essentially been able to set their own pay through their domination of the board.[55] Coffee also found that incentive schemes may stimulate some executives to hide the company's loss or reduction of profits for the purpose of avoiding the drop of their income.[56] Moreover, a number of studies have shown that there is only a very weak or sometimes no link between compensation and firm performance or shareholder wealth.[57]

3. Board Structure (non-executive/supervisory board/independent directors)

Another way in which agency costs can be reduced is by increasing the role and importance of monitoring independent directors on the board. The thrust of the argument is that those independent directors can monitor and control effectively the activities of the executives on the board, on behalf of shareholders. However, there has been considerable debate over the effectiveness of those independent directors.

[53] J Donald H. Chew and S L Gillan (eds), *Corporate Governance at the Arossroads: A Book of Readings* (McGraw-Hill, Boston 2005) 189.
[54] M Becht, P Bolton and A Röell, 'Corporate Governance and Control ' (2002) ECGI - Finance Working Paper No. 02/2002 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=343461>accessed 12 May 2009.
[55] L A Bebchuk and J M Fried, 'Pay Without Performance: Overview of the Issues ' (2005) 30 Journal of Corporation Law 647; L A Bebchuk and J M Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press London 2006.
[56] J Coffee, 'A Theory of Corporate Scandals: Why the USA and Europe Differ' (2005) 21 Oxford Review of Economic Policy 198; Also C Schipani, 'Who Can You Trust? Backdating in the Executive Suite'(2008) 29 Company Lawyer 196; M Narayanan et al., 'The Economic Impact of Backdating of Executive Stock Options' (2007) 105 Michigan Law Review 1597, Schipani and Narayanan found that remuneration schemes may lead executives to manipulation, for example, by 'backdating' of stock options.
[57] Examples of these studies include: M C Jensen and K J Murphy, 'Performance Pay and Top Management Incentives' (1990) 98 Journal Political Economy 225; M Ezzamel and R Watson, 'Executive Remuneration and Corporate Performance' in Keasey and Wright (n 36) 61.

First, whether non-executive directors are truly independent from corporate management is often a matter of controversy. Jensen argued that 'outside directors with little or no equity stake in the company could effectively monitor and discipline the managers who selected them has proven hollow at best.'[58] Doubts also centre on whether independent directors have sufficient professional ability to monitor managerial behaviours.[59] Moreover, there is some empirical evidence showing that the link between board composition and firm performance is not significant or even negative.[60] Similar conclusions have been drawn in respect of China, where the system of independent directors is considered as being of more symbolic than practical value. Theoretical arguments and empirical evidence both suggest that the independence of these directors is often limited.[61]

4. Audit

As it names indicates, the role of the audit is to check and examine the information relevant to corporate management and its operation. Again, there are also problems with auditors as monitors of management performance. Concerns have been raised

[58] M C Jensen, 'Eclipse of the Public Corporation ' (1989) October Harvard Business Review 61, 64; Also see C Elson, 'The Enron Failure and Corporate Governance Reform' (2003) 38 Wake Forest Law Review 855.

[59] T Kirchmaier, 'Inject Governance, and Not Just Cash: Some Thoughts on the Governance of the Banks' (2008) < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1303202> accessed 10 August 2009.

[60] See generally, A Agrawal and C Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders' (1996) 31 Journal of Financial and Quantitative Analysis 377; B Bhagat and B Black, 'The Non-Correlation Between Board Independence and Long-term Firm Performance' (2002) 27 Journal of Corporation Law 231; D Finegold, G S Benson and D Hecht, 'Corporate Boards and Company Performance: Review of Research in Light of Recent Reforms ' (2007) 15 Corporate Governance: An International Review 865 872; N Ozkan, 'CEO Compensation and Firm Performance: an Empirical Investigation of UK Panel Data' (2007) European Financial Management <http://onlinelibrary.wiley.com/doi/10.1111/j.1468-036X.2009.00511.x/full> accessed 20 Apirl 2010(finding that proportion of non-executive directors on board does not have a significant impact on CEO' pay).

[61] D Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125; JinXin Securities Research Institute, 'Xianzhuang Diaocha: Duli Dongshi Zenmeyang Le? [A survey of the current independent director system]' *Zhengquan Shibao [Securities Times]* (August 2003); J Shan and S Zhang, 'An Empirical Analysis of Independent Directorship and Corporate Performance in China' in R Tomasic and others (eds), *Corporate Governance:Challenges for China* (Law Press, Beijing 2005) 48-72; Tan and Wang (n 52) 157-9.

that auditors sometimes ‘work for’ management rather than ‘work with’ management to play their monitoring roles.[62] In China, studies have doubted whether auditing system could truly contribute to enhanced managerial accountability in practice.[63]

1.1.2.2.2 The Role of Shareholder Activism in the Web of Monitoring Mechanisms

The above discussion suggests that other corporate governance mechanisms are all deeply imperfect and thus do not obviate the need for shareholder monitoring. Shareholder activism will strengthen and maximize the effects of these mechanisms and together work in conjunction with them to maintain managerial accountability.[64]

When the market for corporate control fails to be the first to detect managerial problems, shareholders activism can work as ‘an earlier tripwire’ to respond to managerial inefficiency and help management to improve corporate performance before an expensive takeover comes. It monitors the design of remuneration contracts that managers currently make for themselves, assuring linkage to performance over prolonged periods of time.[65] For example, in the UK, recent studies suggest that investors are willing either to withhold their votes or to vote against the board’s remuneration plans.[66] Institutional shareholder engagement is proven to be effective

[62] D J Hatherlya, 'The Future of Auditing: the Debate in the UK' (1999) European Accounting Review 51, 8; D A Moore and others, 'Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling' (2006) Academy of Management Review <http://www.people.hbs.edu/mbazerman/Papers/Conflicts%20of%20Interest.pdf> (They are concerned the same issue from a US perspective).
[63] M DeFond, T J Wong and S Li, 'The Impact of Improved Auditor Independence on Audit Market Concentration in China' (1999) 28 Journal of Accounting & Economics 269; J Lin and others, ‘The Roles, Responsibilities and Characteristic of Audit Committee in China’ (2008) 21 Accounting, Auditing and Accountability Journal 721.
[64] A Agrawal and C Knoeber (n 60) (arguing various control devices can complement and strengthen for one another).
[65] Ozkan (n 60) (He found that institutional ownership has a positive and significant influence on CEO pay-for-performance sensitivity of option grants). For an example, see M Dickson, ‘Tesco and the Winds of Political Correctness’ *Financial Times* (13 June 2003).
[66] See the ABI/IVIS Review (2009)

in mitigating 'rewards for failure' at companies with controversial CEO compensation practices through enhancing the link between pay and performance.[67]

Whether the system of board structure could function effectively depends clearly on the independence of these monitoring directors. The corporate governance system needs active shareholders to ensure that the board remains strong and independent – as in the following example, through replacing the Chairman if needs be.[68] The aborted bid for AIA Insurance by Prudential Insurance, for example, has prompted some of its own institutional shareholders to call for a new, strong independent chairman.[69] It is a good example of how the monitoring board probably works best when it works in conjunction with shareholder activism.

To facilitate the system of audit to function more effectively, institutional shareholder activism can monitor the independence of auditors, reducing at least a little the risk of auditors being affected by strong executives. Meanwhile, the audit system will provide necessary information for shareholders to evaluate the work of managers.

<http://www.abi.org.uk/Media/Releases/2010/04/IVIS_Review_2009_.aspx> accessed 12 July 2010; and K Sheehan, 'Is the Outrage Constraint an Effective Constraint on Executive Remuneration? Evidence from the UK and Preliminary Results from Australia ' (2007) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=974965> accessed 12 August 2010

[67] F Ferri and D Maber, 'Say on Pay Votes and CEO Compensation: Evidence from the UK', Working Paper, 4 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420394> accessed 20 May 2010.

[68] Another notable example is the proposed takeover of the London Stock Exchange by Deutsche Borse at the end of 2004. The proposal was blocked by some institutional investors of Deutsche Borse and the Chairman and CEO were removed. See L Cohen 'A Little Fund with Big Demands' (23 May 2005) < http://www.businessweek.com/magazine/content/05_21/b3934161_mz035.htm > accessed 12 May 2008; R Stevenson 'Revel Deutsche Investor to Force Vote on LSE Bid' *Independent* (17 January 2005) <http://www.independent.co.uk/news/business/news/rebel-deutsche-investor-to-force-vote-on-lse-bid-487078.html > accessed 12 May 2008.

[69] P Davies and K Burgess, 'Pru Investors Turn Focus on McGrath', *Financial Times* (London 16 June 2010) <http://www.ft.com/cms/s/0/987c085e-7984-11df-b063-00144feabdc0.html> accessed 23 June 2010. However, it is still worth noting here that the removal is not successful partly because of the split amongst shareholders in regard to the replacement for the chairman. See, P Davies and K Burgess, 'Fresh Question Over Prudential Chairman' *Financial Times* (9 July 2010) < www.ft.com/cms/s/0/19374422-8b96-11df-ab4d-00144feab49a.html> accessed 19 September 2010.

To recapitulate, the disciplinary framework contains a number of mechanisms and they all provide some constraints on agency problems. However, a brief examination of some major control devices has revealed that there are flaws to constrain their effectiveness. The above also suggests that they will probably function best when they work in conjunction with shareholder activism. As such, there is still much room for institutional shareholder activism and it remains an essential link in the web of mechanisms for managerial accountability.

1.1.3 Is there Empirical Evidence to Support the Collective Benefit of Shareholder Activism?

Thus far I have argued, theoretically, that shareholder activism can play an effective role in corporate governance, producing value-enhancing improvement in corporate behaviour (recall that I am still concerned with the benefits of *collective* action: I am not yet asking whether, for an *individual* shareholder, activism can be 'rational'). It is a fair question to ask: is there any empirical evidence to prove shareholder activism certainly yields positive share returns. Unfortunately, current evidence is inconclusive, providing conflicting results. Some empirical studies suggest activism has indeed produced value creation on the corporation,[70] while some studies suggest that shareholder activism has little or no link to share value and earnings.[71]

However, a careful examination of these results tends to cast doubts on the relevance of their findings. *First*, some studies used 'share prices' as a 'surrogate' for improved

[70] See, for example, S Wahala, 'Pension Fund Activism and Firm Performance' (1996) 31 Journal of Financial and Quantitative Analysis 1; and J M Nelson, 'The "CalPERS effect" Revisited Again' (2006) 12 Journal of Corporate Finance 187.

[71] See, for example, J Karpoff, P Malatesta and R Walkling, 'Corporate Governance and Shareholder Initiatives: Empirical Evidence' (1996) 42 Journal of Financial Economics 365; S L Gillan and L T Starks, 'A Survey of Shareholder Activism: Motivation and Empirical Evidence' (1998) 2 Contemporary Finance Digest 10, 28; and R Romano, 'Less Is More: Making Shareholder Activism A Valued Mechanism Of Corporate Governance' (2001) 18 Yale Journal on Regulation 174, 187-89.

performance but the share market might not accurately reflect economic changes after shareholder activism. Measuring the impact of shareholder activism alone is always *difficult* – there may be too much 'background noise' to measure the outcome of activism alone.[72] Shareholder activism may only account for a bit of the picture of a corporation as lots of other things also are happening at the same time which could potentially overwhelm the impact of shareholder activism on corporate value. Suppose, in an attempt to elect an independent director in the board, nine institutional shareholders of British Airways (BA) formed a coalition and successfully won the support of a majority of votes. However, soon after the election, the cabin crew of BA started strikes in a dispute over pay and staff levels, and the share price of BA fell sharply. Under such circumstances, it is difficult to ascertain what, if anything, the activism of electing an independent director contributed to that change in share price.

Second, some studies measure the effect of shareholder activism through the stock market returns around the announcement of such activism or voting outcomes on the proposals. But these are *short-term* reactions. It may be the case that improvements resulting from shareholder activism are long-term. Here, take the example of independent director again. While we can observe there are more independent directors, the benefits from enhanced monitoring often take a long time to be realized. As noted earlier, the market does sometimes value future benefits, however, it cannot perfectly capture improvements achieved by shareholder activism.[73]

Thirdly, most of those studies are concerned with the link between market performance and shareholders proposals, while this type of activism, as one will see later, is *not* often used by institutional investors in both the UK and China.[74] In an

[72] Gillan and Starks, ibid, 27.
[73] See texts in footnote 30.
[74] See Gillian and Starks, Ibid, Table 2. They summarize 23 empirical studies of shareholder activism

attempt to avoid public confrontation, much institutional shareholder activism in these two countries is conducted through private meetings 'behind the scenes'. This causes difficulty for outsiders to investigate such virtually invisible activity and thus, not be included in most studies.[75] Therefore, the effect of shareholder activism might not be accurate if the full set of shareholder activism is not observed.[76]

Lastly, some of the studies that found no link between activism and corporate performance come from the US.[77] But these could merely reflect the legal obstacles to activism in the US. As the governance mechanisms in the US are distinct from, and in many ways more restricted than, those in the UK and China, the studies on the impact of shareholder activism would also be different. For instance, the US often adopts the plurality voting system, which allows directors to be elected by the highest number of supporting votes, not necessarily the majority of votes.[78] Moreover, many votes on the management of a company at shareholders' meetings are indicative instead of binding. Thus, scholars point out that such system hampers the ability of shareholder activism to have a positive influence on corporate value creation.[79] Under UK and Chinese corporate laws, as one will see later, shareholders are granted a considerably larger scope to exercise their rights over corporations. Therefore, as several US scholars have noted, the governance conditions in the UK provide a more favorable

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and 21 of them focused on the type of shareholder proposal.

[75] M Goergen, L Renneboog and C Zhang, 'Do UK Institutional Investors Monitor Their Investee Firms' 8 Journal of Corporate Studies (2008) 39, 40.

[76] S L Gillan and L T Starks, 'Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective' (2003) 13 Journal of Applied Finance 20.

[77] For example, Romano (n 71); S Wahal, 'Pension Fund Activism and Firm Performance' (1996) 31 Journal of Financial and Quantitative Analysis 1.

[78] M Becht and others, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2009) 22 Review of Financial Studies 3093, 4-5, B Black, 'Shareholder Passivity Reexamined' (1990) 89 Michigan Law Review 520.

[79] See Becht et al., ibid, 3-5; B Black and J Coffee, 'Hail Britannia?: Institutional Investor Behavior under Limited Regulation' (1994) 92 1997, 2003.

environment for activism, increasing the likelihood that such activism will yield positive corporate returns.[80]

Taken together, existing studies present unclear results because of the difficulties above to measure accurately the impact of shareholder activism on corporate value. In spite of that, there is nevertheless some positive evidence to support my position that shareholder activism is value-enhancing.

A recent study, for example, conducted by Becht *et al*. on a UK-based fund – Hermes – found a high correlation between enhanced corporate value and shareholder activism on the part of institutional investors. In 1998, Hermes launched the UK Focus Fund with a mandate to invest in under-performing companies, but with the declared aim of working in co-operation with management through exercising shareholders' rights to increase share returns.[81] Becht *et al.*'s study, based on data that is not in the public domain, including fund's letters, presentations, transcripts and recording of telephone conversations, and client reports, found a high correlation between increased share return and shareholder engagement by Hermes.[82] Hermes' intervention has generated annual raw returns net of fees of 8.2% or 4.9% if measured by the abnormal returns against the FTSE All-Share Index over the period 1998-2004.[83] Impressively, 90% of such returns are attributable to its engagement activism.[84]

In the Chinese context, studies that explore the link between shareholder activism and corporate governance are sparse. However, the evidence available also shows a

[80] Ibid.
[81] Hermes will be introduced in detail in Chapter 3.
[82] Becht and others, (n 78).
[83] Ibid.
[84] Ibid.

positive relation between institutional ownership and various measures of corporate performance. Yang and Wang investigated 901 companies listed in Chinese stock exchanges over the period of 2000 to 2005 and concluded that overall, institutional shareholders play a positive role in improving firm performance.[85]

Taking them as a whole, the empirical evidence is regrettably inconclusive, but there is certainly some evidence supporting the argument that shareholder participation would enhance managerial accountability, curb misuse of authority and decrease the amount of misconduct. This increased accountability, then, should result in a reduction of agency costs and translate into increased share value.

1.2 Understanding *Individual* Shareholder Activism

Suppose, then, that some action by shareholders will indeed be beneficial to the interests of shareholders *collectively*. Does it follow that it is in the interests of each *individual* shareholder to be active too? If it did so follow, then we would expect shareholder action to be widely practiced. However, whether individual action is likely to happen depends upon the motivations that drive *individual* investor action. Perhaps the dominant explanation for individual action in recent years has been an *economic* one, and it is with that I shall begin.

On this approach, an individual investor (including institutional shareholder) will take part in some shareholder action where it is in its own interests to do so. And since institutional shareholders are assumed to be essentially financial institutions, this boils down to whether it is in the shareholder's financial interests to undertake some

[85] Z Yang and Z Wang, 'The Role of Institutional Investors in Chinese Corporate Governance' (2008) 6 China: An International Journal 151.

instance of activism. The individual shareholder will calculate the costs and the likely benefits of its acting, and will either act, or not, according to that calculation.

Now, it might seem from the foregoing that this calculation should proceed as follows. A shareholder will calculate the total benefits to the company as a whole secured by some collective action. It will then work out what proportion of that total benefit the individual shareholder will secure, where that proportion is the same as the proportion of the company's shares the shareholder holds (so an institution holding, say, 5% of the company's shares will thereby keep 5% of the total corporate benefit earned by some collective action). Finally, the shareholder will then calculate its individual costs of participating in the collective action. And only if its share of the total collective benefits outweighs its own individual costs of action will the institution bother to act.

However, the position is *yet more complex* than this, for it raises the 'problem' of collective action (sometimes also called the 'free-rider' problem), to which I turn next.

1.2.1 The Logic of Collective Action

The so-called collective action problem was famously identified by Olson in his classic *The Logic of Collective Action: Public Goods and the Theory of Groups*.[86] The problem that Olson identifies is not just that the individual shareholder will capture only a small fraction (equivalent to the proportion of the company's total share capital the shareholder owns) of the total gains accruing to the company from the collective action, and that this small fraction may be less than the individual shareholder's costs of action. Worse than this is the fact that the individual shareholder's own contribution to the success of the collective action is unlikely *to be decisive*.

[86] M Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Harvard economic studies, Harvard University Press, Cambridge, Mass 1965) 14.

Accordingly, each shareholder will reason as follows. *Either* enough other shareholders will participate in the collective action to ensure it is successful, so that my contribution is unnecessary. *Or* so few others will participate that, even if I join in the action, it will still fail. Moreover, any positive return from monitoring/activism will go to all shareholders regardless of whether or not they have participated, or contributed to the monitoring/activism. My own participation, then, will either be unnecessary (the action will succeed anyway, and I'll still be able to free-ride on others' efforts and share the gains they have generated) or it will be ineffective. Either way, logically, I should not join in. Another way of expressing this seems to be that whatever the benefits of the collective action may be, *the benefits of my own participation* will be nothing. On this view, it does not really matter what the costs of the shareholder's actions may be: given a zero benefit from my action, then *any* costs, *however small*, make my own action irrational, economically speaking.

How can we respond to this analysis? How can we explain any individual institutional activism in the face of this apparent barrier of the logic of collective action/free-riding?

I wish to argue that this logic can indeed (sometimes) be overcome for individual shareholders, but that it entails a more complex analysis of shareholder activism. And, in particular, it in turn requires a *two-step* analysis. First, we must show that, for an individual investor, its own activism will indeed make a difference to the outcome of a collective action. Thus, it will perceive that 'free riding' is not an option; were it to sit back and do nothing, then it would either mean that some collective action would fail (meaning that no one would benefit), or that the inactive shareholder would be denied some individual benefits – that some individual benefits would be secured only if it individually took action. That first step, then, suggests that individual action will be necessary for an individual shareholder to gain some benefits. The second step

proceeds to ask whether, for the shareholder in question, its individual benefits would still be greater than its individual costs. In the following section, I shall deal with the 'first step': when is free-riding not an option, so that a shareholder would think it must act in order to gain some individual benefits? I shall suggest four factors that can make free-riding an individually irrational policy for some shareholders.

1.2.2. Step 1: Overcoming Free-riding

1.2.2.1 The Decisiveness of Large Individual Institutional Holdings

First, voting in a company differs fundamentally from a political election where no one voter is ever likely to make a difference to the outcome of the election. The size of some shareholders' holding may be sufficiently large to 'tip the balance' between failure and success. Of course, a shareholder, even one with 3 or 4 or 5 etc. per cent of the company's shares, cannot be *sure* that its own holding will be sufficient to change the outcome of, say, a contested vote, or a private meeting where a change in corporate policy is demanded. But the point is that the larger the shareholder's holding, *the greater the chance* that its votes may be decisive (a likelihood that never really arises in a one person-one vote political election). And this is one reason (but not the only reason) why we would expect to find that the larger a shareholder's holding of shares, the greater the likelihood that it will indeed be active. Mallin, for example, notes that there should be a positive correlation between the proportion of shares held in a company and the propensity to vote those shares.[87] Taking the Prudential as an example, of its total disclosable interests,[88] only 5.6% are in the companies with the lowest level of voting, while the largest proportion of Prudential's

[87] C Mallin, 'Investors' Voting Rights' in Keasey and Wright (n 36) 160.
[88] A substantial holding of 3% or 5% in a company is required to be disclosed in the company's annual report, in the UK and China, respectively. See UK Financial Services Authority Handbook, Disclosure and Tranparency Rules 5.1.2.R., and Chinese Securities Law 2005 s 86.

disclosable interests (28%) are in companies with voting levels of 35-40%.[89] That suggests that institutional investors will vote their shares in the companies in which they have sufficiently large shareholdings.

1.2.2.2 The Possibility of Concerted Action

Second, the Olson logic assumes that those who decide whether to act do so 'in isolation'. A potential actor (shareholder) is assumed not to agree with others that she will act *if they will also do so*. In that respect, it is modeled as a 'Prisoner's Dilemma'.[90] However, if shareholders can explicitly agree with others that each will join in an action if the others will do likewise then, together they may have enough votes to tip the balance. The practicality of such coalitions by agreement are, as we shall see later, significantly increased to the extent that share ownership is more concentrated, so that fewer shareholders need to agree to act together in order to constitute a decisive block of shares.[91] And indeed, as we shall see in Chapter 5, there are many cases where institutional shareholders have formed coalitions to take actions.

Generally, one or more of the large institutional investors will take the lead to organize other institutional shareholders to join the collective action. This was well illustrated in the ditching of Michael Green, who had been earmarked as the chairman of the new ITV plc., a merger of broadcast companies Carlton and Granada. Fidelity International took the lead and effectively mobilized other institutional investors and

[89] Mallin, 'Investors' Voting Rights' (n 87) 161.
[90] For a detailed discussion of Prisoner's Dilemma, see R Hardin, Collective Action (Johns Hopkins University Press, Baltimore 1993) 23.
[91] R Crespi and L Renneboog, 'Is (Institutional) Shareholder Activism New? Evidence from UK Shareholder Coaliations in the Pre-Cadbury Era' 18 Corporate Governance: An International Review 274. They found shareholder coalition has been an effective corporate governance mechanism for several decades in the UK, even before the first code initiated by the Cadbury committee.

signalled that 35% of Carlton's shareholders wanted Green out. Consequently, this coalition blocked Green's appointment by resolutely arguing against it.[92]

Moreover, as one will see later, shareholder collective actions in the UK are often facilitated by industry representative associations, such as the Association of British Issuers.[93] Those associations will organize their institutional members and use their combined weight to bring pressure on companies to follow corporate governance good practice.

Under these cases, when the collective action is organized by one large institutional shareholder or by representative associations, other institutional investors, even where they do not join a formal coalition, are likely to act in the same way as those taking the lead.

Both these first two factors – the decisiveness of individual holdings and the possibility of concerted action – depend, clearly, upon the pattern of share ownership amongst institutional holders. Are individual institutions acquiring sufficiently large holdings in some companies that, individually, they perceive they can make a difference? Are small groups of institutions, collectively, holding enough shares in some companies that they are likely to think that by joining together they can make a difference? This thesis explores the pattern of share ownership amongst institutions in much greater detail in chapter 3. But we might note for now that over recent decades, institutional ownership of stock has indeed rapidly increased in many countries, including both the UK and China. In the UK, institutions have become the most important holders of company shares, collectively owning some 40% of UK equity.[94]

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[90] J Randall, 'Why Michael Green Had to Go' (2003) BBC News < http://news.bbc.co.uk/1/hi/business/3210372.stm> accessed 20 December 2008.
[93] For the discussion of trade associations see Chapter 3.
[94] More detailed discussion is in Chapter 3.

In China, the rise of institutional ownership has lead to nearly half of the total tradable shares controlled by institutional investors. [95]

One might argue that although institutional shareholding as a whole has increased in listed companies, still few institutions will have sufficient shares to counterbalance the power of the incumbent management. However, they will have if small groups of them collectively constitute a significant block. With regard specifically to the possibility of 'concerted action', or what Scott termed a 'control through a constellation of interests',[96] Scott argued over two decades ago that the growth of institutional holdings had led to 20-30% of shares typically being concentrated into the hands of the top 20 or so shareholders.[97] A more recent study conducted by Mallin found that 88% of the Top 250 companies in 1994 had disclosable interests, that is, had a shareholder owning 3% or more holdings. (Fifty percent of the companies had disclosable interests totaling 13.5% or less.) The mean disclosable interest was about 18.5%. As data suggested, few or no individuals or group hold sufficient shares to exercise control, however, the largest shareholders have substantial shares and collectively, they represent an important group that the board cannot disregard. The thesis will return to this issue in more detail in Chapter 4.

1.2.2.3 'In process' Benefits

The third factor that controls free-riding is that some benefits to individual institutional investors may come not from improvements to the company's own performance, but rather from *the process of engagement* itself. Activism, for example, may be a marketing policy for the institutional shareholder that makes its own fund

[95] In China, shares in a listed company can be divided into non-tradable and tradable shares. Only tradable shares can be circulated in the public. It will be discussed in Chapter 6.1.3.
[96] J Scott, *Corporations, Classes and Capitalism* (Hutchinson, London 1985), 49.
[97] Ibid, 81.

more attractive to *its* potential beneficiary/investors. This possibility is confirmed in Hendry *et al.'* study, in which they found that institutional investors are sometimes motivated by the need to maintain their own competitive position to take action.[98] As they suggested, clients of institutions expected them to exercise a certain level of responsibilities in respect of governance matters, and that fund managers had had to 'follow suit in order to pitch for, gain and retain their business.[99] As such, some institutions might actively engage in activism just in order to promote their brand image and receive *reputational* benefits.

Moreover, Macneil, and Macey, each observes that shareholder intervention in one investee company has the potential to provide some level of deterrence against potential managerial abuses in the *other* companies of his portfolio.[100] The other companies, even if they are not the target of shareholder activism, will feel that they are under attack in much the same way as they would be if they were performing badly in corporate governance. This, in turn, creates strong incentives for institutional shareholders to engage in activism as a way of improving the *overall* portfolio value.

Finally, 'in-process' benefit is perhaps more important, and evident for those funds whose business strategy is precisely to profit by engaging with underperforming investee companies. They rely heavily on an engagement investment strategy to attract clients. One of the leading examples in the UK is that of 'Hermes', which we shall address in Chapter 3.

[98] J Hendry and others, 'Responsible Ownership, Shareholder Value and the New Shareholder Activism' (2004) ESRC Centre for Business Research, University of Cambridge Working Paper No. 297 .
[99] Ibid.
[100] I Macneil, 'Activism and Collaboration Among Shareholders in UK Listed Companies' (2010) Capital Markets Law Journal 1,10; Also Macey (n 31) 250.

1.2.2.4 A Normative Obligation to Act?

Fourthly, we might now move beyond the previous strictly 'economic' analysis to suggest that there may be demands for action that compel shareholders to entertain action *without strictly calculating* on whether they need to do so to make it succeed. And here one can differentiate demands that emanate from legal requirements to act, through to codes of practice that seek to encourage action, and even beyond to a more general 'cultural' expectation that institutions 'do their bit' towards a collective endeavour. The extent to which they force institutional shareholders to take action will vary as between different types of activism and will be covered in detail below.[101] However, it might still be helpful to give a brief account here. For example, legally, UK Companies Act 2006 grants reserve power to the Government to make rules requiring certain types of institutional shareholders to disclose how they have voted shares which they own or in which they have an indirect interest.[102] A desire to avoid intervention by compulsion prompted major institutional investors to increase the level of engagement with their investee companies.[103] Moreover, regulatory guidelines generated a normative obligation on institutional shareholders to vote their shares and accordingly, the voting levels of UK listed companies have been steadily increasing over the last decade.[104] Driven by these normative demands, as one can see later, in many cases, shareholders' propensity for active engagement does not rely solely on a precise calculation of whether or not they *need* to act to ensure success. Nevertheless, even where some shareholders do perceive there to be a positive obligation to join in a collective action, it seems unlikely that, for these financial

[101] See Chapter 4.
[102] CA 2006 ss 1277-1280.
[103] Cheffins (n 4) 386.
[104] Goergen, Renneboog and Zhang (n 75) 56. Regulatory rules regarding voting and voting levels will be discussed in Chapter 5.3.

institutions, they would act on this obligation entirely regardless of the balance between the benefits and the costs of action. One might suggest, for example, that some shareholders will feel that it is wrong to free-ride on the efforts of others, and that they should contribute towards a collective action (regardless of whether they *need* to do so in order to enjoy its benefits), but nevertheless feel this obligation exists only in so far as the institution's own benefits will still outweigh its own costs.

This, then, leads us onto the 'second step' in my model. But to summarize, so far, we have seen how the 'free-rider' problem can be overcome amongst institutional shareholders, for at least four reasons – the decisiveness of (sizeable) institutional holdings, the possibility of concerted action, the existence of 'in process' benefits and a normative obligation to join in collective actions.

1.2.3 Step 2: Balancing Benefits and Costs

Even if the above analysis for step one is accepted, this only takes us to the second step in the model. Whilst the above shows that sometimes individual action may be necessary (and appropriate) to secure individual benefits for any given shareholder, it is likely that each shareholder will still only think this action worthwhile if *its own individual benefits outweigh its own individual costs*. This thesis has suggested that calculating the benefits of action requires us to look more widely to see the full range of benefits that a shareholder may secure. And this thesis has suggested that some institutional shareholders may accept they must play their part in collective actions (even where they might not strictly have to do so in order to ensure the success of some action, or to secure their share of the benefits). But nonetheless nothing argued above suggests that shareholders will still act even where their anticipated benefits are less than their anticipated costs.

Thus, my model for understanding individual institutional activism sees the first step as an *absolute* 'hurdle' – the collective action/free rider problem – that must be overcome. If it is not overcome, then no action is likely to take place. If it is overcome, then the second step involves a *calculation*: are the institution's individual benefits likely to exceed its individual costs?

This thesis shall address these costs and benefits in greater detail in subsequent chapters. However, we can say here a little more about the categories of benefits and costs that institutions will consider as they work out whether activism is likely to pay.

Starting with *benefits*, this thesis suggests that these might be divided into two types. First, each institution will capture a *proportion* of the *collective* gains that are earned by any instance of collective activism. The size of this benefit thus depends upon the size of the collective gain, and the proportion of the company's total share capital that the institution holds. Put simply, an institution holding 1% of a company's shares, and which predicts that some bout of activism will increase the company's value by £1 million, expects to secure £10,000 of benefits. Second, as suggested above, *some* institutions will also secure 'in process' benefits merely from being active. Clearly, it is much more difficult to put a precise figure on the likely magnitude of these gains but, as far as the model I am putting forward is concerned, we must assume that institutions try to quantify these, however difficult it might be to do so accurately.

What, now, about the *costs* of activism. Again, this thesis would divide these into two types. First, there are what we might call the 'direct costs' of action, such as expenses of monitoring companies in order to identify when action might be necessary, the cost of voting or arranging meetings with corporate managers, and so on. Secondly, there are 'indirect costs' – consequential losses that an institution might suffer if it chooses

to engage in a form of activism. Clearly, there are very many such 'knock on' losses that might be suffered, but I shall focus on three which particularly feature in the literature. These are losses suffered as a result of institutional conflicts of interests, potential liability for insider dealing and potential losses that arise as a result of not being able to trade ones shares.

This final cost deserves a few extra words here. Logically, when explaining institutional activism we must, as Rock notes,[105] show not only that benefits exceed costs, but also that the magnitude of this overall gain is greater (or the loss smaller) than alternative courses of action. The main alternative is what Hirshmann calls 'exit' (in contrast with the exercise of 'voice'), i.e. simply to sell ones shares and leave the company.[106] But as we shall see later, growing institutional ownership will make it increasingly costly for institutional shareholders to solve problems through selling their positions, and accordingly, can make engagement less costly. The costs come from their size which makes it hard to offload blocks of unwanted stocks without depressing the market value, and from 'fiduciary behavior that has encouraged them to use indexing as an investment strategy.' [107] Hence, when large institutional

[105] E Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1991) 79 Georgetown Law Journal 445, 455.
[106] A Hirschman, *Exit, Voice, and Loyalty:Responses to Decline in Firms, Organizations, and States* (Harvard University Press, Cambridge, Mass. 1970).
[107] J P Hawley and A T Williams, 'The Emergence of Fiduciary Capitalism' (1997) 5 Corporate Governance: An International Review 206, 209. The difficulty of 'voting with feet' is well explained by the following quotation. At the SEC Routable, Richard H. Moore, The treasurer of the State of North Carolina and the trustee of the ninth largest public pension plan in the US, reaffirmed this observation when commenting on the famous Wall Street rule: 'I'm often told by my friends who are directors of large companies, "Well, Mr. Treasurer, why don't you just vote with your feet?' And I think this point has been made. We no longer can vote with our feet. And I want to give you just some very quick statistics… Twenty-five years ago, the State of North Carolina had a $433 million equity portfolio. We had two managers. They were both actively-managed accounts. The managers could vote with their feet… Today, we have a $35 billion domestic equity portfolio. But here's the interesting part of it. Only 22 percent of it is actively managed. And I think these are representative statistics of all public pension funds. So in 78 percent of the time, we cannot vote with our feet.' U.S.Securities and Exchange Commission, 'Roundtable Discussion on Proposed Security Holder Director Nominations Rules' (2004) <http://www.sec.gov/spotlight/dir-nominations.htm> accessed 18 March 2010

shareholders' ability to exit is limited, 'they have to care. And to care is to monitor.'[108]

In sum, this two stage model suggests that very many factors are relevant to understanding when and why shareholder activism is likely to take place. So, activism seems to depend upon the *type of institutional shareholder*, and the *type of activism* that is being contemplated. The degree of shareholder concentration is clearly relevant, as is the regulatory and governance framework that supports or undermines activism. The following chapters of the thesis explore these various factors in the context of the UK.

1.3 Conclusion

As the first stage of the thesis, this chapter has laid the foundations for the discussion of shareholder activism in subsequent chapters. It has done so by suggesting a model that seeks to explain the circumstances in which institutional shareholders are likely to engage in activism. Since the model is crucial to the subsequent chapters, it is worth summarizing its structure. It suggests a two stage process in understanding shareholder activism. The first stage concerns the collective benefits of collective action. Here, I argued that collective action can indeed produce collective benefits by reducing agency costs and thus can be beneficial to the overall value of the corporation. My argument involved, in part, noting the positive benefits of activism, and in part rejecting some of the counter arguments against activism. I also looked at the (inconclusive) empirical evidence.

[108] Hawley and Williams, ibid.

The second stage of my model turned from collective to individual benefits. And this second stage in turn involved two distinctive steps. The first step is a hurdle that faces any collective action. Why bother taking part, if one can simply free-ride on the efforts of others? I suggested four factors that can, in some circumstances, undermine the likelihood of free-riding. They were: the decisiveness of large individual institutional holdings, the possibility of concerted action, 'in process' benefits and a normative obligation to act.

The second step asks: assuming free-riding can be avoided, nevertheless is activism individually 'profitable' for any given shareholder? Will that shareholder's gains be greater than its costs? I suggested that the 'gains' include the shareholder's share of the total gains to the corporation from the activism in question, plus any individual 'in process' benefits it secures through its own activism (for example by attracting more funds because of its reputation for activism). I also offered a classification of 'costs' based on direct costs and indirect costs, the latter in turn split up into the costs of conflicts of interest, of insider dealing liability and of inability to trade.

Having identified when and why shareholder activism is likely to take place, Chapters 4 and 5 of the thesis develop this model of institutional activism further. Chapter 4 enriches the model of activism by 'feeding in' the variables of different shareholder types. Chapter 5 completes this process by applying this enriched model to the different forms that activism can take. First, however, we need to say more about the landscape of institutional share ownership (Chapter 3) and, next (Chapter 2), explore the background to all forms of activism by looking at the UK' framework of corporate governance.

Part II Shareholder Activism in the UK

Chapter 2 The Framework of UK Corporate Governance

The purpose of this chapter is to provide an overview of the UK's corporate governance framework as a background for later discussion of UK institutional shareholder activism. It begins in 2.1 with a brief overview of UK companies, including the type of company in which institutional shareholders are invested, the class of shares that institutional shareholders hold and the role of the UK's stock exchange. Section 2.2 deals with the regulatory framework for company law and corporate governance in the UK. It is multi-layered, consisting of private ordering, legislative rules and self-regulatory guidance. Section 2.3 turns to examine what we might call the internal corporate governance mechanisms in UK companies. Section 2.4 concludes with a brief summary.

2.1 Data on UK Companies

2.1.1 Typology of Companies

In the UK, as in other countries, there are different types of company incorporated under corporate law. Generally, the Companies Act 2006 (CA 2006) makes a distinction between public limited companies and private companies. The primary difference between those two types of company is that only a public company is eligible to make a general offer of its shares to the public at large.[1] Public companies are therefore more suitable for running a business in which a large number of people are invited to become investors. Members' liability to contribute to their assets is limited to the amount outstanding (if any) on their shares. Its name ends with PLC.[2] A

[1] CA 2006 s 155, s 755.

[2] CA 2006 s 58(1).

private company is suitable for inviting investment by small numbers of people and its name ends with 'Ltd'.[3]

Furthermore, a private company and a public company are subject to different minimum capital requirements. A private company is allowed to provide a trivial amount of contributed capital, such as £1, while a public company has a minimum share capital requirement of £ 50,000.[4]

In fact, most public companies start their lives as private companies and then covert themselves to public companies when they can satisfy relevant requirements.[5] Only a small fraction of companies incorporated in the UK are registered as public limited companies.[6] By April 2010, data from Companies House show that of 2,634,917 companies registered in the UK, only 10,541(0.4%) are incorporated as public limited companies.[7] Nevertheless, from a corporate governance perspective, they are of primary importance.

In the UK, pubic companies that have their shares quoted for trading have been admitted to the Official List maintained by the Stock Exchange and are known as 'listed companies.'[8] A listed company has to meet various conditions to be traded on stock exchanges and is obliged to comply with the Listing Rules issued by the Financial Services Authority (FSA), which will be introduced later in detail.[9] Through subscription of shares in a listed company, an institutional investor becomes the shareholder of that company and can exercise owner rights attaching to the shares. For

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[3] Ibid. Assuming it is a limited private company, over 99% of private companies are limited. See, Companies House, Company Register Statistics for April 2010
< http://www.companieshouse.gov.uk/about/businessRegisterStat.shtml> accessed 5 June 2010.

[4] CA 2006 s 763.(Of which at least 1/4 must be paid up)

[5] B G Pettet, *Company Law* (2nd edn Longman law series., Longman, Harlow 2005) 13.

[6] P Davies, Gower&Davies' Principles of Modern Company Law (Sweet & Maxwell, London 2008), 13.

[7] Companies House, Company Register Statistics for April 2010 (n 3).

[8] Pettet (n 5) 14.

[9] See Chapter 2.2.1.3.1.

the purpose of the study, the company where institutional shareholders activism occurs only refers to the type of public listed companies.

As of 30 April 2010, the London Stock Exchange (LSE) has 2,747 listed companies, with a combined market capitalization of £1.8 trillion.[10] Of them, more than 1,000 companies have an equity market value over £50 million.

Although the number of listed companies only accounts for a small proportion of total companies registered in the UK, they are a crucial part of the UK economy. For the period 1999-2003 the ratio of the stock market capitalization[11] to Gross Domestic Product (GDP) is 157.7, being nearly three times the global average and the ratio of equity issued by newly listed companies to GDP is 5.47, being nearly four times the global average.[12] By 2009, due to the financial crisis, the ratio of the stock market capitalization to GDP has dropped to 128 but undoubtedly, listed companies sector is still a vital part of the UK economy.[13]

2.1.2 Classes of Shares

Section 629(1) of the CA 2006 provides that for the purposes of the Companies Acts shares are of one class if the rights attached to them are in all respects uniform.[14] A UK company may be permitted either in its articles of association or in its

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[10] World Federal Exchange, Statistics: Number of Listed Companies& Domestic Market Capitalization, available at <http://www.world-exchanges.org/statistics/ytd-monthly> accessed at 5 June 2010. Of all 2,747 companies, 2144 are domestic UK companies, while the remaining 603 are foreign companies.

[11] Market capitalization (also known as market value) is the share price times the number of shares outstanding.

[12] B Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press, Oxford 2008) 1.

[13] The World Bank Data, *Market Capitalization of Listed Companies (% of GDP)*, <http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?display=default> accessed 23 May 2010.

[14] CA 2006 s 629 (1).

memorandum to issue different classes of shares.[15] Obvious examples of shares in different classes are ordinary shares, preference shares, convertible shares, non-voting shares and employee shares. Here, since voting is one of the major forms of activism being taken by institutional shareholders to monitor corporate governance, the thesis is only concerned with the class of ordinary shares which grant shareholders voting rights. In order to present a complete picture, other classes of share will therefore be mentioned only very briefly.

Usually, in companies' constitutions, ordinary shares are the default category of share. They entitle holders to participate in companies' distributable profits after the fixed dividend has been paid to the preference shareholders (if any). In terms of voting, ordinary shareholders have the right to vote in the general shareholders' meeting under the principle of one vote one share. In the UK, the vast majority of companies have only one class of ordinary share.

Apart from ordinary shares, investors can invest in other classes of shares, such as preference shares and non-voting shares. Preference shares carry preferential rights, entitling holders to receive fixed preferential cumulative dividends and a return of capital on a winding-up in priority to the ordinary shareholders. Preference shareholders' voting rights are usually restricted so they cannot vote in the general shareholder meeting, except in some circumstances, such as if their dividends are in arrears.[16] Some companies have a class of share which gives holders rights to dividend and to share in surplus assets like ordinary shares but do *not* entitle holders to vote at shareholders' meeting. In practice, these so-called non-voting shares are rarely used in the UK.[17] Whilst not expressly prohibited in legislation, they are

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[15] See further L Sealy and S Worthington, *Cases and Materials in Company Law* (Oxford University Press, Oxford 2008) Chapter 9; A Dignam and J Lowry, *Company Law* (Oxford University Press, Oxford 2010) Chapter 9.

[16] Dignam and Lowry, ibid, 167.

[17] See, e.g., 'Error Deprives Schroders of FTSE 100 Place' (15 March 2007) *Financial Times*. ('Unusually for a UK company, Schroders has voting and non-voting shares.'). Also see Cheffins (n 12) 32.

strongly discouraged by the LSE.[18] As one will see later, these non-voting shares are usually purchased by large overseas institutions, especially Sovereign Wealth Funds.[19]

2.1.3 The London Stock Exchange

In the UK, the LSE is the public share exchange for trading securities of companies and government bonds.[20] The LSE is itself a registered listed company called London Stock Exchange PLC, and is accordingly itself subject to the related listing regulations. It is the world's fifth largest stock exchange by market capitalization and third largest by value of shares traded.[21]

The primary roles that the LSE undertakes are to provide markets to let issuing companies sell their shares to the public (primary market) and to let buyers and sellers of existing shares deal with each other (secondary market). The LSE runs a number of markets for the listing and trading of equity, debt and other securities. Among these, the three most significant markets are: (1) the Main Market – for those large, high-performance companies; (2) the Alternative Investment Market – for smaller growing companies; and (3) the Professional Securities Market – specifically for listed debt and depository receipt securities.[22]

In addition to its listing function, prior to May 2000 the LSE had an important regulatory role to play, for it was nominated as the 'listing authority' in the UK. Where a company's shares were to be listed on the Stock Exchange, that company

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[18] D French, S W Mayson and C Ryan, *Mayson, French & Ryan on Company Law* (25th edn Oxford University Press, Oxford 2008) 158.

[19] See Chapter 3.2.5.

[20] Most information concerning LSE comes from the website: <http://www.londonstockexchange.com/home/homepage.htm> accessed 12 August 2009.

[21] Data from <http://www.world-exchanges.org/files/statistics/excel/WFE09%20final.pdf> accessed 24 April 2010.

[22] See (n 20).

had to meet the 'Listing Rules' developed by the LSE.[23] The rules-commonly referred as the 'Yellow Book' – set out a number of conditions to be fulfilled by an applicant company.[24] The promulgation of the Financial Services and Markets Act 2000 (FSMA 2000) ended the LSE as the listing authority and transferred its regulatory role to the FSA. The LSE's Yellow Book became the Listing Rules issued by the FSA, although the content of the rules remained much the same.[25]

Apart from the Listing Rules and other relevant rules issued by the FSA, to gain a listing in the LSE, companies have to meet with the LSE's own admission and disclosure standard and are subject to ongoing obligations which apply to all listed companies.[26] The principle index in LSE is the FTSE 100, a market capitalization weighted index representing the performance of the 100 largest companies in the UK or approximately 82% of UK equity market.[27] The FTSE 250 is an index of medium size companies that constitute the largest 250 companies in the UK outside of the FTSE 100 index and representing about 14% UK equity market.[28] The FTSE 100 and FTSE 250 are combined to form the FTSE 350.

2.2. The Regulatory Framework in the UK: An Overview

A theme of this thesis is that the legal environment within a country has a significant bearing on the level of institutional shareholder activism. A regulatory framework with many legal supports for shareholder activism will lead to more institutional shareholder involvement than will a system imposing legal constraints on shareholder

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[23] Dignam and Lowry (n 15) 68.

[24] J Dine and M Koutsias, *Company Law* (Macmillan law masters, Palgrave Macmillan, Basingstoke 2009) 92.

[25] Ibid.

[26] For example, Rules of the London Stock Exchange, available at < http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/rules-regulations.htm > accessed 12 March 2010.

[27] Data from <http://www.londonstockexchange.com/home/homepage.htm> accessed 28 October 2009.

[28] Ibid.

engagement. That is because, firstly, the influence that institutional investors have on corporate governance rests critically on the power that the background rules of legislation grant them, and secondly, an effective regulatory framework empowers and enfranchises institutional shareholders by enabling them more easily to engage in corporate governance.

By contrast, if we pause here for a moment to consider the US, legal scholars such as Pound, Coffee, Black and Roe, have argued that legal barriers have increased the cost for shareholders seeking actively to influence management.[29] Notably, Black pointed out that 'shareholder passivity may be part of a function of legal rules.' The evolution of early shareholder activism in the USA is *illustrative* to that point. American financial institutions were active participants in corporate governance as early as the 1900s.[30] However, over the next three or four decades, securities laws passed with the aim of limiting the power of financial intermediaries also limit their roles in corporate governance.[31] Thereafter, shareholder activism was not often seen until the SEC introduced a rule in 1942 that first allowed shareholders to submit proposals for inclusion on corporate ballots.[32]

Coming up to date, a comparative study of shareholder activism between the UK and the US conducted by Black and Coffee is *helpful to explain* the influence of legal rules. They compared the role of institutional shareholders in corporate governance in the US and UK. They argued that UK institutions were more active in participating in corporate governance than their US counterparts since the legal regime in the UK

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[29] J Pound, 'Proxy Contests and the Efficiency of Shareholder Oversight' (1988) 20 Journal of Financial Economics 237; J Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277 ; B Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 UCLA Law Review 811; and M Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press Princeton 1996).

[30] S Gillan and L Starks, 'The Evolution of Shareholder Activism in the United States ' (2007) 19 Journal of Applied Corporate Finance 55, 57.

[31] Ibid.

[32] Ibid.

makes it a better setting for shareholder engagement.[33] A similar point was made by Macneil, who stressed the powers of shareholders in the UK conferred by the legislative framework.[34] He found that UK shareholders are granted a wide range of decision-making powers to facilitate their intervention. By contrast, in the US, the ability of shareholders to overturn board decisions, and the area in which shareholders can be involved, are very limited.[35] For example, in the US, it is usually not possible for shareholders to change the original charter without board approval.[36] That is not the case in the UK.[37]

In light of the importance of legal rules on shareholder activism, the section below sketches out the main elements the UK regulatory framework. A more detailed discussion of the specific rules that facilitate (or occasionally limit) activism will be given in Chapter 4 and below. The UK's corporate governance framework is multi-layered, and consists of private ordering, legislative mandatory rules and self-regulatory guidance.

2.2.1 Private Ordering

It is often easy to forget that UK company law is, in many respects, a 'permissive regime'[38] in that it allows companies to determine for themselves many of their internal governance rules by which they will be bound. This is most obviously true of the 'articles of association', the contents of which the shareholders decide.[39] It forms

[33] B Black and J Coffee, 'Hail Britannia?: Institutional Investor Behavior under Limited Regulation' (1994) 92 Michigan Law Review 1997.

[34] I Macneil, 'Activism and Collaboration Among Shareholders in UK Listed Companies' (2010) Capital Markets Law Journal 1, 4-5.

[35] L A Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 Harvard Law Review 833, 843-850.

[36] Ibid, 844.

[37] See discussion in section 2.3.3.

[38] There is a rich literature discussing the role of private ordering regime in corporate law; B Cheffins, *Company law: Theory, Structure, and Operation* (Clarendon Press, Oxford 1997), especially Part I and Part II, provide a good analysis.

[39] Dignam and Lowry (n 1516) 147.

the basis for much of the way the directors, the shareholders and the company interact. As one will see, the extent of such private ordering serves to distinguish the UK corporate framework from the Chinese counterpart, where the latter relies extensively on mandatory rules to specify the governance system of listed companies.[40] In practice, model sets of articles, provided under the CA 2006 as the default set of rules are generally adopted with some slight amendments subjected to the conditions of individual companies.[41] Changes in the articles of association can be made by a special resolution that requires a supermajority of 75% shareholders.[42]

2.2.2 Legislation

2.2.2.1 Companies Act 2006

The next element in discussing the governance framework in the UK is the system of company law itself. It is now largely a statute-based law, further developed through common law and equitable principles established by the court. At its heart are the relevant provisions of the Companies Act 2006(CA 2006). The CA 2006 contains rules governing the creation, and financing of companies, shareholders' rights, directors' duties and other issues concerning the management of companies. The discussion below will briefly introduce recent development in the CA 2006 as some of its changes are particularly relevant in the context of shareholder activism.

The CA 2006 was passed in November 2006 and fully came into force by October 2009. It replaced, revised and sought to modernise previous corporate legislation. The aim of the Act, as stated by the Secretary of State for Trade and Industry, was to 'create an effective corporate statute to ensure shareholders are informed and involved,

[40] See Chapter 6.

[41] Companies (Model Articles) Regulations 2008 (SI 2008/3229).

[42] CA 2006 s 21(1).

to promote a good understanding and effective shareholder engagement between company and investors and thus to enhance company long-term performance.'[43]

The CA 2006 introduces a number of rules to ensure greater opportunity for shareholders to play a role in company business. Thus, it:

1. Enhances the rights of proxies and makes it easier for a company to empower indirect investors in their shares. These will be discussed in more detail in Chapter 4;
2. Removes old company law requirements for the use of paper system and allows companies to use electronic communication with shareholders as the default position. The thesis will return to this point in Chapter 5;
3. Codifies common law and equitable rules relating to directors' duties and introduces statutory statements to clarify directors' responsibilities and makes the law more accessible;[44]
4. Introduces a statutory footing for derivative claims which helps shareholders to exercise the company's rights where directors have breached their duties. This development will be covered in Chapter 5;
5. Relaxes those rules which prevent auditors from limiting their liability, while introducing rules to improve the quality of the audit.

Particularly with regard to institutional shareholders, the CA 2006 contains provisions giving the Secretary of State or the Treasury power to make regulations requiring institutional shareholders to disclose how they have voted their shares which they own or in which they have an indirect interest.[45]

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[43] There are some other objectives, such as, 1, ensure better regulation and think small first; 2 make it easier to set up and operate company; 3, provide flexibility for future. See Secretary of State for Trade and Industry, *Companies Law Reform Bill-White Paper 2005* (TSO, Norwich 2005).

[44] Before CA 2006, the general duty directors owe to company could only be found in case law.

[45] CA 2006 ss 1277-80.

It is worth noting that case law has a significant impact on the development of corporate governance, particularly in the area of directors' duties. However, as mentioned above, some important common law and equitable principle are now codified into the CA 2006. These principles now, therefore serve as an interpreting role. For example, it is stated in the CA 2006 section 170 that 'the general duties of directors have developed from certain common law rules and equitable principles and thus, they shall be interpreted in the same way as those rules and principles.'[46]

2.2.2.2 Implementation of EU Directives

As a result of the European Communities Treaty 1972, the UK is subject to the law of the European Union. Part of this law includes EU Directives, which member states have an obligation to implement into their domestic legislation. In the corporate legislation area, three Directives are particularly relevant to the subject of corporate governance. There are: the Takeover Directive (Directive 2004/25/EC), the Transparency Directive (Directive 2004/109/EC) and the Directive on the Exercise of Certain Rights of Shareholders in Listed Companies (Directive 2007/36/EC) (Shareholders' Rights Directive).

2.2.2.2.1 Takeover Directive

The Takeover Directive aimed to remove barriers to takeovers in the EU. It set out requirements with regard to takeover activities of companies and stipulated rules for shareholder protection in the event of a takeover. The Directive was implemented in Part 28 of CA 2006. Perhaps the most significant change the implementation brought on to UK corporate law is that it introduced a statutory framework to the old regime. Before the implementation, the takeover regulation was overseen by the Takeover Panel on a non-statutory basis with the support by the Takeover Code or so-called City Code. Now, sections 942 and 943 of the CA 2006 authorise the Panel to be the body to make rules and act as supervisory body for takeover activities. However, as

[46] CA 2006 s 170.

one will see in Chapter 4, some provisions in the current law which originated from the Takeover Directive, have the potential to create an impediment to shareholder engagement due to their uncertainty and ambiguity.

2.2.2.2.2 Transparency Directive

The second relevant Directive is the Transparency Directive, which dealt with information which companies are required to make available to the public. As is well-known, shareholders rely on public disclosure information provided by the company to play their roles as monitors of the company management. Adequate information disclosure is therefore significant for shareholder activism. The Directive set out rules on periodic financial reports and required issuers to disclose major shareholdings in companies.

The CA 2006 served as the opportunity to implement the Directive in Part 43. It appointed the FSA as the competent authority to supervise transparency obligations and make rules with regard to shareholder notification. The rules are mainly implemented in the FSA Handbook Disclosure and Transparency Rules Regime (DTR).[47]

2.2.2.2.3 Shareholders' Rights Directive

The Shareholders Rights Directive, implemented by the Companies (Shareholders' Rights) Regulations 2009,[48] intended to address the exercise of basic shareholders' rights, as well as solving problems in the cross-border exercise of such rights, particularly voting rights.[49]

It brings a number of changes to the UK regime, for example, it requires 'traded companies' to answer any question put by a member at general meetings unless one of

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[47] FSA handbook is available at < http://www.fsa.gov.uk/Pages/handbook/> accessed 12 May 2009.

[48] Companies (Shareholders' Rights) Regulations 2009 (SI 2009/1632).

[49] Explanatory Memorandum to the Companies (Shareholders' Rights) Regulations 2009 (SI 2009/1632).

the reasons for not giving an answer applies,[50] it enables shareholder to cast votes attaching to different shares in different ways,[51] and it reduces the threshold for calling a meeting to 5%.[52] More detail on the resulting changes the Directive will be given in Chapter 5.

2.2.2.3 Financial Services and Markets Act 2000

Another key statute in the corporate regulatory framework is the Financial Services and Markets Act 2000 (FSMA 2000). Its authority covers a wide range of institutions in the financial services industry, including banking, insurance, and listing companies. In particular, the law relating to public offers of shares and listing can be found in Part VI of the FSMA 2000.

Part VI authorizes the FSA to act as the UK listing authority (UKLA) and sets out its general duties and responsibilities in that capacity, as well as outline framework governing the listing process and the mechanisms for its enforcement.[53] The FSA was established in 1985 in the legal form of an independent non-governmental company limited by guarantee and is operationally independent from government, and entirely financed by the firms it regulates.[54] However, it is accountable to the Treasury Ministry and through her to Parliament. The board members of the FSA are appointed by the Treasury.

The range of responsibilities of the FSA is enormous, regulating financial service firms, and supervising exchanges and listed companies in the UK.[55] In particular, as the listing authority, the FSA has an obligation to monitor the listing process, evaluate issuers' eligibility and ensure the compliance of its rules. In order to exercise the

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[50] Companies (Shareholders' Rights) Regulations 2009 (SI 2009/1632) 12.

[51] Companies (Shareholders' Rights) Regulations 2009 (SI 2009/1632) 2.

[52] Ibid.

[53] FSMA 2000 s 72(1).

[54] More information about the FSA can be found in the website <www.fsa.gov.uk>accessed 12 August 2009.

[55] Dine and Koutsias (n 24) 106.

power under the FSMA 2000, the FSA has a number of possible sanctions such as public censure, fines, injunctions, restitution orders and to verify or cancel investment authorisation.[56]

2.2.2.3.1 Delegated Rule-making

Rules issued by the FSA take the form of high-level principles, detailed rules, guidance and supporting material. These rules supplement and support statutory legislation with detailed requirements and standards.

Rules relevant to listing issued by the FSA are contained in the FSA Handbook, in particular Listing Rules, Disclosure Rules and Transparency Rules (DTR) and a Code of Market Conduct. As said earlier, to get listed, a public company shall satisfy the requirements in Listing Rules, for example, companies intended to be listed in the Main Market shall have a minimum 25% of its shares in public hands and a minimum market capitalisation of £700,000.[57]

Officially listed companies are subject to certain continuing obligations under the Listing Rules (LR). The best-known examples are listed companies must state how they have complied with the principles set out in the UK Corporate Governance Code[58] – must confirm compliance with the Code or indicate and explain areas of non-compliance,[59] and must report directors' remuneration policies and packages.[60] If the FSA considers that an issuer of listed securities or an applicant for listing has breached LR, it can impose a financial penalty.[61]

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[56] Dignam and Lowry (n 15) 84.

[57] London Stock Exchange, A Guide to the Main Market (LSE, London 2007). For a good evaluation on the enforcement of the FSA and its action, see I Macneil, 'The Evolution of Regulatory Enforcement Action in the UK Capital Markets:A Case of 'Less is more'' (2007) 2 Capital Markets Law Journal 345.

[58] The UK Corporate Governance Code will be addressed below, see section 2.2.3.1.

[59] Listing Rules 9.8.6, 9.8.7 A R, the UK Corporate Governance Code will be introduced in 2.2.3.1.

[60] Listing Rules 9.8.8.

[61] FSMA 2000, s 91 (1).

The DTR, as discussed earlier, implement the Transparency Directive and set out rules to address disclosure requirements for listed companies. The Code of Market Conduct is relevant as it provides guidance as to the sort of conduct which will amount to market abuse and insider dealing. To undertake shareholder activism, institutions shall be careful that their activities do not breach these relevant rules. We shall return to see the potential impact of this on shareholder activism in Chapters 4 and 5.

2.2.3 Codes

Whilst the UK's formal body of legal rules and regulations is important in defining the nature of corporate governance standards and obligations, much of governance relies heavily on less formal bodies of rules, such as upon reports, guidance or rules issued by various bodies. Chief among these bodies are the Financial Reporting Council (FRC), a number of institutional investors' trade associations, institutional investors themselves and various bodies representing industry professions. Provisions issued by these organizations may take the form of recommendations, guidance, and code of practice. Here, this broad range of provisions will be generally referred to as 'Codes'. Such Codes are not a mandatory set of rules; rather they provide a set of recommendations as to good practice. This approach is intended to permit flexibility, so that companies or investors subject to the guidance, can, in appropriate circumstances, choose not to comply, and explain why if required.

The initial development of this Codes system started in the 1990s as a response to financial scandals at that time, such as the collapse of BCCI and the Robert Maxwell pension scandal, both in 1991.[62] A series of recommendations – known as the Cadbury Report – was soon issued in 1992 to address issues such as the establishment, composition, and operation of key board committees, chairman and chief executive, and the role of non-executives. Since then, there have been a series of reports dealing

[62] Financial Reporting Council, *The UK Approach to Corporate Governance* (FRC, London 2006) 3.

with particular aspects of corporate governance over the last decade or so in the UK. The following outlines the more important ones:

(1) Cadbury Report, 1992 – issued by the Committee on the Financial Aspects of Corporate Governance. It has been regarded as the foundation for a best practice system of corporate governance;[63]

(2) Greenbury Report, 1995 – issued by the Greenbury Working Group, which was mainly concerned with the directors' remuneration;[64]

(3) Hampel Report, 1998 – issued by the Hampel Committee and emphasized the role that institutional shareholders could play in corporate governance;[65]

(4) Combined Code, 1998 – combined the recommendations of the Cadbury, Greenbury and Hampel reports;[66]

(5) Turnbull, 1999 – prepared by the Turnbull Committee which was established by the Institute of Chartered Accountants in England and Wales. It focuses on the internal control;[67]

(6) Higgs, 2003 – focused on the role and effectiveness of non-executive directors; (Turnbull 1999)[68]

(7) Smith, 2003 – focused on the role of audit committee;[69]

(8) Paul Myners' reports – commissioned by the Government, Paul Myners was concerned with the investment and voting activities of institutional shareholders.

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[63] Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance*(Gee&Co.Ltd, London 1992).

[64] Sir R Greenbury, *Directors' Remuneration* (Gee&Co.Ltd, London 1995).

[65] Sir R Hampel, *Committee on Corporate Governance: Final Report* (Gee&Co Ltd, London 1998).

[66] Combined Code, *Combined Code, Principles of Corporate Governance* (Gee&Co Ltd, London 1998).

[67] N Turnbull, *Internal Control: Guidance for Directors on the Combined Code* (Institute of Chartered Accountants in England and Wales, London 1999).

[68] D Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (Department of Trade and Industry, London 2003).

[69] R Smith, *Audit Committees Combined Code Guidance* (Financial Reporting Council, London 2003).

His reports include 2001 Institutional Investment in the United Kingdom;[70] 2004, 2005 and 2007 Reviews of the Impediments to Voting UK shares;[71]

(9) Walker' Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities – commissioned by the Government, Sir David Walker, lead an independent review of corporate governance in the UK banks and other financial institutions.[72]

Apart from Codes commissioned (or strongly encouraged) by the Government, there are also a number of guidelines issued by institutional trade associations and institutions themselves. These organizations and their guidance will be discussed in detail in Chapter 3.

These Codes were originally proposed by non-government institutions to issue statement of best practice, but some of their recommendations have been recognized or adopted by legal norms.[73] The remuneration vote under the CA 2006 is an example of how self-regulation can move into legislation.[74]

2.2.3.1 UK Corporate Governance Code

Currently, the UK Corporate Governance Code (formally the Combined Code, hereinafter the UK Code) is probably the most influential one in the UK since it is explicitly referred to in the DTR regime.[75] It is now maintained and periodically

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[70] P Myners, *Institutional Investment in the United Kingdom: A Review* (2000). London: HM Treasury.

[71] P Myners, *Review of the Impediments to Voting UK Shares* (2004); (2005); (2007). London: Shareholder Voting Working Group.

[72] D Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations' (2009) <http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 16 January 2010.

[73] K Johnstone and W Chalk, 'What Sanctions Are Necessary?' in K Rushton, *The Business Case for Corporate Governance* (Law practitioner series, Cambridge University Press, Cambridge: New York 2008) 169. For example, some recommendations in Paul Myners' report, such as when calculating notice of meeting, non-working days shall not be included, have been put into legislation.

[74] CA 2006 s 459.

[75] DTR 7.2.5.

revised by the FRC – an independent regulator responsible for corporate governance and reporting.[76] The most recent version was issued in May 2010 (when it was also renamed as the UK Corporate Governance Code.)

Perhaps one of the best-known features of the UK Code is its enforcement approach – *'comply or explain'*. All registered UK companies listed on the main board of LSE under the listing rules are required state how they apply the UK Code in their annual reports and accounts.[77] There is no punishment for non-compliance but if a company chooses not to comply with the Code, it must provide an explanation to shareholders. Instead of prescriptive regulation, it leaves the compliance with the UK Code to the scrutiny of the market and shareholders.

The core principle of this approach is to let shareholders enforce governance standards. It is based on the belief that shareholders have incentives to maximise their investment and want companies they own to be successful.[78] Once they find directors are not complying, they will exercise their rights as owners to force companies to comply with the UK Code.[79] In extreme cases, shareholders will dispose of their shares as a punishment.[80]

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[76] FRC is a 'light-touch, market-led' regulator, which derives its funding equally from listed companies, the accountancy profession and government. See Company Law Reform Bill-White Paper 2005, (n 43).

[77] DTR 7.2; Also in Listing Rules 9.8.7 A R.

[78] For a more detailed discussion of this approach, see generally, I MacNeil and L Xiao, 'Comply or Explain: Market Discipline and Non-compliance with the Combined Code' (2006) 14 Corporate Governance: An International Review 486 (They found that there is a strong link between share price performance and investors' tolerance of non-compliance with the Combined Code in FTSE 100); R Tomasic, 'Towards A New Corporate Governance After the Global Financial Crisis' in *The Prospect of Structural Reform of Corporate Legal System* (The 21st Century Commercial Law Forum-Tenth International Symposium 2010) 213 (arguing that this 'light touched' approach has failed to place an adequate check upon companies in financial sector as revealed in the recent financial crisis).

[79] Further discussion on how shareholders can exercise their rights will be provided on the following section.

[80] A Dignam, 'Capturing Corporate Governance: The End of the UK Self-regulating System' (2007) 4 International Journal of Disclosure and Governance 24, 26.

The UK Code identifies best corporate governance practice which is not covered in the legislation. It contains principles of good practice relating to issues such as the role of directors, board composition, directors' remuneration, accountability and audit.

Previously, the UK Code contained a separate section (Section E) that set out a number of recommendations addressed to institutional shareholders, including that they should enter into a dialogue with companies based on the mutual understanding of objectives, evaluate companies' governance arrangements and make considered use of their votes.[81] However, recognising the importance of these matters, they have now been taken out and form part of a new, separate so-called 'Stewardship Code'.

2.2.3.2 The UK Stewardship Code

Starting from July 2010, a new Stewardship Code[82] for institutional shareholders takes effect in the UK, as recommended by Sir David Walker following his review of Corporate Governance in UK Banks and Other Financial Industry Entities (Walker Review).[83]

In the wake of the financial crisis in the UK banking industry, Sir David Walker, was commissioned by the Government to carry out a review of corporate governance in UK banks and other financial institutions in 2009. One of the purposes of the review was to examine the role of institutional shareholders in engaging effectively with companies and in monitoring of boards'.[84] The 'Stewardship Code' is the outcome of the recommendation made by Sir David Walker that the earlier Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee, should be 'ratified' by the FRC and implemented on a comply-or-explain

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[81] Combined Code 2008, E1 E2 E3.

[82] It is available at < http://www.frc.org.uk/corporate/investorgovernance.cfm > accessed 4 July 2010.

[83] D Walker (n 72).

[84] Ibid, 5.

basis.[85] After some amendments, the Stewardship Code came into effect in July 2010 with objectives 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.'[86]

The Stewardship Code represents the most detailed attempt to date in the UK to address institutional shareholder engagement in listed companies. Institutional investors are encouraged to disclose in their reports or websites if and how they have applied the Stewardship Code. The FRC will retain a list of those investors who have published a statement on their compliance or otherwise with the Stewardship Code. The good practice in respect of shareholder engagement recommended by the Stewardship Code and its influence on shareholder activism will be covered in Chapters 4 and below.

2.3 The Internal Corporate Governance Structure of UK Listed Companies

The above sections have shown the source of the different rules and norms that make up the governance system of listed companies. How do these rules and norms translate into the structure and operation of listed companies?

2.3.1 Division of Power

Generally, the articles of association vest the authority to operate the business in the hands of the board of directors and allocate power to shareholders to decide who they

[85] D Walker, ibid, Recommendation 17; Stewardship Code, Preface; The ISC and its guidance will be discussed in Chapter 3.

[86] Stewardship Code, Preface.

wish to sit on the board.[87] As such, UK listed companies contain a model involving two organs: the board of directors and the general meeting. The legal regime creates a clear division of power between managers and owners. Under the Model Articles for Public Companies, for example, the division of power is stated as:

> '(3) Directors' general authority
>
> the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company.
>
> **(**4) Shareholders' reserve power
>
> a. The shareholders may, by special resolution, direct the directors to take, or refrain from taking, specified action.
>
> b. No such special resolution invalidates anything which the directors have done before the passing of the resolution.'[88]

2.3.2 The Board

UK companies adopt a unitary board structure, in contrast to the dual-board system in Chinese listed companies.[89] A board typically comprises of both executive directors, responsible for the management and performance of the company, and non-executive directors, who play a monitoring role over executive directors. Instead of running day-to-day corporate decision-making, the board typically delegates its powers to individuals to carry out managerial matters, pursuant to a clause in the articles of association.

Under the UK Code, the board is required to maintain an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive

[87] CA 2006 s 160. Section 168 also authorizes shareholders to remove directors before his or her term has expired.

[88] Companies (Model Articles) Regulations 2008 (SI 2008/3229), Schedule 3, 4.

[89] For discussion of Chinese board system, see Chapter 6.

directors).[90] Also, the UK Code set up a 'senior independent director' system to improve board-shareholder communication. The senior independent director is expected to communicate with shareholders 'if they have concerns which contact through the normal channel of chairman, CEO or executive directors has failed to resolve or for which such contact is inappropriate'.[91] The role of the senior independent director will be discussed in Chapter 5.[92]

To ensure the board works effectively, sub-committees are recommended, namely, a remuneration committee, audit committee and nomination committee.[93] The Walker Review recommended a 'risk committee' to facilitate risk control of investment in listed companies.[94]

2.3.3 Shareholders

Delegation of directors to run the company does not mean that shareholders lose all powers over the company. A characteristic of the UK corporate legislation system, as observed by Nolan, Davies, Rickford and Macneil, is the wide range powers that are reserved to the shareholders to act collectively as controllers and monitors of the company.[95] So, for example, CA 2006 confers on shareholders:

1. power to change the company's constitution; as said earlier, changes in the articles of association can be made by a 'special resolution that requires a supermajority of 75% of votes at a shareholders' meeting;[96]

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[90] UK Corporate Governance Code, B.1.

[91] UK Corporate Governance Code, A.4.1.

[92] See Chapter 5.2.1.1, 5.2.1.6, 5.2.2.1.

[93] UK Corporate Governance Code, B.1.

[94] Walker (n 72).

[95] R C Nolan, 'Indirect Investors: A Greater Say in the Company?' (2003) 3 Journal of Corporate Law Studies 73, 75; P Davies and J Rickford, 'An Introduction to the New UK Companies Act: Part 1' (2008) 1 European Company and Financial Law Review 48, 57; and Macneil (n 34) 4. As wide as these powers may be, they are still dwarfed by those reserved to shareholder in Chinese Governance; see Chapter 6 below.

[96] CA 2006 s 21(1)

2. power to remove directors;[97]
3. power to call a special meeting and to submit proposals.[98]
4. In a number of cases, the approval of shareholders is required to certain managerial actions, such as the award of long service contracts to directors,[99] and substantial property transaction with directors.[100]

Moreover, to hold directors accountable to shareholders, the legislation lays down directors' duties and responsibilities and the legal consequences if directors breach their duties. Under the CA 2006, a director of a company has duties to act within powers, to promote the success of the company, to exercise independent judgement, to exercise reasonable care, skill and diligence and to avoid conflicts of interest.[101] Shareholders in turn are expected to take action where they believe that the directors breach their duties, and the law provides them with voting and other rights, as said above, to enable them to enforce directors' duties. The issue of how shareholders exercise their rights will be discussed in Chapter 5.

2.4 Conclusion

The above has offered an overview of the corporate governance regime in the UK. As we have seen, it ranges from private ordering through legal norms and self-regulatory codes of practice. The Government's stated ambition is that this regime will be 'a modern robust system to enhance shareholders' protection, to promote company long-term performance and to stimulate investment.'[102]

How far this ambition is realised will be analysed in later chapters. For the moment, however, we might note that it is now generally recognized that UK plays something

[97] CA 2006 s 168.

[98] CA 2006 s 303, 314.

[99] CA 2006 s 188.

[100] CA 2006 ss 190-6.

[101] CA 2006 ss 171-177. For detailed discussions, see Dignam and Lowry (n 15) Chapter 14; D Kershaw, *Company Law in Context* (Oxford University Press, Oxford 2009) Chapters 9-15.

[102] Companies Law Reform Bill-White Paper 2005, see (n 43).

of a pioneer role in corporate governance. This success, undoubtedly, is partly attributable to its regulatory system. Meanwhile, there is evidence indicating UK regulatory framework appears to be having a positive impact in corporate governance practice. In January 2006, the FRC published the report on their review of implementation of the (then) Combined Code.[103] The review shows that the Code has improved the quality of corporate governance among listed companies, and created a better investment environment for listed companies. The total number of new flotation companies on the LSE increased from 167 in 1999 to 576 companies in the 2006.[104] The number of new foreign listings increased to 32 in 2006.[105]

However, as noted, whether the regulatory framework on shareholders' engagement is effective cannot simply be concluded from the above evidence, and requires the more detailed analysis of later chapters. Before proceeding to do that, Chapter 3 will first provide a further overview, this time of the institutional landscape in the UK.

[103] Discussed in S Lowe, 'Is the UK Model Working?' in Rushton (n 73) 224.

[104] Ibid, 225.

[105] Ibid.

Chapter 3 The Landscape of UK Institutional Investment

The way in which the model of shareholder activism, put forward in Chapter 1, will apply to UK shareholder activism can only be understood by reference to the basic features of different types of institutional investors. Chapter 3 therefore surveys UK institutional ownership and explores characteristics of major UK market participants. Section 3.1 examines the extent of institutional share ownership to highlight the fact that institutional shareholders have the potential to participate in corporate governance. Section 3.2 investigates the four major types of institutional investors that are likely to engage in shareholder activism in the UK. They are: pension funds, insurance companies, mutual funds and hedge funds. Sections 3.3 to 3.7 identify a range of other interested parties in institutional investment and shareholder activism, including industry trade associations, fund engagement staffs, Hermes, securities lending participants and proxy voting agencies. Section 3.8 concludes.

3.1 The Growth of Institutional Share Ownership in the UK

Over recent decades, a notable change in equity ownership in UK listed companies is the growth of institutional shareholdings. Share ownership has moved away from individual investors to become concentrated in the hands of a relatively few powerful institutional shareholders – see Table 3.1.[1]

Table 3.1 Summary of main categories of share ownership in the UK, 1963–2008

Type of investor	**1963 (%)**	**2008(%)**
Individuals	54	10.2
Insurance Companies	10	13.4
Pension Funds	6	12.8
Unit Trusts	1	1.8

[1] For what are included in the category of institutional shareholders, see section 3.2 below.

Investment trusts	1.3	1.9
Other financial institutions	0	10
Overseas	7	41

Source: Office for National Statistics, 'Share Ownership Survey'.[2]

As Table 3.1 shows, institutional shareholders (including insurance companies, pension funds, unit trusts, investment trusts, banks and other financial institutions) accounted for 39.9 per cent of the UK ordinary shares. These represented a combined value of £462.4 billion.[3] Of these, the largest holders were insurance companies (£154.9 billion) and pension funds (£148.8 billion). Overseas shareholders (themselves predominately institutional shareholders) own 40%,[4] and individual ownership of UK listed shares fell to just 10.2%.

Whilst by no means universal, it is not uncommon for individual institutional shareholders to hold more than 3% of any given listed company's issued shares. In this regard, consider the ownership structure of Marks and Spencer Plc, as set out in its 2009 Annual Report. These data reveal that while the number of retail investors account for super-majority of the total number of shareholders, they own comparatively few shares: 19% retail investor ownership as against 81% institutional investor ownership. 72% of ordinary shares are owned by 0.09% of shareholders by number. As such, equities are concentrated in a relatively small group of institutional investors. Elsewhere Marks and Spencer Plc's 2009 annual report reveals that there are five shareholders with a greater than 3% shareholding: three of them with 5% or above.[5]

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[2] Office for National Statistics, 'Share Ownership Survey' <http://www.statistics.gov.uk/pdfdir/share0110.pdf> accessed 17 August 2010.

[3] Ibid, 3.

[4] These overseas institutional shareholders may also be 'traditional' (but foreign) institutional investors of the type discussed in the thesis. Alternatively, an increasing number may be so-called 'sovereign wealth funds', see below, section 3.2.5.

[5] See Table 4.1 in Chapter 4.1.1.

Table 3.2 Marks and Spencer Plc Shareholders (Ordinary shares) as of April 2010

Ordinary shares

As at 3 April 2010, there were 217,541 holders of ordinary shares whose shareholdings are analysed below.

	Number of holdings	Percentage of total shareholders	Number of ordinary shares	Percentage of ordinary shares
Range				
1 – 500	108,735	49.98	21,582,412	1.36
501 –1,000	43,817	20.14	32,780,554	2.07
1,001 – 2,000	33,458	15.38	47,897,697	3.03
2,001 – 5,000	22,468	10.33	68,859,124	4.35
5,001 – 10,000	5,709	2.62	39,645,480	2.51
10,001 – 100,000	2,714	1.25	62,120,241	3.93
100,001 – 1,000,000	452	0.21	152,384,856	9.63
1,000,001 – HIGHEST	188	0.09	1,157,046,217	73.12
Total	**217,541**	**100.00**	**1,582,316,581**	**100.00**

	Number of holdings	Percentage of total shareholders	Number of ordinary shares	Percentage of ordinary shares
Holders				
Private	208,497	95.84	295,630,971	18.68
Institutional and Corporate holders	9,044	4.16	1,286,685,610	81.32
Total	**217,541**	**100.00**	**1,582,316,581**	**100.00**

Source: Marks and Spencer, Annual Report and Financial Statement 2010, 117. Available at <http://annualreport.marksandspencer.com/downloads/M&S_AR10.pdf> accessed 11 April 2010.

Compare this data with information on Prudential Plc's and Vodafone Plc's ownership structure. Both Prudential and Vodafone have a similar shareholder structure involving a significant number of individual investors and a small number of institutional investors owing most of the shares in the company.[6]

These ownership structures are representative of large UK listed companies, as suggested by Goergen and Renneboog. In a sample of FTSE 250 Index listed companies, they observed that the largest institutional shareholding averages 5.5% in

[6] Prudential Plc, 2010 Financial Report <http://www.prudentialreports.com/2010hy/files/pru_hy10_report_AdditionalInfo.pdf >available 12 July 2010; Vodafone Plc, 2010 Annual Report <http://www.vodafone.com/static/annual_report10/additional_information/shareholder_information.html > accessed 12 July 2010.

UK listed companies.[7] This thesis will bring on more evidence concerning the size of individual institutional shareholdings in Chapter 4.

Myners and Cheffins argue that the primary reason for the rise of institutional share ownership in the UK is tax privileges for institutions.[8] For example, pension funds are exempt from capital gain tax, and contributions to such funds by their beneficiaries are made out of pre-tax income.[9] Moreover, the increase in private retirement savings, in the form of pension schemes and insurance, is another reason pushing the growth of institutional investment in the UK.[10] Collective investment through institutions also allows individuals to spread (indirectly) their investment amongst a much wider range of companies, thereby reducing their exposure to the risk of a catastrophe should any one such company collapse. And individuals may reason that institutions will be more expert in picking the best companies in which to invest their holdings.[11]

3.2 The Institutions

The main types of UK institutional investors that I cover in the thesis are pension funds, insurance companies, mutual funds (including unit trusts and investment trusts) and hedge funds. This section introduces and describes each of them, including their size, organizational structure and investment arrangement and other features I believe will be relevant to applying the model that I developed in Chapter 1.There is an important point to be made here: investments of different types of institution are not

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[7] M Goergen and L Renneboog, 'Strong Managers and Passive Institutional Investors in the UK' in F Barca and M Becht. (eds), *The Control of Corporate Europe* (Oxford University Press, Oxford 2001) 259, 270.

[8] P Myners, *Institutional Investment in the United Kingdom: A Review* (London 2001), 27; B Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press, Oxford 2008) 346-49.

[9] Ibid.

[10] P Davies, *Institutional Investors in the United Kingdom* (1993) In 1993) D D Prentice and P R G Holland (eds), *Contemporary Issues in Corporate Governance* (Clarendon Press New York) 69-96.

[11] D Hobson, *The National Wealth: Who Gets What in Britain* (HarperCollins, London 1999) 1035-42. For an evaluation of how capitalism has changed over time, see, C Clark, 'The Four Stages of Capitalism: Reflections on Investment Management Treatises' (1981) 94 Harvard Law Review 561.

separate but often overlap. Insurance companies both hold shares in their own right and also manage the investment of other institutions, such as pension funds. Pension funds and insurers are often the large clients of mutual funds. Meanwhile, many funds are typically managed by external fund management companies, who simultaneously manage money business for a number of different institutions.

3.2.1 Pension Funds

Pension funds form a large category of institutional shareholder in the UK. They collect, pool, and invest assets contributed to provide for the future pension entitlement of beneficiaries.[12] Pension funds' investments have shown strong increase historically. Over the period 1963 to 2008, pension funds' shareholding in the UK equity market increased from 6% to 12.8%.[13]

Pension schemes can be broadly divided into 'unfunded' and 'funded'. Most unfunded schemes are in the public sector. They are operated on a Pay-As-You-Go basis, financed solely 'from the current contributions of the employers and of existing employees or from other revenues on a year-to-year basis.'[14] Pensions that are financed from a reserve or fund which has been built 'up over a period of years by investing accumulated contributions in earning assets' are funded schemes.[15] Most occupational pension funds in the UK are operated on a 'funded' basis. This thesis only focuses on funded schemes because it is this type of pension scheme that purchases stakes in listed companies.

Almost all pension plans are organized in the form of a trust which makes pension schemes separate entities from their sponsoring company.[16] In making funds

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[12] P Davis and B Steil, *Institutional Investors* (MIT Press, Cambridge, Mass 2001) 15.

[13] See Table 3.1.

[14] D Blake, *Pension Schemes and Pension Funds in the United Kingdom* (Clarendon Press, Oxford 1995) 293.

[15] Ibid.

[16] Myners (n 8) 6.

investment, fund trustees are required to follow a 'prudent person' approach.[17] According to the fiduciary duty established in case law, a trustee must:

> 'exercise, in relation to all matters affecting the fund, the same degree of care and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide and to use such additional knowledge and skill as the trustee possesses or ought to possess by reason of the trustee's profession, business or calling.'[18]

As one will see later, the 'prudent person rule' differs from the Chinese quantitative limitation approach, granting trustees more discretion over investment asset allocation.[19]

Funded pension schemes are either defined benefit (or salary-related) schemes, where the value of the pension is related to the employee's salary (usually at, or close to, retirement) and the length of service, or defined contribution (or money-purchase) schemes, where the value of the pension is determined by reference to the value of the members' own fund.[20] This will depend upon the money paid in, and the performance of the investments purchased with the money in the fund. For both defined benefit and defined contribution funds, the liability tends to be *long-term*, as the objective of asset management is to attain a high replacement ratio at retirement.[21]

Previously, most pension funds were set up in the form of defined benefit schemes. In recent years, there has been a continuation of the sharp decline in the number of defined benefit schemes, from 17,900 in 2000 to 2,240 in 2007.[22] Many defined benefit schemes have closed to new members because of the increased costs to

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[17] Pension Act 1995 s 35.

[18] Bartlett v Barclays Bank (No.1) [1980] Ch 515 at p.531, per Brightman J. See also the discussion in Pension Law Reform. The Report of the Pension Law Review Committee, HMSO, 1993, para 4.9.7.

[19] Chapter 7.2.3.

[20] Davis and Steil (n 12) 15.

[21] Ibid.

[22] Office for National Statistics, 'Occupational Pension Schemes Survey' (ONS, London 2007).

employers of providing defined benefits for their employees.[23] For example, BP, as one of the last remaining FTSE 100 companies to provide a defined benefit scheme to new employees, announced that it will close the scheme from April 2010 so as to avoid the financial burden resulting from sharp rises in life expectancy.[24] The defined contribution scheme has taken its place and is expected to gain further development in the future.[25]

3.2.1.1 The Structure of Pension Fund Investments

There are a number of different ways in which the investment of a pension fund can be managed. It is important to explain these approaches clearly here because as one will see, these approaches vary in the strength of conflicts of interest (and, as this thesis noted in Chapter 1, such conflicts represent one of the costs in my model of shareholder activism).[26]

First, most large pension funds are self-insured or self-administered. The fund trustee is the registered beneficial owner of the fund assets in investee companies. They may be managed by the trustees themselves (in house management), or managed directly through an appointed fund manager, or indirectly through external financial intermediaries, such as an investment bank.[27]

The majority of pension funds in this type contract out management functions with fund managers to perform the investment task. These external fund managers thus play a fundamental role in institutional arrangement for pension schemes. They perform a range of activities in accordance with their contracts, such as portfolio analysis, portfolio adjustment and risk management.

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[23] Myners (n 8) 29.

[24] N Cohen and E Crooks, 'BP Ends Final Pay Pension for New Staff', *Financial Times* (2 June 2009) London.

[25] Office for National Statistics, 'Occupational Pension Schemes Survey' (n 22).

[26] See Chapter 4.2.2.2.1.

[27] Blake (n 14) 366.

Investment decision-making for pension funds can be further divided into two principal management approaches: balanced mandate model and customised bench mark. Under the balanced mandate model, the fund trustee 'entrusts the assets of the fund to one or more fund management companies, leaving both strategic asset allocation and security selection to them'.[28] Within the alternative customised bench mark, instead of entrusting all fund assets to a fund manager, the fund trustee will delegate stock selection decisions to a fund manager while retaining the power to make the strategic assets allocation.[29]

Second, small pension funds often choose to have their portfolio managed by insurance companies. The insurance companies, rather than fund trustees, are both the registered and beneficial owner of the underlying assets.[30] In such case, voting rights rest in the hands of the insurance company.

Third, sometimes funds are pooled. Under this arrangement, all contributions from a number of different pensions are pooled together and invested as a single sum. Pooled funds are typically operated as either unit trusts which are established under a trust structure or managed pension funds which operate under insurance contract. Unit trusts will be discussed separately. In a managed pension fund, the fund simply purchases units of a diversified investment from insurance company. This kind of fund is also called insurer-administered pension fund. In 2007, the insurer-administered pension funds accounted for 45% of all pensions, with £2,420 billion assets.[31] In this way where pension schemes invested in pooled funds, the insurance company which manages the fund is the beneficial owner of the assets and thereby has the right to exercise voting rights. Pension schemes purchasing funds own just their insurance policies.[32]

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[28] Myners (n 8) 8.

[29] Ibid.

[30] G Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon, Oxford 1996) 22.

[31] ABI, *Money in Funded Pensions in 2007* (ABI, London 2008).

[32] Stapledon (n 30) 22.

3.2.2 Insurance Companies

The second type of institutional investor the thesis addresses are insurance companies. They are large equity holders in the UK, collectively controlling 13.4% of investment in the UK stock market in 2008.[33] The UK insurance industry accounts for 11% of total worldwide premium income, (compared to just 3% of that insurance industry in China.)[34]

Within an insurance contract, an individual pays a sum to an insurance company and the company, in turn, pays the policy-holder a specified sum if an insured event (such as death) occurs, or in some cases at the end (term) of the insurance contract.[35] To help ensure that clients' needs are met, UK insurance companies invest in stocks, real property and other investment sources to maximum return.

The UK insurance industry is dominated by life business and other term long-term insurance contracts, controlling 93% of the total assets, as opposed to their general (i.e. household, casualty, health, etc.) insurance funds.[36] Most of the equity investments of insurance companies are in life insurance and this thesis will thus be more concerned with this type of insurance company.[37]

Life insurance companies can be broadly divided into linked investment, where the amount invested is linked directly to the investment performance, and non-linked where policyholders receive an annual bonus and a discretionary terminal bonus decided by the insurance company. Like pension funds, insurance companies are

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[33] ABI, *UK Insurance-Key Facts* (ABI, London 2010).

[34] ABI, Ibid, 4

[35] Davis and Steil (n 12) 15.

[36] ABI, *UK Insurance-Key Facts* ,(n 33) 3.

[37] For a detailed introduction on insurance management, see, S Zenios and WZiemba (eds) *Handbook of Asset and Liability Management, Volume 2: Applications and Case Studies* (North Holland, Oxford 2007) 543-705.

long-term institutional investors, mainly subject to prudential person regime to handle investment in 'due diligence' on the behalf of their clients.[38]

A large majority of insurance assets are managed in house, by asset management subsidiaries on behalf of parent groups' insurance companies, or have a large insurance component with the group.[39] The British insurance industry is concentrated, with 80% of the business written controlling by the top ten of life insurance and pension insurance groups.[40] For example, in 2007, 26% of all insurer-administered pension funds are Legal & General managed. The top five companies altogether accounted for 57% of all insurer-administrated pension funds.[41]

As discussed above, insurance companies are closely linked to pension funds, as they often act as external fund managers for pension funds, or offer annuities for guaranteed pension benefits.[42]

3.2.3 Mutual Funds

Mutual funds pool the assets of individuals or other funds for investment purposes. In the UK, mutual funds offer short-term liquidity on pooled funds, either via direct redemption of holdings (open-end fund), or via the ability to trade shares in the funds on exchanges (close-end fund).[43]

Open-end funds, including unit trust and open-ended investment companies (Oeics) have grown rapidly to the third-placed group of institutional shareholders in the UK. Their total assets have increased 141% over the five years from 2002 to 2007 when

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[38] P Davis, 'Portfolio Regulation and Life Insurance Companies and Pension Funds' 2001 The Pensions Institute, Working Paper No. PI-0101, 25; M Bijapur and others, 'An Empirical Analysis of European Life Insurance Portfolio Regulation' 2007 FSA Occasional Paper Series 21, 8.

[39] ABI, *UK Insurance-Key facts* (ABI, London 2008), 31.

[40] Ibid, 6.

[41] Ibid, 5.

[42] Ibid, 16.

[43] Davis and Steil (n 12) 17.

funds assets were £ 468 billion.[44] A majority of open-end funds' clients are institutional investors, such as insurance companies and pension funds, owing 76% of total assets under management.[45]

Unit trust and Oeics are similar in nature but differ in the way they are constituted. Unit trusts are set up under the terms of a trust deed and issue units. They can be authorised, or unauthorised (only the former can be promoted to the public), but most are authorised unit trusts.[46] Oeics are organized in the form of a company and issue shares.

Authorised unit trusts and Oeics are regulated by the Financial Services Authority (FSA) under the terms of the Financial Services and Markets Act 2000 (FSMA 2000). They must conform to the FSA rules for authorised investment funds as set out in the FSA 'COLL' handbook.

Unit trusts and Oeics are typically managed by fund managers. A total of 2,178 unit trusts and Oeics in 2007 were managed by about 110 fund management companies.[47] Amongst them, the top ten companies control about 45% of total industry asset by 2007, indicating the relatively concentration of the asset management industry.[48] Unit trusts and Oeics' asset split is heavily geared to equities, with 70% of total assets held in the UK and other equities in 2007.[49]

Close-end investment funds in the UK mainly refer to 'Investment Trusts'. Despite their name, they are not trusts in the legal sense at all: they are public companies subject to company law.[50] Their assets are fixed at the start by issuing a set number of shares. They invest in a wide range of assets such as shares, private equity, property

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[44] IMA, *Asset Management in the UK 2007* (IMA, London 2008) 50.

[45] Ibid, 30.

[46] Stapledon (n 30) 23.

[47] Ibid, 55.

[48] Ibid, 55.

[49] Ibid, 51.

[50] Stapledon (n 30) 23; Myners, Institutional Investment in the United Kingdom: A Review (n 8) 37.

and bonds. Each investment company has a board of directors who appoint fund managers to make day-to-day decisions about investment selection. The great majority of investment trusts are managed by external fund management companies.[51]

There are major differences between mutual funds in their portfolio strategies. A key distinction is between actively managed, and passive or 'index funds'. Active management seeks to identify and purchase misvalued securities, assuming that 'the market is inefficient and that not all relevant information is present in securities market'.[52] Active management thus attempts to make profit by trading securities. Passive management assumes returns are maximized by 'holding the shares'.[53] Index funds seek to reproduce or replicate the behaviour of a market index.[54] In doing so, costs are minimized by keeping portfolio switches to a minimum. Determined by their investment strategy, active managed funds tend to be more short-term, while the latter two manage long-term assets.

3.2.4 Hedge Funds

In addition to the above 'mainstream' institutional investors, one recent emerged type of institution – hedge funds – have, as Amour and Cheffins, and Macneil show, the potential to be an important player in the corporate governance arena.[55] As of March 2010, total assets under management by global hedge funds are estimated to be $1.5 trillion.[56]

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[51] Myners, Institutional Investment in the United Kingdom: A Review (n 8) 36.

[52] Davis and Steil (n 12) 58.

[53] Ibid.

[54] Ibid, 445.

[55] 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 10 August 2010; I Macneil, 'Activism and Collaboration Among Shareholders in UK Listed Companies' (2010) Capital Markets Law Journal 1, 7.

[56] Credit Suisse/Tremont Hedge Fund Index, 'Q1 2010 Hedge Funds Update: Staying the Course' (2010) <https://www.credit-suisse.com/us/hedge_strategies/en/> accessed 10 August 2010.

Despite an absence of agreed definition, hedge funds distinguish themselves from other traditional institutional investors in their organizational structure and investment strategies. First, hedge funds are usually organized as limited partnerships managed by a general partner.[57] The investment of funds is subject to minimum requirements – usually between $ 1 million to $ 10 million.[58] Due to the high investment minimum, in contrast with traditional institutional arrangement, most funds are open exclusively to wealthy high net-worth institutions or individuals.[59] Investors of hedge funds are limited partners or members. Contracts governing investment in hedge funds typically lock up investor's capital for six months, although a first-time investor often cannot withdraw for at least one year. In an effort to produce strong returns, some funds are now moving towards a longer lock-up term – two years or longer.[60]

Secondly, in terms of investment strategies, hedge funds are generally said to pursue investment strategies of identifying 'pre-existing value inherent in market inefficiencies and pricing anomalies'.[61] Ganshaw finds that the four most commonly-used investment strategies are:[62]

1. Long-short equity: funds adopting this strategy buy in long equity positions to short sales of securities or shares index;[63]
2. Global macro: funds who take this approach will invest in a broad range of

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[57] J Macey, *Corporate Governance:Promises Kept, Promises Broken* (Princeton University Press, Princeton, N.J. 2008), 242.

[58] Ibid.

[59] A Brav and others, 'Hedge Fund Activism, Corporate Governance, and Firm Performance ' (2008) 63 Journal of Finance 1729, 1735.

[60] I Kishner and K Foster, 'The New Masters of the Buyout Universe' (2005) 243 New York Law Journal 11, 11.

[61] F J Blassberg (ed), *The Private Equity Primer: The Best of the Debevoise & Plimpton Private Equity Report* (Debevoise and Plimpton, New York 2006) 3.

[62] T Ganshaw, *Hedge Funds Humbled: the Seven Mistakes that Brought Hedge Funds to Their Knees and How They will Rise Again* (McGraw-Hill,, New York 2010) 8-9.

[63] For a detailed discussion of this approach, see Deutsche Bank Research, 'The Role of Long/Short Equity Hedge Funds in Investment Portfolios' (August 2004)
< http://www.trendfollowing.com/whitepaper/long_short.pdf> accessed 1 August 2010.

financial instruments, including currencies, commodities, sovereign securities, and seek to capture value by changes such as, governmental policies, economic growth and other country-specific issue;

3. Relative value: funds pursuing this strategy take advantage of differentials, such as liquidity and maturity, between given financial instruments. Fund mangers will simultaneously buy and sell, for example, securities to generate returns from the relative value of the two securities;
4. Event-driven: funds seek to profit from pricing inefficiencies created by actual or anticipated corporate events, such as mergers and acquisitions. *Activist funds* engaging in shareholder activism are within this category. In fact, only *a small portion* of hedge funds assets, as found by Kahan and Rock, are devoted to shareholder activism.[64] They will first find and invest in 'undervalue' securities, in expectation of generating strong returns through shareholder activism, to restore share prices. The research focus of hedge funds is on this type of activist hedge funds.

Most hedge funds are based in the US and shareholder activism by hedge funds remains largely, as pointed out by Armour and Cheffins, a US phenomenon.[65] In the UK, Hermes is a typical type of hedge fund, pursuing an event-driven strategy, to generate returns through shareholder engagement. I will give a detailed discussion of the approach Hermes adopted in section 3.5. Following Armour and Cheffins, hedge fund activism will be termed 'offensive activism', in contrast with the 'defensive activism' in which institutional shareholders have traditionally engaged.[66] This will be discussed in Chapter 5.1.

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[64] M Kahan and E Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 University of Pennsylvania Law Review 1021, 1028.

[65] Armour and Cheffins (n 55) 36.

[66] Ibid.

3.2.5 Overseas Institutions: Sovereign Wealth Funds

Although the thesis is only concerned with domestic UK institutional investors, given the large portion of overseas institutions, it would be helpful to have a brief look at this type of investor. Among the group of overseas investors, most are institutions, such as pension funds, insurance companies and mutual funds and they often share the same features as the UK institutions.

However, there is a distinct type of fund that deserves a specific mention here – Sovereign Wealth Funds (SWFs). It is defined by the U.S. Treasury as 'government vehicles funded by foreign exchange but managed separately from foreign reserves.'[67] Although they are by no means a recent phenomenon (the first fund – the Kuwaiti Investment Board – was established in 1953), they have attracted increasing recent attention as they doubled in size since 2000 from $ 1.5 trillion to $ 3.8 trillion in 2009, and are anticipated to swell to $ 12 trillion by 2015. Table 3.3 lists the 10 largest SWFs and their estimated assets.

Table 3.3 Estimated Size of Sovereign Wealth Funds by 2006 (In billions of U.S.Dollars)

Country	**Fund Name**	**Lunch Year**	**US (Billion)**	**% of 2006 GDP**
UAE (Abu Dhabi)	ADIA	1976	625.0	520.7%
Norway	Governmental Pension Fund-Global	1990	322.0	102.6%
Singapore	GIC	1981	215.0	169.0%

[67] C Lowery, 'Sovereign Wealth Funds and the International Financial System'. Remarks at the Federal Reserve Bank of San Francisco's Conference on the Asian Financial Crisis Revisited. Washington: US Treasury, 21 June 2007, 1.

Kuwait	Kuwait Investment Authority	1953	213.0	268.7&
China	China Investment Corporation	2007	200.0	8.0%
Russia	Stabilization Fund	2004	127.5	14.2%
Singapore	Temasek	1974	108.0	84.9%
Qatar	Qatar Investment Authority	2005	60.0	185.3%
US(Alaska)	Permanent Reserve Fund	1976	40.2	0.3%
Brunei	Brunei Investment Authority	1983	30.0	309.4%

Source: G Lyons, 'State Capitalism: The Rise of Sovereign Wealth Funds' Standard Chartered Bank, 15 October 2007.

The main financial sources of SWFs come from reserves, natural-resource payments and the like.[68] The sudden emergence and growth of SWFs as big players in the global capital markets are due to the spike in world oil prices, which has brought massive revenues to oil exporters such as Norway's Government Pension Fund, or the large amount of foreign-exchange reserves by Asian central banks, such as China's State Foreign Exchange Investment Corporation.[69]

[68] The Economist, 'The World's Most Expensive Club', May 24 2008 <http://www.economist.com/node/9230598?story_id=9230598> accessed 30 June 2010.

[69] R J Gilson and C J Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism' (2008) 60 Stanford Law Review 1345, 1358.

Typically, SWFs are established with a primary focus on one or more of the following aims: macroeconomic stabilisation (to smooth short- and medium-term fluctuations, higher returns (to increase investment return), future generations (create a reserve of fund for future) and domestic industries (to restructure and encourage domestic industries).[70]

To reach those aims, the vast majority of SWFs structure their holding to maximize investment return. They have conservatively invested heavily in safe products, such as U.S.Treasury and other national government bonds.[71] Recently, some of them have begun to shift their investment strategy to some higher-risk/higher-return investments in equities or corporate acquisitions.[72]

Although it is difficult to track how SWFs invest their assets, recent high-profile deals enable us to have a look at their investment scale. As shown in Table 3.4, the largest SWFs have all acquired minority (but significant) stakes in large U.S., British, or European companies. They are, therefore, become important shareholders of those financial institutions.

Table 3.4 Recent Major Acquisitions by Sovereign Wealth Funds

SWF Origin	Company	Size of Stake	Total Cost ($bln)	Sector	Country
China	The Blackstone Group	10%	3.0	Private Equity	U.S.
	China Railway Corporation		0.1	Construction	Hong Kong
	Morgan Stanley	10%	200.0	Financials	U.S.
	ANZ		0.6	Financials	Australia
	Barclay's	3%		Financials	U.K.
UAE	EADS	3%		Aerospace	France, Germany, U.K.
	Citigroup		7.5	Financials	U.S.
	China Development Bank	3%		Financials	China
Qatar	London Stock Exchange	20%		Financials	U.K.
	J. Sainsbury	25%	1.5	Supermarkets	U.K.
Singapore	UBS		10.0	Financials	U.K.
	Barclay's	3%	19.0	Financials	U.K.
	China Construction Bank	4%		Construction	China

[70] B J Balin 'Sovereign Wealth Funds: A Critical Analysis ' (Johns Hopkins University School of Advanced International Studies, 2007).

[71] Gilson and Milhaupt, (n 69) 1347.

[72] Ibid.

Source: B J Balin, *Sovereign Wealth Funds: A Critical Analysis* (Johns Hopkins University. School of Advanced International Studies, 2007) 7.

Until now, there is *no* completed and comprehensive study investigating the impact of SWFs on corporate governance of their portfolio companies. However, some evidence indicates that those funds have no or little incentives to get involved in their investee companies. Some of them tend to avoid public scrutiny of their investment and keep their secrecy through purchasing non-voting shares. An example of their passive strategy is the deal by the Chinese Investment Corporation and U.S. Blackstone Group, where Chinese SWF forfeited its voting rights in the Blackstone Group.[73] In 2009, Qatar and Chinese Investment Corporation invested in Canary Wharf with £880m bail-out of Songbird Estates Plc, but the shares subscribed by those two SWFs are non-voting and non-preferential.[74]

The purchasing of non-voting shares may well become more common in the future as there are calls for more regulations on the investment of SWFs.[75] Many SWFs have provided low levels of transparency, raising a fear that SWFs may be motivated by strategic intentions, instead of an investment purpose, to control the investee companies through their large purchase. One proposed policy is to require SWFs with low levels of disclosure to buy only non-voting shares in companies as a means of controlling their influence over investee companies.[76] Some SWFs funds, for example, China Investment Corporation declared their willingness for taking non-voting shares

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[73] Balin (n 70) 9.

[74] Graham Ruddick, 'China Invests in Canary Wharf with £880m Bail-out of Songbird', Telegraph, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6107221/China-invests-in-Canary-Wharf-with-880m-bail-out-of-Songbird.html, accessed at 30 June 2010.

[75] For example, see Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions of 27 February 2008 – 'A common European approach to Sovereign Wealth Funds' [COM/2008/ 115 final) < http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf > accessed 30 June 2010.

[76] Gilson and Milhaupt (n 69) 1362-1345.

and restricted stakes, although they might take positions on boards.[77] Hence, such self-restriction may *further* weaken the role of SWFs in corporate governance in their investee companies.

3.3 Industry Trade Associations

Each type of institution has its own industry trade association: the National Association of Pension Funds (NAPF), the Association of British Insurers (ABI), the Investment Management Association (IMA), and the Association of Investment Companies (AIC). These four associations are collectively represented by the Institutional Shareholders Committee (ISC). These organizations are said to serve the role of pioneers for their members in corporate governance.

The NAPF is made up of 200 fund members and represents the interests of nearly 1,200 pension schemes and 400 businesses providing essential services to the pension sector.[78] The ABI was established in 1985 to represent the collective interests of the UK's insurance companies. It has around 400 members, which between them account for about 94% of domestic insurance services sold in the UK.[79] The IMA is the representative body for the UK investment management industry. Its members collectively manage over £3 trillion of assets in the UK.[80] The AIC was formed in 1932, to represent the closed-ended investment company industry. It has some 300 members, which between them account for approximately 77% of the sector by assets.[81]

In 1973, these four trade associations agreed to create the ISC as a body to collectively represent institutional investors in the UK. Its role is to allow 'the UK's

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[77] D K Das, 'Sovereign-Wealth Funds: the Institutional Dimension ' (2009) 56 International Review of Economics 85, 99.

[78] See <http://www.napf.co.uk/> accessed 16 January 2007. .

[79] See <www.abi.org.uk> accessed 16 January 2007.

[80] See <http://www.investmentuk.org/factsheets/ima/cb.pdf> accessed 16 January 2007.

[81] See <www.theaic.co.uk> accessed 16 January 2007.

institutional shareholding community to exchange views and, on occasion, coordinate their activities in support of the interests of UK investors.'[82]

It should be borne in mind that the creation of the ISC did not replace the roles of its members, NAPF, ABI, IMA and AIC. Although the range of institutions has acted as one through the ISC, each trade association will sometimes act separately based on the different features and demands of their members.

These industry trade bodies have all, to varying degrees, been active in promoting institutional shareholder engagement in corporate governance. Their efforts are mainly reflected in three areas.

First, they play a traditional role of lobbying government on behalf of their members. They have liaised with and or lobbied with institutions including governmental departments, the London Stock Exchange and the Institute of Chartered Accountants of England and Wales on matters such as executive share-option, large transaction and management buy-outs.[83] In addition, they are also represented in some important bodies, such as the Takeover Panel and the Stock Exchange's Investors Advisory Group.[84] Moreover, these associations are invited to give their opinions on the UK corporate governance framework. For example, they have issued many responses to governmental-related bodies, such as FRC, who requires comments on various aspects of corporate governance.[85]

Second, UK industry associations have produced and promoted statements of, and guidance on, best practice in areas such as institutional investment, tax and share schemes. In the area of corporate governance, such statements include *ISC's A Statement of Principle on the Responsibilities of Institutional Shareholders and*

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[82] See <http://www.institutionalshareholderscommittee.org.uk/library.html>, accessed 16 January 2007.

[83] Stapledon (n 30) 133.

[84] Ibid.

[85] For example, NAPF issued its response to the FRC Combined Code Review in 2009.

Agents (Statement of Principle), *ISC's Code on the Responsibilities of Institutional Investors* and *NAPF's 2009 Corporate Governance and Voting Guidelines*[86] *and Responsible Voting – a Joint ABI – NAPF Statement in 1999*. They will be discussed later in Chapter 4.2.2. All the above guidance is voluntary but those associations call on institutions to state publicly how they apply the principles.

Third, industry associations serve as nexus between their institutional members and their investee companies to deal with their concerns or problems.[87] For example, when there is concern over either corporate governance issues or strategic matters of the company, these associations sometimes assist members holding large number of shares to form 'case committees' to meet with the board and typically negotiate their concerns. These case committees were active in the late 1980s and 1990s. As reported by Stapledon, the ABI formed about 200 case committees annually.[88] However, thereafter they were less seen until 2003 when NAPF was reported as reviving its case committee. The case committee is kept non-public and the meetings are conducted in a behind-the-scene way.

Some associations, such as the NAPF and ABI, help their members to monitor their investee companies through their voting-information services. Their monitoring services will test listed companies' compliance with relevant corporate governance

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[86] NAPF, 'Corporate Governance Policy and Voting Guidelines' NAPF,'Corporate Governance Policy and Voting Guidelines' (2009) <http://www.napf.co.uk/DocumentArchive/Policy/Corporate%20Governance/20090207_NAPF%20Corp%20Gov%20policy%20and%20voting%20guidelines%20-%202009%20updated.pdf> accessed 20 May 2009.

[87] A good example is the institutional shareholders-management row over the CEO's pay in Sainsbury plc in 2004. The NAPF met with the chairman of Sainsbury plc's Remuneration Committee and recommended its members to vote against the management's proposal. See J Finch, 'Sainsbury's Facing Pay Defeat' (10 July 2004) *Guardian* <http://www.guardian.co.uk/business/2004/jul/10/executivesalaries.executivepay> accessed 12 December 2007.

[88] Stapledon (n 30) 137.

guidance, such as the UK Corporate Governance Code, and make voting recommendations on behalf of their subscribers.[89]

In addition, industry associations have conducted surveys to examine the extent to which members are complying with good practice and engage with investee companies to act as responsible investors. They cover fund managers' monitoring of investee companies, voting their shares, interacting by other means and informing their clients of their policy and engagement. These surveys are important sources of evidence in the thesis to investigate the level of shareholder engagement.[90]

In sum, UK industry trade associations play an important role in promoting good corporate governance among institutional shareholders and facilitating shareholder engagement with their investee companies. As one will see later, the increase of shareholder activism in recent years in the UK is to some extent driven by these associations.[91]

3.4 Corporate Governance Personnel

An institutional shareholder, as its name indicates, is an institution with its own internal organization. To deal with corporate governance engagement, they have adopted a variety of administrative arrangements. Some institutions delegate to fund manager's responsibility for both investment and handling of corporate governance engagement. Some institutions set up separate departments comprising of dedicated teams of governance analyst. Some investors outsource engagement activity to a corporate governance agency. This section introduces the first and second approaches. The delegation of authority to outside agencies will be discussed in the section 3.7.

First, for some institutional investors, dealing with corporate governance issues is treated as part of every fund managers' job. In addition to managing investment, they

[89] See section 3.7.

[90] See surveys conducted by the NAPF, ABI and IMA, cited in Chapter 5.

[91] See Chapter 4.1.2 and 4.1.4.

need to closely monitor and research the companies they invest in and make decisions on whether to intervene when there are contentious issues regarding investee companies. Their roles as investment decision-makers and corporate governance monitors often overlap, because corporate governance is sometimes an important indicator for fund managers to assess a company, and shareholder engagement would potentially increase investment returns. Since nowadays corporate governance has increasingly become an important issue, research shows that fund managers devote more resources to engagement with investee companies than before.[92] The advantage of this approach is cost-saving. Moreover, in some circumstances, fund managers, who get involved in investment process, are more likely to make accurate decisions on whether and how to engage in corporate governance. However, fund managers have traditionally performed their portfolio management duty and due to the special knowledge required for engaging corporate governance, they may sometimes not be well-suited for shareholder engagement.

The second and now *more common* approach to handle engagement is to establish a separate corporate governance team, composed of governance specialists. A survey by IMA shows that only two of 32 firms appointed fund managers to manage shareholder engagement, while the rest of firms dedicated particular specialists to corporate governance.[93] The increasing popularity of this approach may be partly in response to increasing pressure on institutional shareholders to take an active role in corporate governance, partly because of the importance of corporate governance in institutional investments, and partly because of the need for specialist knowledge to handle corporate governance issues.

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[92] NAPF, *Pension Funds' Engagement with Companies Survey 2007* <http://www.napf.co.uk/PolicyandResearch/DocumentLibrary.aspx> accessed 23 December 2008

[93] Investment Management Association, *Survey of Fund Managers' Engagement with the Companies for the Year Ended 30 June 2008* < http://www.investmentfunds.org.uk/news/press_centre/default.asp> accessed 23 August 2009.

The costs of developing specialist knowledge are likely higher, but this approach has a clear advantage in that specialists equipped with related knowledge would lead to a more effective shareholder involvement. These specialists play a single role of dealing with engagements but sometimes, they will provide advice to fund managers if information with regard to a company's corporate governance is needed. They decide the way in which institutions approach investee companies, attend meetings with corporate managers and vote in the shareholders' meetings. Under some circumstances, these specialists would work in conjunction with outside advisors to make decisions.

Generally, whichever approach institutions have adopted, empirical evidence from the IMA suggests that the number of staff devoted to engagement rose by 10% in the year to 2005, having already risen by 10% in the previous year.[94]

3.5 Hermes UK Focus Fund

In the UK, Hermes, the fund manager owned by the British Telecom Pension Scheme, operates a UK Focus Fund who pursues shareholder engagement as its investment strategy. The Hermes UK Focus Fund (HUKFF) invests in underperforming companies on the expectation that by engaging with underperforming investee companies, if necessary, using their ownership rights, it may achieve corporate governance improvements that they consider will ultimately lead to a higher value of investee companies. Due to its distinctive investment strategy, free-riding is not an option for the HUKFF (nor does the free-riding of others seem to be a threat to its own activism). I will return to this issue in Chapter 4. This section will first provide an introduction of the HUKFF's activism approach and corporate governance principle it follows.

3.5.1 The HUKFF Activism Approach[95]

[94] Ibid.

The HUKFF's approach can be broadly divided into two stages: investment stage and engagement stage. At the investment stage, the HUKFF selects a list of companies that have consistently underperformed in the market as a result of structural or strategic governance weakness but have the potential to be remedied by shareholders engagement. It applies three criteria when evaluating which portfolio company to target, asking (1) whether the target is underperforming; (2) whether the fund believes it can engage the company successfully; and (3) whether the fund expects to achieve at least a 20% increase in current share price. If all three criteria are satisfied, the Fund will decide to include the company into its portfolio.

The HUKFF begins engagement process with a meeting of the company at which it outlines proposals to improve corporate governance. If it gets a positive response from the board, the HUKFF will monitor and assist board in implementing decisions that are taken. If the response is negative, the Fund will meet with the independent board members and other major shareholders, to convince the board to make changes. The HUKFF will choose to threaten companies by taking public action, such as calling an EGM if there is no change made by the board.

Once the changes have been taken, the HUKFF will continue to hold the shares and wait the changes to be released to the market, so that the market can re-evaluate the shares. Typically, it will take two to three years for an engagement to be successfully completed.

3.5.2. Hermes' Principles of Corporate Governance

Hermes has issued a series of well-known statements in regard to corporate governance. They are:

[95] Information with regard to Hermes focus funds are obtained from <www.hermes.co.uk>.

a. *Corporate Governance and Performance* – was published in 2005.[96] It provides an updated review and assessment of the evidence for a link between corporate governance and performance. The statement concludes that active shareholders' engagement will lead to enhancement of shareholder value in the long term in investee companies.

b. Corporate Governance Principles – was published in 2006. The Principles form the basis of its engagement with companies in which it invests. It contains two parts: the Global Principle and the Regional Principle. The former is formulated on the basis of *International Corporate Governance Network(ICGN)'s Statements on Institutional Shareholder Responsibilities*,[97] whilst the latter is produced by local market participants or regulators, taking into account specific needs in different regions.

3.6 Securities Lending

There is no doubt that institutional shareholders are the owners of investee companies' shares and thus are entitled to exercise rights attached to the shares. However, under some circumstances, shares may be temporarily transferred to others for certain reasons. Securities lending, which is widely undertaken in the UK equity market, is one of the main activities contributing to this temporary share transfer. Before going to discussing how securities lending affects shareholder activism in detail, it is necessary to give some relevant background information about securities lending.

In fact, the term 'lending' is somewhat misleading. The 'lender' and 'borrower' enter into a contractual relationship whereby beneficial ownership of the shares is transferred by the former to the latter. The borrower pays a contractual fee[98] to the

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[96] Hermes, *Corporate Governance and Performance* (Hermes, London 2005).

[97] The International Corporate Governance Network (ICGN) is a global membership organization of around 450 leaders in corporate governance based in 45 countries with a mission to raise standards of corporate governance worldwide. More information can be found at <http://www.icgn.org/> accessed 29 December 2007.

[98] Cowell suggest fees range between about 5 basis points (5/100 of 1per cent) and 400 basis points,

lender for the loan of the shares, and agrees to return an equivalent number of shares back to the lender at the end of the contract.[99] The borrower of the shares may retain them during the period of the loan, but equally may sell them on, or re-loan them. Because beneficial ownership of the shares passes from the lender to the borrower, the borrower will, as owner of the shares, become entitled to dividends payable on them. However, the terms of the loan transaction will usually stipulate that the borrower is to provide the lender with (or 'manufacture') an amount equivalent to the dividend paid.[100] Likewise, the borrower will also be entitled to exercise the votes attaching to them.[101] It is this consequence of share lending, in particular, that gives rise to concern about the governance implications of the practice, a point to which I return in Chapter 5.3.2.2.2.2.

To protect the lender, share loans are usually 'collateralised', with the borrower providing security to the lender against a default by the borrower in returning the shares to the lender at the end of the loan agreement. The security may be cash or a variety of other forms of property, such as government or corporate bonds, letters of credit or other shares owned by the borrower. Where the borrower provides cash as security, the lender will usually pay interest thereon to the borrower, but typically at a rate lower than that which the lender should be able to earn by itself investing the

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see M Cowell, *Stock Lending: A Perspective* (2005) <http://www.makinson-cowell.co.uk/mak/publications/insights/2005> accessed 12 August 2008. whilst Spitalfields advisors quote fees between 8 and 100 basis points, see, Spitalfields Advisors, *An Introduction to Securities Lending* (Third edn Spitalfields Advisors limited, London 2006) The level of fee depends on a number of factors, including supply of, and demand for, loans of the shares in question, the size of the issuing company (the smaller its capitalisation, the higher the fee), and the likelihood that the lender will seek to recall the shares.

[99] Spitalfields Advisors, ibid, 13.

[100] Nevertheless, the dividend will, as a matter of tax law, be treated as earned by the borrower, not the lender. This may entail a more advantageous tax treatment of the dividend from the point of view of the parties to the loan agreement, and provides the motivation for some share lending deals.

[101] The entitlement depends upon the borrower having been registered as the new owner at the 'record date' specified by the company.

cash.[102]

At a macro-level, securities lending has grown considerably in recent years. It now represents a substantial part of the total number of day-to-to securities transactions.[103] The market in lent securities is estimated to be around $6 trillion, with about $22 trillion available for loan and around $100 trillion in issue, according to Data explore Consulting.[104] Nearly 50% of large firms' shares in the Financial Times Stock Exchange 100 Index are estimated to be generally borrowable.

The main lenders are those institutional shareholders with sufficiently large holdings to enjoy economies of scale in the making of loans. A survey carried out on behalf for the ICGN[105] in 2004, amongst its institutional investor members, found that 29 out of 39 respondents 'frequently' engaged in share lending, whilst a further 2 did so 'sometimes'.[106] Almost two thirds of respondents lent, on average, upwards of 10% of their portfolios each year. A more recent survey carried out jointly by *Pensions Week* and *Data Explorers Consulting* also suggested the practice of share lending to be prevalent amongst institutional investors,[107] with some 68% of fund managers found to offer for lending the shares of the institutions whose investments they managed. Loan transactions are recognized as a growing source of additional and

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[102] Indeed, this ability to earn a positive return on the collateral may be yet a further reason for the lender entering into the loan agreement in respect of the shares in the first instance.

[103] Section 5.2 of the European Commission' consultation document of the Services of the Internal Market Directorate General: Fostering an appropriate regime for shareholders' rights.

[104] D Rule, 'An Overview of the Securities Lending Market' (2008) Canadian Investment Review <http://www.investmentreview.com/archives/2008/fall/onloans.pdf> accesse 20 December 2009, quoted data from Spitalfields Advisors. Spitalfields Advisors has been rebranded as Data Explorers Consulting in 2009.

[105] In respect of this organization, see introduction in (n 97).

[106] Lintstock, Share Lending vis-à-vis voting: A Report Commissioned by the ICGN, 28 May 2008.

[107] Pensions Week and Data Explorers, 'UK pension Fund Securities Lending Survey Results' (October 2009), <http://www.dataexplorers.com/sites/default/files/Data%20Explorers%20Consulting%20UK%20Pension%20Fund%20Survey%202009.pdf> accessed 10 December 2009. The survey, undertaken during August and September 2009, was addressed to the 'top' 50 UK pension funds, and claimed a response rate of 50%.

relatively low risk, income for lenders. So, it has been estimated that 47.1% of funds under Pension Week's survey have obtained revenue of between £1 million to £5 million from securities lending in 2008, a significant contribution to their overall profit.[108]

In the UK, the conduct of stock lending should be carried on as a regulated activity under the FSMA 2000 (regulated activities) order 2001, and would have to be authorized and supervised under that Act. Those involved in the lending of securities, such as lenders, borrowers and agents will also abide by the provisions of the FSA Handbook, including the Market Conduct sourcebook and the Conduct of Business Sourcebook. The commonly used agreement for securities lending in the market is the Global Master Securities Lending Agreement which issued by the International Stock Lending Association.[109]

Faulkner suggested that the most common reason behind the *borrowing* of securities is to cover a short position-settling an outright sale of securities.[110] Short-selling allows borrowers to sell borrowed securities on the expectation that they can re-purchase those securities back at a cheaper price at some future date.

Second, securities lending may also arise for tax arbitrage. Securities owners are subject to withholding tax on dividends or interest. But some investors can be free of withholding tax and they could use their tax position to borrow securities, receive the dividend free of tax and obtain rewards from the lenders via a large fee or large 'manufactured' dividend.[111]

A third motive for share borrowing is that some shareholders may be offered a choice of taking a dividend or reinvesting in additional securities at a discount to the market

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[108] Pensions Week and Data Explorers (n 107).

[109] International Stock Lending Association, *Global Master Securities Lending Agreement*, <http://www.isla.co.uk/uploadedFiles/Gmsla%202000%20version.pdf> accessed 23 August 2009..

[110] Spitalfields Advisors (n 98) 10.

[111] For example, where the borrower pays or 'manufactures' an amount equal to, or larger than, the dividend back to the lender.

price. But some funds may be unable to take the dividend opportunities because their holding would exceed the permitted amount under investment guidelines. For the latter investors, they could borrow guaranteed dividend alternatives and sell the shares to the market. They will profit from the price difference between the discounted share and market share and also, they can share profits with the lenders via a larger fee or larger manufactured dividend.

Finally, securities lending may also be driven by other financial considerations. For example, lenders may seek to obtain cash in exchange for the lent securities, and can use trading strategies such as buy/sell backs or cash collateralised securities lending.

The reason why securities lending is relevant to this thesis, however, is that once securities have been lent, absolute title transferred between the parties and the new owner are entitled certain rights, including voting in the annual meeting.[112] As a result, securities lending has a large impact on the exercise of share rights by institutional shareholders with particularly regard to voting. This will be returned to below, in section 5.3.2.2.2.2.

3.7 Proxy Voting Agencies

As shareholder activity has become both more important and more complex, it demands for sufficient time and resources from institutional investors. However, few institutional shareholders, even large investors which may be able to assign dedicated staff members to assess corporate governance issues, have adequate resources to consider every issue in shareholders' meetings and investigate every company in their portfolio each year around the world. To remedy this, many institutions employ one of the proxy advisory services to discharge their duty to ultimate beneficiaries to vote their shares. Those proxy voting agencies become one of the participants in the voting process and have the potential to facilitate more effective shareholder activism. For example, they help institutions to overcome restraint from conflicts of interest and

[112] Spitalfields Advisors (n 98) 5.

their professional opinion can lead to more efficient monitoring activities. It is therefore, necessary for this thesis to introduce some major advisors. More discussion of their roles in corporate governance is in Chapter 5.[113]

In the UK, there are three major agencies offering proxy advisory services: the Institutional Voting Information Service (IVIS), the Research, Recommendation Electronic Voting (RREV), the Pensions and Investment Research Consultants (PIRC).

3.7.1 Institutional Voting Information Service (IVIS)

The IVIS is operated by the Association of British Insurers (ABI) since 1993.[114] It is one of the largest proxy advisory providers, and has been subscribed to by the top 15 investors in the UK FTSE All share index. Its services assist institutions to evaluate companies' compliance with corporate governance best practice, to review companies' executive remuneration and all other proposed resolutions. It makes voting recommendations and issues reports based on the corporate governance standards set out in the ABI' guidance and in the UK Corporate Governance Code. The monitoring targets of the IVIS include all UK FTSE ALL Share Index companies.

A notable feature of the service provided by IVIS is its colour coding system, It uses different colours to highlight areas of concern: (a) Blue top indicates companies comply with ABI guidance and the UK Corporate Governance Code; and (b) amber top indicates concern; (c) red top indicates that non-compliance with guidance or corporate governance best practice and suggests members abstain or vote against in the meeting; and (d) green top indicates that there was previously non-compliance issue but it has been resolved.

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[113] See Chapter 5.3.1.8.

[114] Information come from IVIS' website <http://www.ivis.co.uk/ > accessed 10 August 2008.

3.7.2 Research, Recommendation Electronic Voting (RREV)

The second widely used proxy service is RREV which was launched jointly by the NAPF and American RiskMetrics (previously known as Institutional Shareholder Services) in 2004.[115] Prior to 2004, the NAPF operated it own agency – Voting Issue Service from the beginning of 1993. The subscribers of RREV can also access RiskMetrics' voting recommendations on more than 22,000 companies in about 80 countries.

Its monitoring services cover all companies in the FTSE All-Share and selected UK companies not included in the FTSE All-Share Index. The voting recommendations and corporate governance research reports are based on guidelines issued by the NAPF.

The scope of its recommendations of best practice mainly include governance and financial performance, board structure, remuneration, auditing and accounting disclosure, and shareholder relations.

3.7.3 Pensions and Investment Research Consultants (PIRC)

Similar to IVIS and RREV, PIRC, which was established in 1986, offers research and advisory consulting services to institutional shareholders.[116] It provides research on all shareholders' meetings held by companies in the UK FTSE All Share Index and below, and issues proxy voting services to institutions. In addition, it has a shareowner engagement service, providing subscribers with 'advice on engagement strategies and priorities' and 'facilitation of coalition-building among investors'.[117] It has also established its own benchmark for good corporate governance – proxy voting guidelines and Shareowner Voting Guidelines.

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[115] More information can be found at <www.rrev.co.uk> accessed 10 August 2008.

[116] More information can be found at< www.pirc.co.uk> accessed 10 August 2008.

[117] More information can be found at <www.pirc.co.uk/services> accessed 10 August 2008.

3.8 Conclusion

This chapter has examined the institutional share ownership landscape in the UK. We have seen the rise of that ownership, as well as the different types of institutional shareholder, and the structures they employ to make, and to manage, their investments. We have seen the distinctive role played by one particular investor, Hermes, and the pervasive reliance on shareholder voting agencies.

There are two important points that can be drawn from these observations. First, we found that the institutional investment market is mainly dominated by long-term institutions, including pension funds and insurance companies. Second, institutional shareholders in the UK are supported by institutions, such as association organizations and proxy voting services, to participate in corporate governance. As one will see in Chapter 4, these features have significant implications for applying the model that I have developed in Chapter 1. Moreover, as we shall see in Chapter 7, they serve to distinguish UK institutional investment from their Chinese counterpart.

With this firm grasp on the empirical reality of UK institutional investment, the discussion in Chapter 4 now takes a more theoretical turn. In particular, we can now begin to develop the model sketched in Chapter 1 by ‘feeding’ into relevant findings about the UK governance framework (drawn from Chapter 2) and the landscape of institutional share ownership (drawn from this chapter).

Chapter 4 Developing the Model for Institutional Investor Activism

To properly understand shareholder activism, this thesis sought to develop a model in Chapter 1 to explain whether and when institutional shareholders might decide, individually, to take action. Recall that it suggests a two-steps process in understanding activism for individual institutional shareholders. The first step deals with the free-riding hurdle that faces an individual shareholder. This thesis suggested that under some circumstances, free-riding on the efforts of others is not a rational option for an individual shareholder. This thesis suggested four factors are relevant: the decisiveness of large individual institutional holdings, the possibility of concerted action, 'in process' benefits and a normative obligation to act.

The second step proceeds to ask whether, for the shareholder in question, its individual benefits from action would still be greater than its individual costs. I suggested that the 'gains' include the shareholder's share of the total gains to the corporation from the activism in question, plus any individual benefits it secures through its own activism. I also offered a classification of 'costs' based on direct costs and indirect costs of activism.

In dealing with the first stage of the model in Chapter 1, this thesis emphasized that the precise functioning of these factors – the impact they have on the decision-making of any given institutional investor – will depend upon the governance or regulatory environment, upon the *type* of institutional shareholder concerned, and upon the form of activism being undertaken. This chapter develops the model by feeding in some relevant issues about the governance/regulatory environment and the type of institutional shareholder involved in the potential activism. Chapter 5 turns to feed into the model the different types of activism.

4.1 Step 1: Overcoming Free-Riding

4.1.1 Individual Shareholding

As I said in Chapter 1, one of the factors which might overcome the 'free-riding' problem is where a shareholder's stake in the company is sufficiently large that the shareholder calculates that stake will be decisive in changing corporate behaviours. (Moreover, the size of individual shareholding is also relevant to the cost-benefit analysis as well, as we shall see in section 4.2.)

So, are large institutional investors' shares big enough to be decisive? The accepted norm is that UK listed companies have a dispersed shareholder base by international standards.[1] However, it is certainly now arguable that they are not as widely dispersed as has commonly been assumed.

Recall, by way of illustration, the shareholding of major investors in Marks and Spencer PLC.[2] As we can see in Table 4.1, the largest shareholder own 6.57% of total shares. This is large in absolute terms. Moreover, in practice, when it comes to, for example, voting, its power could be even larger since not all shareholders would cast their votes at shareholders' meeting. If we calculate based on the average voting level in UK – 60%[3] – the largest shareholder controls 10.9% of total votes cast at the AGM, which may well be decisive to take action.

Table 4.1: Major shareholder of Marks and Spencer PLC

[1] See generally, A Shleifer and R Vishny, 'A Survey of Corporate Governance' (1997) 52 Journal of Finance 737.

[2] See Chapter 3 Table 3.2.

[3] See Chapter 5.3.1.2.

	Ordinary shares	% of capital
Brandes Investment Partners, L.P.	111,595,173	6.57%
AXA S.A.	89,374,221	5.66%
Capital Research & Management	78,591,394	4.98%
Legal & General Group plc	63,188,326	3.99%
The Wellcome Trust	47,464,282	3.01%

Source: Marks and Spencer, Annual Report and Financial Statement 2010, 73.

Similarly, Prudential has four shareholders with a greater than 3% shareholding: one with 3.08%; one with 3.87; another holding 6.39% and another with 13.018%.[4] There are two shareholders with a disclosable shareholding in Vodafone: one with 5.74% and the other with 4.03%.[5] Clearly, for these large shareholders, the collective action problem is surely not as significant as has been traditionally assumed.

Recent research conducted by ISS Europe in mid-2000s looked at the share ownership structure of 20 large UK listed companies and 20 recently listed companies and found that share ownership in these companies was much less widely dispersed than commonly thought.[6] 15% of large UK companies and 45% of recently listed companies have one or more significant shareholders owning at least 20% of the share capital.[7] Those large shareholders clearly have potential to be decisive in taking action.

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[4] Prudential Plc, 2010 Financial Report <http://www.prudentialreports.com/2010hy/files/pru_hy10_report_AdditionalInfo.pdf >available 12 July 2010.

[5] Vodafone Plc, 2010 Annual Report <http://www.vodafone.com/static/annual_report10/additional_information/shareholder_information.html > accessed 12 July 2010.

[6] ISS European, European Corporate Governance Institute and Shearman& Sterling, Report on the Proportionality Principle in the European Union, (2007) <http://www.ecgi.org/osov/documents/final_report_en.pdf> accessed 10 April 2010.

[7] Ibid.

We should not, then, be too quick to assume that individual shareholders in the UK, can never reasonably think their actions will be decisive. Nevertheless, nor should we go too far in the opposite direction and assume individual shareholders will often be decisive. The UK does, in comparison to many other countries (including China), remain one characterised by comparatively dispersed ownership. Given that, it remains relevant to ask whether UK listed companies should move towards even greater concentration of share ownership.

4.1.1.1 The Impracticality of Significantly Greater Concentration

There are two reasons for doubting that greater concentration would be likely or desirable. The first is the attitude of institutions towards risk. The second is legal norms favouring diversification.

First, institutional shareholders, as custodians of others' assets, want to handle risk appropriately by diversifying their investment portfolios.[8] This has created a bias against concentration.[9] To maintain diversification, institutional investors imposed upon themselves limits on the maximum percentage of equity they would own in a single company.[10] A 2 or 3% stake will represent a very large proportion in any UK public listed companies. In HSBC, for example, a 3% stake would be £3.5 billion, or roughly 10% of the assets of the Universities Superannuation Scheme.[11] Any further increase in investment in HSBC would suggest a large size of their holding for

[8] There is a rich literature discussing this issue. For a detailed discussion on portfolio theory, see W F Sharpe *Portfolio Theory and Capital Markets* (McGraw-Hill, New York 1970); R Dobbins and S F Witt, *Portfoliot Theory and Investment Management* (Robertson, Oxford 1983); D Blake, *Pension Schemes and Pension Funds in the United Kingdom* (Clarendon Press Oxford 1995) 487; A L Tucker and others, *Contemporary Portfolio Theory and Risk Management* (West Publishing, New York 1994); E J Elton and others, *Modern Portfolio Theory and Investment Analysis* (Wiley, Hoboken 2009).

[9] J Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277, 1355-7.

[10] P Davies, 'Institutional Investors: A UK View' (1991) 57 Brooklyn Law Review 129, 140.

[11] C Riley, N Ryder and N Stansbury, 'A submission to the Walker Review' (2009), on file with the author.

a scheme. It would be therefore risky for institutions to increase their concentration of share ownership in listed companies and the cost to sacrifice liquidity for more control is unacceptable.[12] The traditional way in which fund managers had been trained further enhances their preference for diversification over concentration. Many fund managers have 'grown up with modern portfolio theory, in which securities are fungible, characterized by risk and return and no more.'[13] Diversifying their portfolio to reduce investment risk is worthwhile, while attempting to improve performance by monitoring governance is not recommended.[14]

Secondly, this portfolio investment strategy to spread risks is supported by legal restrictions. Some institutional investors are not free to purchase shares as large as he wants in a single listed company. For example, authorized open-ended investment funds cannot invest more than 5% of their scheme property in transferable securities or approved money-market instruments of a single issuer.[15] Nor may such institutions control more than 10% of transferable securities of a single issuer.[16] Although pension funds are not subject to such regulatory restrictions, they must operate under a 'prudential model' which requires managers to undertake investment with minimum risks.[17]

Moreover, larger holdings also trigger potentially more onerous disclosure obligations. A shareholder is obliged to notify the FSA if his interest in a company is in 3% or more of the issuer's voting rights.[18] Once a shareholder has reported his major

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[12] Coffee (n 9).

[13] B Black, 'Shareholder Passivity Reexamined' (1990) 89 Michigan Law Review 520, 563.

[14] M Goergen, L Renneboog and C Zhang, 'Do UK Institutional Investors Monitor their Investee Firms' 8 Journal of Corporate Studies (2008) 39, 43.

[15] FSA Handbook, COLL, 5.2.11.R.

[16] FSA Handbook, COLL, 5.2.29.R.

[17] Pension Act 1995 s 35.

[18] FSA Handbook, DTR 5.1.2.R.

holding, every change in that holding must be notified when the percentage of voting rights reaches or crosses every 1% threshold up to 100%, going up or down.[19]

Similar observations have been expressed in respect of the US.[20] In summary, both economic concerns and legal rules are likely to deter institutional shareholders from moving towards significantly greater concentration of share ownership.

4.1.2 The Possibility of Concerted Action

Given that it is likely to remain comparatively rare for any single individual institution's holding to be decisive, the more likely and practical way in which free-riding will be overcome is if *concerted* action by a relatively small group of investors is feasible. The practicality of such coalition, as I have suggested in Chapter 1, significantly increases to the extent that share ownership is more concentrated, so that fewer shareholders need to agree to act together in order to constitute a decisive block of shares.

In Chapter 3, we have seen a significant shift in the ownership of UK listed companies from individual investors to institutional investors. A significant portion of shares is now concentrated in a small group of institutional investors, suggesting that a collective action amongst institutional shareholders will more often constitute a decisive block of shares.

So, how many institutional investors are likely to need to be involved to form an effective coalition? By way of illustration, in Marks and Spencer, as Table 4.1

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[19] Ibid.

[20] For example, Black suggested that US ownership restrictions on institutional investment, make a single institution hard to own a large portion of shares in a single company than it would otherwise be. See B Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 UCLA Law Review 811,822. Similarly, Roe contends that mutual funds 'could have been a conduit of shareholder power' but for regulations and ownership restrictions. See, M Roe, 'Political Elements in the Creation of a Mutual Fund Industry' (1991) 139 University of Pennsylvania Law Review 1469, 1470.

suggests, the collective shares of top five shareholder amount to 24% of Marks and Spencer' total equity and they control approximately 40% of the votes cast when the voting level of the meeting is around 60%.

Writing in 1985, Scott argued that a group consisting of 10-20 institutional investors would typically represent 20-30% of the issued share capital of the company concerned.[21] Since then, institutional share ownership appears to have become yet more concentrated. So, under Stapledon's research, a coalition consisting of 2-6 large institutional investors can represent 20-30% of the shares of the company.[22] Goergen and Renneboog showed that, in a sample of FTSE 250 Index companies, a coalition of the top three shareholders in 250 UK listed companies would own 27.7%, and all large shareholdings combined would come to about 40%.[23] This evidence suggests that it might not be difficult to organize a collective action in UK listed companies as the number of shareholders needed to act together in order to constitute a decisive block of share is comparatively small.[24]

Moreover, the likelihood of coalitions is *further* increased by the facilitation of industry associations. As we have seen in Chapter 3, trade associations, such as the NAPF, IMA and ISC, play an important role in organizing collective actions amongst institutional shareholders. For example, when their member institutions have concerns over investee companies, those industry associations can establish 'case committees', comprising members holding the largest shares in the companies, to meet with the executives/board. When large institutional investors in Prudential reacted angrily to

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[21] J Scott, *Corporations, Classes and Capitalism* (Hutchinson, London 1985) 49.

[22] G Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon, Oxford 1996) 126.

[23] M Goergen and L Renneboog, 'Strong Managers and Passive Institutional Investors in the UK' in F Barca and M Becht. (eds), *The Control of Corporate Europe* (Oxford University Press, Oxford 2001) 259, 270.

[24] R Crespi and L Renneboog, 'Is (Institutional) Shareholder Activism New? Evidence from UK Shareholder Coalitions in the Pre-Cadbury Era' 18 Corporate Governance: An International Review 274. They found shareholder coalition has been an effective corporate governance mechanism for several decades in the UK, even before the first code initiated by the Cadbury committee.

the aborted bid for AIA, the managers of Prudential have to meet with the NAPF to seek its help.[25]

Therefore, the concentration of institutional holdings in UK listed companies and the facilitation of trade associations, undermine the likelihood of free-riding by making it easier for institutions to form a coalition to counterbalance the power of the incumbent management. On the other hand, we have to consider whether some aspects of the legal framework make concerted action *more* difficult. Of most relevance here are first disclosure rules and second takeover rules.

4.1.2.1 Legal Impediments to Acting in Concert

Institutional shareholders who act together to form a decisive block of stakes face legal risks of being identified as 'acting in concert' and triggering disclosure or takeover obligations. As one will see later, despite regulators having issued statements to confirm these rules are not intended to conflict with shareholder collective action, these rules still might constrain shareholder coalitions as the rules lack the clarity and certainty for which institutions might have hoped.

4.1.2.1.1 Takeover Rules

In the UK, the activity of acting in concert is currently regulated by the Takeover Code. The term '*acting in concert*' is defined under the Takeover Code as where

> 'persons coordinate with the offeror or the offeree company on the basis of an agreement, whether formal or informal, aimed either at acquiring control of the offeree company or at frustrating the successful outcome of a bid.'[26]

[25] P Davies and K Burgess, 'Pru Investors Turn Focus on McGrath', *Financial Times (*London 16 June 2010) < http://www.ft.com/cms/s/0/987c085e-7984-11df-b063-00144feabdc0.html > accessed 23 June 2010.

If shareholder collective action towards a company is deemed to be 'acting in concert', relevant investors have to face the choice: to make a *mandatory bid* on the target company or place themselves in breach of the Takeover Code.[27]

4.1.2.1.2 Disclosure rules

As noted in section 4.1.1.1, a shareholder is obliged to notify the FSA if he has an interest in holdings of 3% or above of the issuer's voting rights. Moreover, he must seek pre-approval from the FSA for acquisition of controlling levels of shareholdings and voting power in a company.[28] The FSMA 2000 further provides that in certain situations, when calculating a person's percentage level of voting power, it is necessary to aggregate that person's holdings with another's, to decide if together they are large enough to trigger these obligations.[29] These circumstances include, for example, where those persons have concluded an agreement which obliges them to adopt 'by concerted exercise of the voting power they hold, a lasting common policy towards the management of the undertaking in question'.[30]

In 2007, the FSA issued guidance in its publication, *Market Watch Number 20*, which warned that, if several shareholders acted together to build stakes with the intention of avoiding market disclosure requirement that would otherwise be required if the shares

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[26] Takeover Code, C1 definitions; This rules further provide that The afflicted persons are all deemed to be acting in concert with each other. 'The control of a company' means 30% or more of the voting rights are concentrated in the hand of shareholders in collective action.

[27] Takeover Code, Rule 9.

[28] The Financial Services and Markets Act 2000 (Controllers) Regulations 2009 (SI 2001/3495) s 178. And s 422 (2) provides that 'controller' means (1) a person holds 10% or more of the shares or voting power in the authorised firm or a parent undertaking of the authorised firm; or (2) is able to exercise significant influence over the management of the authorised firm by virtue of its holding of shares or voting power in the authorised firm or a parent undertaking of the authorised firm.

[29] The Financial Services and Markets Act 2000 (Controllers) Regulations 2009 (SI 2001/3495) s 422 (3).

[30] The FSMA 2000 (Controllers) Regulations 2009, 422 (5)(a)(i).

had been bought by one investor, they may be at risk of committing market manipulation.[31]

4.1.2.1.3 Statements from the FSA and the Takeover Panel

While these rules aim to protect the interests of public, in the context of shareholder activism, they are considered by many investors as ambiguous and fail to distinguish between collective action aimed at achieving a degree of control on target companies and collective action which is not designed to seek control but to promote good corporate governance. For example, when the public criticises institutional shareholders for their being passive in dealing with banks during the banking crisis, some shareholders claimed that they were afraid to break the 2007 guidance from the FSA.[32] Being afraid of breaking rules on acting in concert, instead of taking concerted action with other investors, Knight Vinke, an activist group, attacked HSBC by outlining its view on a quarter-page advertisement in the Financial Times.[33] Robert Jenkins, chairman of the IMA, said that when institutions join forces for change at specific companies they should be exempted from the rules.[34]

These concerns have been noted by Sir David Walker in his consultation report for the *Review of Corporate Governance in UK Banks and Other Financial Institutions*.[35] The consultation emphasized the importance of shareholder activism as a means of promoting good corporate governance and pointed out that current regulations are not specific enough to allow institutions to join forces on governance issues. He

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[31] FSA, Markets Division: Newsletter on Market Conduct and Transaction Reporting Issues, *Market Watch* Issue 20, available at http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter20.pdf accessed 25 May 2009.

[32] See 'FSA Spells Out Rules for Activist Investors' *Financial Times* (August 19 2009) < http://www.ft.com/cms/s/0/ac934b4a-8cbd-11de-a540-00144feabdc0.html> accessed 21 August 2009

[33] See 'Knight Letter Targets HSBC Investors'*Financial Times* (7 September 2009) < http://www.ft.com/cms/s/0/3fa8c3d6-5d6a-11dc-8d22-0000779fd2ac.html > accessed 21 August 2009.

[34] L Norman and M Foster, 'FSA Says Rules Won't Hurt Shareholder Activism ' *Wall Street Journal* (August 20 2009)<http://online.wsj.com/article/SB125072471082144583.html> accessed 2 November 2009.

[35] Available at < http://www.frc.org.uk/corporate/walker.cfm> accessed 15 October 2009.

suggested the regulators, including the FSA and Takeover Panel, ensure 'there are no regulatory impediments, real or imagined, to effective dialogue.'[36]

Building on that recommendation, on August 2009, the FSA sent an open letter to the ISC to explain how shareholders can work jointly to promote effective corporate governance without triggering obligations of being identified as acting in concert.[37] In the letter, the FSA clarified how its rules on market abuse, disclosure of major shareholding and changes in control interact with collective shareholder activism. Such clarification is, however, restricted to specific ad hoc corporate issues. Institutional shareholders should remain vigilant that long-term agreement to vote together may constitute market abuse. Moreover, they must not trade in investee securities based on the information they obtain while working together.[38]

Following close on the FSA' statement, the Takeover Panel also issued a Practical Statement to allay institutional shareholders' concern that collective action may be constrained by the rules of acting in concert and mandatory offer requirements.[39]

The statement deals with the way in which it normally interprets and applies certain provisions of the Takeover Code in the context of shareholder activism. It sets two tests, both of which must be satisfied before a mandatory offer will be triggered:

> '·those shareholders requisition a general meeting to consider a "board control-seeking" resolution or threaten to do so; and
>
> ·after an agreement or understanding is reached between the activist shareholders that a "board control-seeking" [emphasis added] resolution should be proposed or threatened, those shareholders acquire interests in shares such that the shares in

[36] Ibid, 5.43.

[37] FSA, 'Shareholder Engagement and the Current Regulatory Regime', a Letter to Keith Skeoch, Chairman of ABI <http://www.fsa.gov.uk/pubs/other/shareholder_engagement.pdf> accessed 25 December 2009.

[38] More detailed discussion on this issue is provided in Chapter 5.2.

[39] The Takeover Panel, Practice Statement No.26 Shareholder Activism, 2009.

which they are interested together carry 30% or more of the voting rights in the company (or, if they are already interested in shares carrying 30% or more of the voting rights of the company, they acquire further interests in shares).'[40]

In determining whether an action is 'board-control seeking', the Panel will assess a number of factors listed in the Statement. These are mainly:

'·Whether there is significant relationship between the proposed directors and the shareholders proposing them or their supporters

·The number of directors to be appointed or replaced compared with the total size of the board

·The board position held by the directors being replaced and to be held by the proposed directors

·The nature of the mandate

·Whether the activist shareholders will benefit as a result of the implementation of the proposal, other than through their interests in shares in the company

·Relationship between the proposed directors and the existing directors and/or between the existing directors and the activist shareholders'

In particular, the Panel confirms three common situations which will *not* lead the Panel to conclude a concert party had come together. They are:

'·Discussions between shareholders about possible issues which might be raised with a company's board;

·Joint representations by shareholders to the board; and

·The agreement by shareholders to vote in the same way on a particular resolution at a general meeting.'

[40] Ibid.

Undoubtedly, these statements have produced a greater degree of certainty and clarity over the application of provisions on acting in concert, and thus to some extent mitigate institutional shareholders' concern. As Danka Starovic, policy adviser on regulation at the ABI, noted 'this time, the Executive has produced a very worthy effort to go the extra mile, and …..the FSA…also provides encouragement for the members of the Institutional Shareholders' Committee.'[41]

However, these statements have not gone far enough in providing clarity or regulatory certainty. There are some issues which remained unaddressed. First, in the FSA' letter, it simply comments that 'a lasting common policy towards the management of the issuer through the exercise of their voting rights' is unlikely to 'include the kind of ad hoc discussions and understandings which might be reached between institutional shareholders in relation to particular issues or corporate events'.[42] However, it does not go further to give an explanation on what constitute a lasting common policy. Again, as observed by Slaughter and May, ambiguity arises as to what would fall into particular issues or corporate events.[43] For example, would jointly voting for a change of board member constitute 'particular issues' and not break the rules? Explanations illustrating what kind of corporate issues are likely to fall on each side of the line are required.

Second, as McQuay noted, uncertainty remains as to what will constitute board control-seeking proposal under some circumstances.[44] A particular concern arises when the board refuses the shareholders' proposal and the institutions want to take further action. Institutional shareholders must be careful not to fall on the wrong side

[41] M McQuay, 'Shareholder Activism: A Modicum of Reassurance' (2009) Practical Law Company <http://fs.practicallaw.com/9-500-3174> accessed 20 October 2009.

[42] FSA (n 37).

[43] Slaughter and May, 'Shareholder Activism-A Call for More Extensive Guidance from the FSA' (2009) <http://www.slaughterandmay.com/media/848084/shareholder_activism_call_for_more_extensive_guidance_from_fsa.pdf> accessed 20 October 2009.

[44] M McQuay, 'Shareholder Activism: a Modicum of Reassurance' (2009) Practical Law Company <http://fs.practicallaw.com/9-500-3174> accessed 20 October 2009.

of the line set up by the Panel when they inform the board about their further action. According to the Panel's statement, if the activist shareholders make it known that, if their initial proposal fails, they will put forward a 'board control-seeking' plan, this may lead the Panel to conclude that the initial proposal is 'board control-seeking' and that a concert party has arisen. Thus, what institutions tell the board is crucial. If institutional shareholders are not careful enough, their action would cross the line accidentally. Moreover, when institutions plan an agreement which would oblige them to adopt a consistent voting policy in the next general meeting, this risk of constituting a long-lasting policy under the FSA's letter emerges again.

In short, statements from regulators have provided some welcome reassurance as to their attitude towards collective shareholder actions. They give institutional shareholders safe harbours when they team up for lobbying changes for management at investee companies. With these clarifications, it is likely that the level of collective voting activism will increase. In the future, it is hoped that the regulators can provide further certainty and clarity in respect of collective shareholder actions if possible.

4.1.3 'In process' Benefits

Some institutional shareholders, as argued in Chapter 1, may regard engagement itself as a way of gaining profits and thus, have incentives to forego free-riding to gain these 'in process' benefits. Perhaps the leading example in the UK is that of the Hermes UK Focus Fund (HUKFF), which I have introduced in Chapter 3. Hermes has actively engaged in shareholder activism to improve the corporate governance of investee companies. To be sure, part of the benefit of doing this is an anticipated rise in the value of its investee companies. Recently, researchers from the London Business School examined the investment and shareholder engagement approach adopted by HUKFF over the period 1998-2004 and found that its engagement is

ultimately value increasing.[45] During that period, the HUKFF invested in 41 companies, and engaged with 30 of them. It had meetings with chairmen, CEOs, divisional managers, head of investor relations and with non-executive board members.[46] It also contacted other institutional shareholders to seek their supports for its efforts.[47]

The research found that the fund's engagement approach was highly successful. It generated annual raw returns net of fees of 8.2%, or 4.9% if measured by the abnormal returns against the FTSE All-Share Index over the period 1998-2004.[48] 90% of such returns are attributable to its engagement activists.[49] Information from Hermes' own publication, *Corporate Governance and Performance* also confirms that its HUKFF outperformed the FTSE all shares Total Return Index by 3.9% on an annual basis since its inception in 1998.[50]

However, this thesis would argue, besides hoping for (and achieving) a rise in the value of its investee companies, part of Hermes' gain from its policy of engagement is an in process gain, namely a positive reputation. Engagement has become a reputational issue which could help institutional shareholders to maintain competitive position in the market.[51] Hendry et als found that the institutions' main clients – normally the pension fund trustees – had become increasly preoccupied with corporate governance.[52] Those clients would therefore request institutions to pay a lot

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[45] M Becht and others, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2009) 22 Review of Financial Studies 3093.

[46] Ibid, 3095.

[47] Ibid.

[48] Ibid.

[49] Ibid.

[50] Hermes, *Corporate Governance and Performance* (Hermes, London 2005).

[51] P Montagnon, 'The Role of the Shareholder' in K Rushton(eds), *The Business Case for Corporate Governance* (Cambridge University Press, New York, 2008) 81.

[52] J Hendry and others, 'Responsible Ownership, Shareholder Value and the New Shareholder Activism' (2004) ESRC Centre for Business Research, University of Cambridge Working Paper No. 297.

of attention to corprorate governance.[53] As such, institutional investors' failure to ensure good corporate governance in portfolio companies will be seen by potential investors as an inability to manage their management properly. This creates incentives for institutional investors to make sure that their portfolio companies are well monitored. Such demand is stronger on large institutional investors as their activities are more easily observed: 'If you've got 5% in a company and it goes wrong, then there's a risk to our reputation.'[54]

Moreover, as a result of the implementation of the Stewardship Code, this kind of reputational benefit is likely to become an even more relevant factor when institutions determine whether to take action. As Macneil observes, the Stewardship Code is more focused on disclosure, such as of shareholders' engagement policy, than the process for activism.[55] This implies that motives for greater shareholder monitoring after the implementation of the Stewardship Code are more likely to be driven by the public and funds' clients. Institutional investors who often free-ride on others' efforts face the shame threat and the risk of losing their clients.

4.1.4 A Moral/normative Obligation to Participate

As said in Chapter 1, there may be occasions when shareholders do not calculate in the economic way, accepting an *obligation* to act regardless of whether they could free-ride on the efforts of others. This obligation may derive from a regulatory norm, or institutions' fiduciary duty towards their clients, or a moral or social obligation to act. The strength of these obligations is, as we shall see, likely to vary between institutions and between different situations.

4.1.4.1 Regulatory Demand

[53] Ibid.

[54] Ibid.

[55] I Macneil, 'Activism and Collaboration Among Shareholders in UK Listed Companies' (2010) Capital Markets Law Journal 16.

Institutional shareholder engagement has long been regarded as vital to the corporate governance system in the UK and there has been much regulatory pressure from various bodies to encourage institutional shareholders to engage more actively in corporate governance. Firstly, since 2006, the Government took power under the CA 2006 to require institutional investors to disclose how they have voted their shares.[56] While it is stated that the government will use this power only if a voluntary regime were to fail to improve disclosure, it is threatening and forces institutional investors to consider their responsibilities to be responsible owners of investee companies for the interests of their beneficiaries and public.

Secondly, successive governance guidance in the UK, from the Cadbury Report in 1992, through the Greenbury, Hampell, Turnbull and Higgs reviews in the mid 1990s to early 2000s, and on to the current UK Corporate Governance Code (UK Code), all emphasized the importance of institutional shareholders' monitoring in enhancing the accountability of corporate management. The UK Code, for example, previously contained a separate section (Section E) that set out a number of recommendations addressed to institutional shareholders.[57]

The Stewardship Code can be considered the culmination of this long process of addressing institutional behaviour. In 2000, Paul Myners was commissioned by the Chancellor of the Exchequer to carry out a review of institutional investment. His Report (Myners Report) was first published in 2001, and reviewed in 2004, 2005 and 2007.[58] The Myners Report sets out principles for investment decision making for pension fund trustees, including a recommendation on incorporating shareholder activism into fund management mandates.[59]

Meanwhile, a variety of representative organizations all issued statements or

[56] CA 2006 ss 1277-1280.

[57] Combined Code 2008, E1 E2 E3., See introduction in Chapter 2.

[58] P Myners, *Review of the Impediments to Voting UK Shares* (2004); (2005); (2007). London: Shareholder Voting Working Group.

[59] P Myners, *Institutional Investment in the United Kingdom: A Review* (2000). London: HM Treasury.

guidelines to push institutional shareholders to use their considerable governance power for both beneficiaries and the companies in which they invest. The most influential guidelines include the following:

4.1.4.1.1 ISC's *A Statement of Principle on the Responsibilities of Institutional Shareholders and Agents*[60] (Statement of Principle) – was first issued by ISC in October 2002 and the latest version was published in 2007. The Statement of Principle was formed as a response to the Government' argument that institutional investment industry can develop a voluntary approach to ensure their considerable power is being used responsibly. The Statement of Principle outlines best institutional investor practice, and identifies the responsibilities of institutional investors in respect of the companies in which they invest. In particular, institutional investors are required to: (1) set out corporate governance policy; (2) monitor investee companies' performance; (3) intervene, where necessary; and (4) evaluate and report how they discharged their responsibilities to their clients.[61] The Statement of Principle was revised in 2009 and renamed as the Code on the Responsibilities of Institutional Investors.

4.1.4.1.2 ISC's *Code on the Responsibilities of Institutional Investors*[62] – was published on 16 November 2009. It sets out best institutional investor practice with regard to monitoring companies, dialogue with company boards and voting at general meetings. The Code is now adopted by the FRC as the Stewardship Code for institutional investors.

4.1.4.1.3 NAPF's *2009 Corporate Governance and Voting Guidelines*[63] and *Responsible Voting – a Joint ABI – NAPF Statement in 1999*[64] – both

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[60] It is available at <http://www.institutionalshareholderscommittee.org.uk/library.html> accessed 19 August 2009.

[61] Ibid.

[62] Ibid.

[63] NAPF, 'Corporate Governance and Voting Guidelines'
< http://www.napf.co.uk/PolicyandResearch/DocumentLibrary.aspx >accessed 19 August 2009.

[64] Ibid.

statements set out guidance to their members on how to responsible vote their shares in investee companies. As shown in Chapter 5, these guidelines become the voting guidance for the voting services provided by the NAPF and ABI.

Finally, the Stewardship Code, made on the basis of the ISC Code on the Responsibilities of Institutional Investors, contains seven principles which institutions should respect, namely:[65]

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

Although the practical effect of the Stewardship Code remains to be seen, there is some empirical evidence suggesting previous regulatory calls seem at least partially effective. For example, Cheffins and Goergen *et al*., suggested that institutional shareholders activism stepped up a gear after the Myners' Report in 2001.[66] Williams and Conley also pointed out that many institutional shareholders started to increase their engagement level with investee companies as a result of the desire to avoid

[65] Stewardship Code, available at < http://www.frc.org.uk/corporate/investorgovernance.cfm > accessed 4 July 2010.

[66] B Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press, Oxford 2008) 386 (summarizing cases of institutional shareholder activism after Myners' report in 2001); M Goergen, L Renneboog and C Zhang, 'Do UK Institutional Investors Monitor Their Investee Firms' 8 Journal of Corporate Studies (2008) 39, 56.

legislative intervention.[67] Moreover, as we will see later in Chapter 5, many large institutional investors incorporated the ISC' Statement of Principle into fund managers' contracts as a guidance for engagement.[68]

4.2 Step 2: A Cost-benefit Analysis

Once the free-rider problem is overcome, my model suggests activism by an individual institution is likely if a second step is satisfied, namely if that shareholder's benefits outweigh its own costs. The benefits and costs of activism depend in part on the type of institutional shareholder and it is the purpose of the part below to work out how different types of institutional shareholder will calculate his costs and benefits.

4.2.1 Benefits

As discussed in Chapter 1, the benefits of activism mainly come from (1) share of total gains to the company; plus (2) any personal gains (e.g reputational).

4.2.1.1 Share of Total Gains to the Company

Generally, successful shareholder activism will generate more benefit to larger institutional shareholders with long-term investment horizons than it will to small, short-term, institutional investors.

First, the overall size of shareholding is clearly one of the factors influencing the amount of benefits secured from activism. Larger institutional investors have more incentive for activism because they receive greater return from activism than smaller institutional shareholders. A good example is activist hedge funds. In order to have sufficient leverage over the management of investee companies, activist hedge funds invest a large portion of their funds only in a small number of companies. HUKFF,

[67] C A Williams and J M Conley, 'An Emerging Third Way?: The Erosion of the Anglo-American Shareholder Value Construct ' (2005) 38 Cornell International Law Journal 493, 540-41.

[68] See Chapter 5.3.

for example, invested only forty-one companies between the beginning of 1999 and the end of 2004.[69] The size of their holdings allows them to receive more of the financial benefits of intervention than do smaller investors. Thus, they are more willing to take action for great return.

The *second* characteristic that can affect institutional shareholders' incentives for activism is their shareholding time horizon. The length of investment held by institutions is positively linked with the size of benefits secured from activism. As needs for liquidity vary, there are different equity holding terms among institutional shareholders. For example, pension funds and insurance companies have traditionally held more equity in the UK with long-term time horizons. In contrast, mutual funds have to maintain a high diversification of their portfolios. Fund managers' performances are annually reviewed and if they are found to lag behind others, clients can easily shift from one fund to another or withdraw their funds on short notice.[70] As a result, mutual funds with shorter investment horizon tend to rely on market forces rather than engagement as a means for improving fund performance.

Institutional shareholders with long-term investment horizons will receive more benefits than those with shorter term investment. Firstly, longer investment offers a good opportunity for institutions to develop long-term relationships with investee companies to increase those institutions' influence over the company and to secure more accountability from the board.[71] It has been argued that a close relationship between institutional investors and corporate management would facilitate the board to adopt a longer-term investment to the strategy of their companies by reducing the

[69] Becht and others (n 45) 3097.

[70] Coffee (n 9) 1318.

[71] I A Millstein, 'The Responsibility of the Institutional Investor in Corporate Management' in A W Sametz and J L Bicksler. (eds), *The Battle for Corporate Control: Shareholder Rights, Stakeholder Interests and Managerial Responsibilities* (Business One Irwin, Homewood 1991) 67-76.

possibility of managerial short-termism.[72] Moreover, investors with longer investment time horizons institutions with long-term horizons tend to receive more gains in the sense that many benefits of activism take long time to be realised.[73] For example, in Hermes case, Herms anticipates it can take two to three years for its activism to result in a sufficient increase in the company's stock price.[74]

4.2.1.2 Personal Benefit

I have already discussed the possibility of some institutions enjoying in-process, personal benefits in section 4.1.3 and need not repeat that discussion here.

4.2.2 Costs

4.2.2.1 Direct Costs

Direct costs will to some extent vary depending on the type of activism, so will be discussed mainly in Chapter 5. Here, in Chapter 4, I address some general issues about costs (or cost reduction) that apply to all forms of activism.

4.2.2.1.1 Empowering Indirect Investors: Information Rights

Direct costs of activism will depend partly on legal regulation. As I have noted in Chapter 2, in an effort to enhance shareholder engagement, CA 2006 has introduced new provisions to empower shareholders' rights in corporate governance. One

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[72] Research on managerial incentives frequently found that managers tend to focus on the short-term and ignore the long-term impact of their investment. For example, see J Robert, *The Modern Firm: Organizational Design for Performance and Growth* (Oxford University Press, Oxford 2004) 271.

[73] Admittedly, this presumes that stock market is 'insufficient' in pricing up a company's shares-that stock market do not instantaneously build into a company's present share price. All the future gains that will be enjoyed as a result of today's bout of activism. But this presumption of market inefficiency seems reasonable, and the opposite presumption–the so-called Efficient Capital Markets Hypothesis-seems unreasonable. For a detailed discussion see, E Fama and K French, 'The Cross-Section of Expected Stock Returns ' (1992) 47 Journal of Finance 427.

[74] See Chapter 3.1.2.3.

significant change is to address the problem of those who own company shares but are not registered as the legal holders. Some other reforms such as electronic voting and 'Say on Pay' will be discussed later.

In the UK, it is a common practice that shares in the company in which the institutions have chosen to invest are registered in the name of a custodian nominee company for prudential reasons.[75] Thus, it is the name of the custodian nominee that appears on the company's register. As a registered owner, the nominee has all the powers and rights attaching to those shares as against the issuer, even it has little economic incentive to use those rights and engage in monitoring the company. There may be some contractual arrangements in place between the custodian and institutional shareholders in respect of the way shareholders' rights can be exercised. However, as discussed in detail in Chapter 5.3.1.1, as indirect share owners, engagement process for institutional shareholders is often complex, time-consuming and costly. It can be argued that the engagement process would be more effective if institutional shareholders can directly communicate with the company or going further, if they can exercise some of governance rights attached to the shares.[76]

Prior to CA 2006, institutional shareholders or so-called indirect investors had few rights and unless they were appointed as proxies by registered owners. To empower them, CA 2006 has introduced new provisions to expand those indirect shareholders' rights and made it easier for them to participate in the running of companies.

The reform is mainly contained in Part 9. It allows a registered shareholder to nominate one or more indirect shareholders to enjoy information rights.[77] It enables institutional shareholders to receive information directly from the company. The

[75] R C Nolan, 'Indirect Investors: A Greater Say in the Company?' (2003) 3 Journal of Corporate Law Studies 73, 75; Myners, Review of the Impediments to Voting UK Shares 2004 (n 58) 14; P Davies and J Rickford, 'An Introduction to the New UK Companies Act: Part II' (2008) 5 European Company and Financial Law Review 239, 242-44.

[76] Davies and Rickford (n 75) 243.

[77] CA 2006 s 145.

information includes all communication which the company sends to its shareholders generally, for example, the annual report and accounts and notices of meetings. The information can be provided by hard copy or electronically as requested. If an address is not provided, the company can satisfy its obligations through website publication. Moreover, institutional shareholders who are nominated by the registered owner must be informed, when they are sent a notice of meeting, that they may have a right under an agreement between them and the registered holder to be appointed as a proxy or give instructions as to the exercise of voting rights.[78]

The direct transfer of information between institutional shareholders and the company avoids any delay which would occur in the process, helping to reduce direct costs for institutional shareholders when they wish to exercise shareholders' rights.

4.2.2.2 Indirect Costs

Indirect costs incurred by engaging in shareholder activism can be mainly split up into the costs of conflicts of interest, of insider liability and of inability to trade. The sections below will discuss each of these in turn.

4.2.2.2.1 Conflicts of Interest

The indirect cost incurred from conflicts of interest is certainly one of the factors that affects institutional shareholders' propensity for activism. Unlike retail investors, institutional investors are business institutions that have to get involved in multiple business relationships with many financial corporations. If they vote against management, it is likely that they have to bear the costs of losing business relationships with investee companies. Accordingly, they might be more concerned with their private interests than with maximizing shareholder returns.[79] In order to

[78] CA 2006 s 149.

[79] K Camara, 'Classifying Institutional Investors' (2005) 30 The Journal of Corporate Law 219, 219.

understand fully the conflicted interests of institutional shareholders, or of their fund managers, each type of institution must be discussed separately, as follows.

4.2.2.2.1.1 Pension Funds

As we have seen in Chapter 3, pension funds often employ external fund managers to undertake investment management and delegate authority to them to exercise shareholders' rights. Shareholder engagement will sometimes give rise to conflicts of interest when fund managers are part of large financial groups, which want to keep good business relationship with companies in a fund managers' portfolio. In such case, prior to taking action, fund managers have to take the interests of the affiliated group into account since an activist reputation may have an adverse impact on the group's other areas of business. Suppose, a fund manager, who is part of large financial group C Plc, invest pension funds' assets in B Plc. Meanwhile, C Plc also provides insurance services to B Plc. If the fund manager does not vote in favour of B's management, B may threaten to change insurance services to other companies. Therefore, the fund manager has to consider C and B's banking contracts when he makes decisions on whether and how to engage in B's corporate governance affairs.

Secondly, shareholder engagement may be conflicted with fund managers' personal interests. In the UK, a majority of trustees in pension schemes are directors or former directors of the company.[80] They are less likely to welcome a fund manager having an anti-manager reputation, for it may be detrimental to their wide business relationships. Even those doing well on shareholder activism might be a danger to companies' future interests. As such, fund managers may tend to behave 'modestly', if not passively, to secure their future positions in labour market.[81]

Moreover, a fund manager's previous performance is a one of the crucial criteria when potential employers judge their investment ability. In some cases, even though

[80] Myners, Institutional Investors in the United Kingdom: A Review, (n 59) 72.

[81] Black 'Shareholder Passivity Reexamined' (n 13) 564.

shareholder engagement will lead to better investment values, returns from improved corporate governance tend not to be a quick or obvious result for assessment. For those fund managers who want to impress their future potential employers, a slow return from corporate activism will not help them to outperform competitors.

4.2.2.2.1.2 Insurance Companies

Insurance companies offer a wide range of products against various risks, such as life, health, property or casualty policies to customers, including their investee companies. They compete in insurance market by selling these policies.[82] Developing and retaining good business relationships with their clients is important for them to maintain an advanced position in the market. Owing to this concern, insurance companies could be reluctant to take any action that might put their business relationship with their investee companies at risk.

Competition between insurance companies would also give rise to conflicts of interest in cases where one institution investor's engagement will benefit its competitors. For example, A insurance company and B insurance company, both invested in X Plc, with 2% and 1% of the X's shares, respectively. B might think that improving performance of X will benefit its competitor A twice as much as itself, which will then lead itself to lose competitive advantage in the insurance market.

Also, as said in Chapter 3, many insurance companies are closely linked to pension funds, as they often hold significant stock for them as external fund managers.[83] The conflicts would be the same for insurance companies as the pension funds managers when they hold significant amounts of stock for pension funds.

In addition to insurance policies and pension fund management, some large insurance companies run other areas of business, such as investment banking and property. For example, Prudential, as a large international financial services company, provides a

[82] Ibid, 53.

[83] See, Chapter 3.2.2.

wide range of services including personal banking, insurance, pensions and retail investments, institutional fund management and property investments.[84] Hence, before embarking on shareholder activism, they have to examine various related interests from their business network.

4.2.2.2.1.3 Mutual Funds

Mutual funds invest for numerous individuals, and thus face less conflict than pension funds and insurance companies that rely on corporate business. However, they are not entirely free of conflicts of interests.

Mutual funds are either active, which compete on investment skill, or indexed which compete on cost.[85] Active funds are motivated to make sure that their manual selection of investment will outperform the index. They do this by relying partly on the access to soft information provided by corporate managers. Conflicts of interest will therefore arise when shareholder activism would result in their future access to such soft information in investee companies being denied by incumbent management.

Index funds seek to replicate the behaviour of market indexes. They do not care about access to soft information and thus they are less voluntary to conflicts of interest than active mutual funds. To be sure, they may still face some conflicts of interests when they hold institutional clients' accounts and invest for them. The conflicts will be the same as those of other external funds managers.

4.2.2.2.1.4 Hedge Funds

Hedge funds are said to be more independent from conflicts of interests than the above traditional institutional investors.[86] First, Kahan and Rock found that most

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[84] More information can be found on Prudential website <http://www.pru.co.uk> accessed 10 May 2008.

[85] See discussion in Chapter 3 in terms of the way mutual funds manager their business.

[86] M Kahan and E Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 University of Pennsylvania Law Review 1021, 1066-8.

hedge funds are organized as limited partnerships. They are usually independent investment vehicles and not affiliated with other institutions.[87] Second, activist hedge funds rely on engagement to generate investment return. They will therefore not regard conflicts of interest as impediment to intervention if their return would be maximised through active engagement.

Nevertheless, hedge funds still face some conflicts of interest to the extent that they want to attract institutional clients. As I have mentioned in Chapter 3.2.4, investors in hedge funds are high net-worth institutions or individuals, including traditional institutional investors, such as pension funds and insurance companies. In this sense, conflicts of interest that hedge funds confront are much the same as other institutional shareholders as I discussed above.

Taken together, conflicts are manifold. Without exception, when institutional shareholders make decisions whether to take action on governance issues, they will take their own landscapes into consideration. However, as situations vary, so, too, do the strength of these factors.

4.2.2.2.2 Insider Dealing and Market Abuse

The potential legal risk arising out of private meetings between the board and institutional shareholders is an important source of indirect costs for many institutions. Regarding any possible action to be taken, an activist institution must consider whether his action could breach insider dealing and market abuse regulation. As insider dealing is more likely to occur during the process of private meetings, it will be discussed later in Chapter 5. For now, I merely set out relevant legal norms.

Currently, insider dealing is subject to: (1) Criminal Justice Act 1993 (CJA 1993), Part V 'Insider dealing'; (2) FSMA 2000, Part VIII 'Penalties for market abuse'; (3) FSA, Handbook, the Code of Market Conduct.

[87] Ibid, 1066.

Part V of the CJA contains the main criminal provisions on insider dealing. It defines two insider dealing offences. The first offence, the dealing offence, is committed if an individual has information as an insider and 'deals, in specific circumstances, in securities which are price-affected in relation to that information.[88] The second offence, the 'tipping' offence is committed either by disclosing inside information to another otherwise than in the proper performance of the functions of his employment, office or profession, or by encouraging another person to deal in price-affected securities related to such information.[89]

A crucial element in constituting offence of insider dealing, from the above definition, is the inside information. The CJA 1993 defines inside information in section 56(1) as follows:

> 'inside information" means information which—
>
> (a) relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally;
>
> (b) is specific or precise;
>
> (c) has not been made public; and
>
> (d) if it were made public would be likely to have a significant effect on the price of any securities.'[90]

Hence, inside information must be undisclosed and price-sensitive. Once undisclosed and price-sensitive information is not properly handled, companies face a risk of insider dealing upon disclosure of inside information to institutional shareholders during their private meetings with institutional shareholders. Institutional shareholders also face a risk of being insiders from their engagement and therefore *unable to trade in* the securities concerned.

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[88] Criminal Justice Act 1993, s 52(1).

[89] Criminal Justice Act 1993, s 52 (2) (a) (b).

[90] Criminal Justice Act 1993, s 56 (1).

To complement the criminal offence of insider dealing and market manipulation, the government introduced a civil offence of insider dealing in s 118 of FSMA 2000 under the regime of 'Market Abuse'. Meanwhile, apart from imposing rules on insider dealing, the concept of market abuse also introduced statutory prohibition on several other forms of abusive conduct which represented a considerable expansion in the scope of the law.[91] Behaviours, such as improper disclosure of inside information, disseminating false or misleading information, also constitute breach of market abuse provisions. As a result, institutional shareholder shall be more carefully in the process of shareholder activism to avoid breaching of market abuse rules. This will be discussed in detail in Chapter 5.2.1.3.2.1.1.

The FSA also maintains a Code of Market Conduct which provides guidance to elaborate the statutory provisions on market abuse. For example, it describes what factors should be considered when determining whether information is inside and behaviours that do or do not amount to market abuse. Furthermore, in a 2007 FSA' guidance, it provides that in some circumstances, when the strategy being adopted by shareholder involves building upon or acquiring a stake in a target company, the strategy itself will be considered as inside information, thus requiring disclosure to the market as a whole.[92] The guidance also stated that in general, simply taking advantage of their own expert analysis of otherwise publicly available information to carry out acquisitions of the target's securities will not be regarded as market abusive.[93] However, where a shareholder comes to trade on the basis of another participant's strategy or deal on the basis of their knowledge of another participant's intentions and strategy, his behaviour might be considered as market abuse. The FSA has warned shareholder that deliberately generating a false rumour or deceptive signals about their future strategy intentions could also constitute market abuse. Failure to comply

[91] More details on forms of market abuse is provided in FSMA 2000 s 118.

[92] FSA, Markets Division: Newsletter on Market Conduct and Transaction Reporting Issues, *Market Watch* Issue 20, available at http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter20.pdf accessed 25 May 2009.

[93] Ibid.

with related regulations on market abuse subjects companies and shareholders to a wide range of possible sanctions, including suspension of trading or financial penalties. Chapter 5 will return to discuss the influence of insider dealing and market abuse rules on shareholder activism, in particular, private meetings.

4.2.2.2.3 Inability to Trade

The traditional Wall Street Rule – sell your shares if you do not like what the management is doing – is becoming costly for some institutions. Institutional investors have to continue hold firms in their portfolio because they are part of a market index or because their size of ownership would make exit costly.

First, passive indexing results in funds' inability to exit as they are 'lock-in' in portfolio companies by the market index.[94] Index funds must hold every company in the index, irrespective of how poor the governance of the company. This, in turn, creates a great need for them to be activists to boost the performance of the stock market overall.[95] It might be argued that monitoring is pointless for fund managers because intervention in a portfolio company will improve the index to the same extent.[96] Against this, however, Riley suggested that, the overall improvement of the index is best achieved 'not by focusing *ex post* upon the individual company, but by improving the structure under which all companies operate and are managed.'[97]

Secondly, the larger and the longer-term the shareholding, the more difficult it is for the owner to trade their shares on the market without depressing the price.[98] Many analysts and small retail investors tend to purchase the stock and monitor the

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[94] G Clark and T Hebb, 'Pension Fund Corporate Engagement: The Fifth Stage of Capitalism' (2004) 59 Industrial Relations 142, 144.

[95] D D Guercio and J Hawkins, 'The Motivation and Impact of Pension Fund Activism' (1999) 52 Journal of Financial Economics 293, 294.

[96] C A Riley, 'Controlling Corporate Management: UK and US Initiatives' (1994) 14 Legal Studies 244, 261, See his discussion in footnote 89.

[97] Ibid.

[98] Coffee (n 9) 1329.

operations of firms that attract large institutional investors. It is unlikely, therefore, for large institutions to dispose their shares in an unnoticed way.[99] When the alternative course of action-exit-become more costly, monitoring becomes more rational.[100] The cost for activism as said by these fund managers under research can be well compensated for by the return of their efforts, given their large investment scale.[101] Del Guercio & Hawkins found the annual activism program budget for the top five public pension funds in the US ranges from $50 thousand to $1 million, which constitute less than 0.005 percent of fund assets. Larger institutional shareholders have more research budget, staffs and resources for activism than smaller institutional shareholders.

In short, for those indexed or large institutional investors, it is sometimes not an option, and activism is described as the only way in which they could create value for their clients. As said by a fund manager, ‘It is a means to an end rather than an end in itself’.[102]

4.3 Conclusion

This Chapter has developed the model of institutional activism set out in Chapter 1 both by explaining in detail how these factors driving activism play out in the case of different types of institutional investor, and by expanding on the discussion of some of the relevant regulatory norms.

In developing the two-step analysis, we found that those larger institutional shareholders with long-term investment horizon are more likely to engage in activism because (1) it is easier for them to overcome free-riding as the factors of decisions of

[99] P O'Brien and R Bhushan, 'Analyst Following and Institutional Ownership' (1990) 28 Journal of Acccounting Research 57.

[100] E Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1991) 79 Georgetown Law Journal 445, 462.

[101] D Del Guercio and J Hawkins, 'The Motivation and Impact of Pension Fund Activism' (1999) 52 Journal of Financial Economics 293.

[102] Hendry and others, (n 52).

shareholding and collective action work strong for them; and (2) They will receive more benefits from engaging, while suffer from costs resulted from inability to trade. We also found that some institutional shareholders – as exemplified by Hermes, have additional incentives for activism as they will receive some 'in process' benefits through engagement.

Moreover, Chapter 4 found that there are some factors are 'in play' on all types of institution. In determining whether to overcome free-riding, institutional ownership restriction limits institutions' ability to become more decisive and the risk of being identified as 'acting in concert' to some extent deters institutions from forming coalitions. The normative obligation to participate has become increasingly strong in recent years as there have been growing regulatory demands on institutional shareholders to be more active. In analysing the costs of activism, we have found that the CA 2006 brings some reforms to enable institutional shareholders – especially 'indirect shareholder' – more easily to take action. The indirect losses as result of potential liability for insider dealing are one of the factors that shareholder must consider when deciding whether to take action.

Chapter 5 will complete our analysis of UK institutional shareholder activism by applying the model described in Chapter 1, and developed in Chapter 4, to the different forms that activism can take.

Chapter 5 Applying the Model to a Typology of Activism

The aim of this chapter is to apply the model of shareholder activism to the different forms that activism can take. It begins by setting out a typology of activism, differentiating four forms that activism can take: private meetings, proxy voting, submitting proposals, and derivative actions. It then works through these four forms in turn. For each one, it starts with an exploration of the current degree to which that type of which institutional shareholder activism takes place. Based on those empirical findings, it then applies the model, to explain how the various factors the model captures shaping institutional shareholders' propensity for these different types of activism.

5.1Typology of Institutional Shareholder Activism

Shareholder activism is not in itself a new phenomenon. There is a long history, especially in the US, where shareholder activism can trace back to the beginning of the 20th century.[1] It encompasses a broad range of formal or informal activity when institutional shareholders become dissatisfied with the board's performance (and presumably that of the company). Writing in 1970, Hirschman offered a now-famous discussion of responses to unsatisfactory organizational behaviors in terms of 'exit', 'voice' and 'loyalty'.[2]

First, shareholders can simply 'vote with their feet,'– a practice also known as 'the wall street walk' – exit the company by selling their shares. By virtue of their initial purchase and subsequent exit, they convey the message to the market that they are not satisfied with the company's performance. Second, institutional shareholders could continue to hold their shares and do nothing, and thereby show their 'loyalty'.

[1] S Gillan and L Starks, 'The Evolution of Shareholder Activism in the United States ' (2007) 19 Journal of Applied Corporate Finance 55. For example, early action had been taken by financial institutions such as Morgan Stanley to propose changes in the board of corporations.

[2] A Hirschman, *Exit, Voice, and Loyalty:Responses to Decline in Firms, Organizations, and States* (Harvard University Press, Cambridge, Mass. 1970).

Perhaps people are more familiar with the third approach of '*voice*'. Institutional shareholders continue to hold their shares but express their dissatisfaction through a broad spectrum of activities. The activism with which we are concerned all falls within Hirschman's category of 'voice'. And within that, we can distinguish four different forms, namely: initiating frequent meetings with corporate management, filing shareholder proposals, voting against managers' proposals in meetings and bringing legal procedures against directors.

Cutting across this four-fold typology set out above, one can also further note a further division, identified by Armour and Cheffins, between 'offensive' and 'defensive' activism.[3] *Offensive* activism is designed to improve corporate governance and performance so as to raise the value of the company above what it was when the shareholder purchased her investment. This corresponds typically to the behavior of hedge funds which identify an underperforming company, then purchase undervalued stocks and engage with the company to raise its value. *Defensive* activism, on the other hand, is action designed to ensure the company's value does not fall below that paid by the investors. This is typically the motive behind action by traditional institutional shareholders, such as pension funds and insurance companies. Kahan and Rock has put it thus:

> 'Mutual fund and public pension fund activism, if it occurs, tends to be incidental and ex post: when fund management notes that portfolio companies are underperforming, or that their governance regime is deficient, they will sometimes be active (footnote omitted). In contrast, hedge fund activism is strategic and ex ante: hedge fund managers first determine whether a company would benefit from activism, then take a position and become active.'[4]

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[3] 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 10 August 2010, 2.

[4] M Kahan and E Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 University of Pennsylvania Law Review 1021, 1069.

In spite of these differences of *motive*, engagement approaches employed in offensive activism, as we have seen in Hermes' case, are precisely the same as that of adopted in defensive activism.[5] Hedge funds will exercise their shareholders' rights, including meeting with corporate managers, proxy voting, submitting proposals and legal actions, to push corporate changes and ultimately, increase corporate value.

5.1.1 Private Meetings

Meeting privately with company management is often the first approach that many institutional investors could adopt when they have concerns over corporate management, as it avoids public confrontation between the company and institutions.

A typical private meeting is conducted through the following three steps. First, when institutions realize that the company's governance might be problematic, they will evaluate the target company by applying internal criteria to decide matters such as whether the private meeting could be successful.[6] Second, once institutions decide to adopt the private meeting as an engagement means, they will make informal contact with the target company to raise their concerns. This step will start with a letter or a phone call with the managers or related officers of the target company. Third, when both parties have initially understood each other's concerns, the target company will arrange a meeting with the institutions and have a dialogue on specific governance topics.

Apart from shareholder-initiated meetings, *the board* can generate a dialogue with its investors to help both parties to obtain an understanding on a variety of issues, such as recent financial performance, corporate change or investment strategies. As one will see later, private meetings have traditionally been preferred by both company

[5] For a detailed discussion and cases of hedge funds activism, see J Macey, *Corporate Governance:Promises Kept, Promises Broken* (Princeton University Press, Princeton, N.J. 2008) 244-264.

[6] J Yockey, 'On the Role and Regulation of Private Negotiations in Governance' Illinois Public Law and Legal Theory Research Paper No.09-01 <http://ssrn.com/paper=1438793>3 September 2009..

managers and institutions and it is still now one of the *most commonly used* activism approaches.

5.1.2 Proxy Voting

At the heart of any discussion about shareholder activism is the role of voting and, especially, of proxy voting.[7] In its simplest interpretation, it is arguably the principal method by which a company's shareholder can affect its governance and signal their views to management. Through the media of the ballot, shareholders can elect or remove directors, approve or disapprove directors' proposals and (increasingly) authorize executive pay packages. Given its importance, it is the primary focus of the thesis in the context of considering shareholder activism.

Briefly, the voting process starts when shareholders receive a Notice of Meeting by mail, or other electronic forms, from their investee companies.[8] The Notice of a general meeting must state the time, date and place of the meeting. It must also contain information regarding the general nature of the business to be dealt with at the meeting subject to any contrary provision in the company's articles of association.[9]

Shareholders of a listed company are given 14 to 21 days to consider how to vote on matters proposed in the meeting.[10] To cast their votes, a shareholder can attend the

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[7] B Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford 1997) 17-8; E Ferran, *Company Law and Corporate Finance* (Oxford University Press, Oxford 1999) 118-22; For a comparative explanation of the importance of the proxy voting in various jurisdiction, see G Hertig, 'Convergence of Substantive Law and Convergence of Enforcement' in J Gordon and M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press, Cambridge 2004) 328, 336-8.

[8] CA 2006 s 308.

[9] CA 2006 s 311(2).

[10] CA 2006 s 307A. After implementation of the Shareholders Right Directive, listed companies are required to call all general meetings on at least 21 days' notice, unless three conditions are satisfied, in which cases it can be held at 14 days. The first condition is that the general meeting is not an annual meeting. The second condition is that the company offers the electronic means for all members and the third condition is that a special resolution has been passed reducing the period of notice to 14 days at previous AGM.

meeting in person, or appoint one or more proxies to vote shares on their behalf. The voting process ends when a shareholder's vote is recorded.

The issues regarding voting procedures are only touched upon here. The technical rules are dealt with more fully in section 5.3. This thesis focuses on activism in the form of voting. However, it is worth nothing that there are some related issue/shareholder rights, but too few data to discuss separately. These things include:

(1) Requiring the directors to call a general meeting of the company;[11]
(2) Requiring a company to circulate a statement in advance of shareholders' meeting and circulate a resolution in advance of AGM;[12]
(3) Requiring an independent assessor's report on a poll at a general meeting of the company, the independent report to be disclosed on the company's website,[13] and
(4) Requiring the company to publish audit concerns on its website.[14]

5.1.3 Submitting Proposals

The third approach that an institution can adopt is submitting a proposed resolution for a shareholders' meeting. In the UK, CA 2006 section 338 allows shareholders representing at least 5% of the total voting rights, or shareholders who are at least 100 in number and whose shares are paid up by an amount averaging at least £100 per member, to require a resolution to be proposed at the AGM. Any request for a resolution to be proposed must identify the resolution and be received by the company at least 6 weeks before the relevant AGM (or, if later, when notice is given of the meeting).

[11] CA2006 s 303.
[12] CA 2006 s 314.
[13] CA 2006 s 342.
[14] CA 2006 s 527.

5.1.4 Derivative Action

Finally, shareholders have the ability to bring legal actions against a director on behalf of the company in the form of a derivative suit. The CA 2006 allows a derivative action brought by shareholders for any breach of duty, including the duty to exercise reasonable care, skill and diligence or the duty to promote the success of the company.

Before substantial action begins, shareholders should first make a prima facie case (based on written pleadings alone) that the company is entitled to the relief claimed, and must then apply for permission to continue the action as a derivative action.[15] In respect of the application for permission to continue, the court is bound to consider a number of factors when deciding whether to give permission. There are certain 'mandatory factors' which, if present, mean the court *must* refuse permission.[16] These include the ratification of the breach of duty, its approval in advance by the shareholders, and the fact that a director fulfilling the directors' statutory duty to promote the success of the company would not proceed with the action.[17]

If none of these mandatory factors apply, then the court has a discretion to grant permission, and there is then another list of discretionary factors that the court shall take into account, such as the importance a hypothetical director would attach to continuing the action, whether the case could be brought by the member personally (in which case the shareholder would usually be expected to bring his own action rather than bring a derivative action) and the views of independent members of the company, i.e. members with no personal interest, direct or indirect, in the matter.[18]

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[15] CA 2006 s 261.

[16] For a detail discussion, see A Dignam and J Lowry, *Company Law* (Oxford University Press, Oxford 2010) 191-6.

[17] CA 2006 s 263.

[18] Ibid.

This type of action is usually considered as an action of last resort and is very rare in practice. Until now, there is one case where an institutional investor did try to bring a derivate action: P*rudential Assurance Co Ltd v Newman Industries Ltd (No.2*).[19]

5.2 Private Meetings

Private meetings are one of the most commonly used shareholder engagement approaches. The following section, based on empirical evidence provided by other scholars or institutions, gives a detailed illustration on how institutional shareholders engaged in private meetings with investee company management. It then applies the activism model as described in Chapter 1, and developed in Chapter 4, to private meetings. It is organized as follows. Section 5.2.1 is concerned with empirical evidence in respect of private meetings between UK institutional investors and company management. The available evidence on private meetings covers such matters as: frequency of meetings, collective action, meeting model, meeting participants, topics and meeting effect. Following is a specific analysis on 'say on pay' practice in the UK. Section 5.2.2 applies the model to analyse institutional shareholders' propensity for the activism of private meetings.

5.2.1 Empirical Evidence

One inherent challenge of examining empirically the details of negotiations between shareholders and executives/the board is that these meetings are usually undertaken behind-the-scenes and are not shared with outsiders. Despite this difficulty, such evidence as does exist comes from a variety of sources (1) trade association reports on institutional shareholder engagement;[20] (2) previous academic research;[21] and (3) newspaper reports.

[19] [1981] Ch 257 (Vinelott J); [1982] 1 Ch 204 (CA).

[20] For example, Investment Management Association has issued five surveys since the year of 2003. The latest covers the situation for the two year from mid-2006 to mid-2008 and published in 2009. Its

5.2.1.1 Frequency of Meetings

According to a survey by the Investment Management Association (IMA) from 2006, an overwhelming majority of 33 fund management companies routinely met with executive management at least once a year, with one doing so as many as five to six times.[22] Some institutions have annually or regularly met with non-executives, but the majority of institutions contacted non-executives when there were issues, or at the company's request. On average, each institution conducted 33 meetings with investee companies by the middle of 2006.[23]

There is a wide disparity between the institutions regarding the frequency of meetings. IMA's survey observed that among 23 institutions that reported in detail, one had 290 meetings, ten institutions had ten or less and the remaining 11 had between 11 and 88 meetings during the year of 2006.[24]

However, due to the behind-the-scene character of private meetings, the number of meetings only indicates the frequency of contacts where there is a record. The IMA suggested that in many cases, meetings conducted between the executive/ the board and shareholder were not captured on records.[25]

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survey covers over30 managers which are responsible for about 68% of equities managed in the UK and represented around 32% of UK market capitalization as measured by the UK All share index.

[21] For example, G.P Stapleton' study on UK institutions, G.P Stapleton conducted interviews with the chief executive or a senior fund manager of 17 investment management companies in 1993. These 17 totally companies represented over 25% of the value of the UK equity at the end of 1991. The research also covers interviews involving the ISC, ABI, NAPF, AITC (now IMF) and PIRC.

[22] Investment Management Association, *Survey of Fund Managers' Engagement with the Companies for the Year Ended 30 June 2006* (It will be referred to as 'IMA 2006 Survey' in subsequent footnotes) < http://www.investmentfunds.org.uk/news/press_centre/default.asp> accessed 23 August 2008,14.

[23] Ibid, 1.

[24] Ibid.

[25] Investment Management Association, *Survey of Fund Managers' Engagement with the Companies for the Two Years Ended 30 June 2008* (It will be referred to as '2008 Survey' in subsequent footnotes)
< http://www.investmentfunds.org.uk/news/press_centre/default.asp> accessed 14 October 2010, 3.

There are several factors that are likely to influence the frequency of meetings. First, companies that deliberately invested in under-performing companies, such as Hermes, held more frequent meetings with management than other institutions under the assumption that more intervention will have a positive impact on the value of companies. Second, as Martin and Nisar note, some large companies have established their own corporate governance engagement principles which require meetings with investee companies on a regular basis but less frequently than the first case.[26] Third, when there are contentious issues, the meetings held and contact between company and institutions become more frequent.

To make their intervention more effective, as recommended by the ISC's *Responsibilities of Institutional Shareholders and Agents – Statement of Principles* (Statement of Principles), in addition to the routine meetings described above, institutions can escalate their action by meeting with independent directors or senior independent directors.[27] On average, each firm had 46 meetings with independent directors in the year ended June 2005 although the number decreased to 34 in 2006.[28]

5.2.1.2 Jointly Working with other Institutional Shareholders

When an institution seeks for more influential power over the board, it can conduct private meetings collectively with other institutional shareholders. Stapledon found that in most cases, such coalition occurred after the failure of discussion by an individual institution with company management.[29] The number of institutions in a coalition varied between two and six.[30] Most coalitions comprised of two to four

[26] R Martin and T M Nisar, 'Activist Investment: Institutional Investor Monitoring of Portfolio Companies' (2007) 45 Management Decision, 832.

[27] Institutional Shareholders Committee, 'The Responsibilities of Institutional Shareholders and Agents – Statement of Principle', I have introduced this guidance in Chapter 4, see Chapter 4.1.4.

[28] IMA 2006 Survey (n 22) 15.

[29] G Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon, Oxford 1996), 122.

[30] Ibid, 126.

members, and represented between roughly 20% and 40% of the equity of the companies concerned.[31]

Black and Coffee's research regarding British institutional shareholder activism in the early 1990s also confirmed that successful institutional coalitions did form with the characteristic of few participants but with substantial collective shareholdings.[32]

5.2.1.3 Forms of Meeting

Contacts between institutional shareholders and corporate management may take place by simple phone call or letters. If they decide to meet in person, institutional shareholders would come to see management individually or collectively in certain locations, such as a company's office. Sometimes company management can visit their institutions for meetings.

Riskmetric Group's US study found a wide diversity in the ways in which boards met with shareholders.[33] Some companies were mainly positioned as a listening post to hear shareholders' concern, while others, such as Pfizer, met with institutional shareholders in a two-way discussion. Companies, like UnitedHealth carried out meetings in two ways: on *an ad hoc* basis, and in a separate, formal shareholder advisory committee on board nomination. Occidental Petroleum used 'road shows'. Generally, there is no consistent model for board-shareholder meeting and companies often adopt a combination of models depending on the aims of the meeting.

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[31] Ibid.

[32] B Black and J Coffee, 'Hail Britannia?: Institutional Investor Behavior under Limited Regulation' (1994) 92 Michigan Law Review 1997, 2054.

[33] S Dean, 'Board-Shareholder Dialogue: Why They're Talking' Riskmetric Group <http://www.riskmetrics.com/system/files/private/Board_Shareholder_Dialogue_0.pdf> 3 September 2009.

5.2.1.4 Participants

Most institutional shareholders' contacts are with the Chairman, financial directors, non-executives and senior independent directors.[34] For example, in the Marks and Spencer case, as discussed in section 5.2.1.6, nine institutional investors held meetings with the chairman and seven had meetings with the senior independent directors/non-executive directors.[35] Also, five institutional investors interacted collectively through trade associations to bring pressure on the management of Marks and Spencer Plc. Moreover, Stapledon found that some large companies have set up specialist investor-relations executives who also attended meetings with institutions.[36]

From institutions' perspective, there are several types of people who represent the institutions in their meetings to have dialogue with company management. First, in a minority of institutions (two in 33 under IMA survey), portfolio managers were responsible for all engagement and were present at all board-institution meetings.[37] Second, the majority of institutions have specialist teams on corporate governance separate from their fund managers. The specialists were delegated by institutions to attend most of the meetings with company management, and in some cases, both the specialists and portfolio manager were present in meetings but with different aims.[38] Specialists were more concerned with corporate governance issues, while fund managers focused on company's financial performance.

5.2.1.5 Topics

The topics covered at the meetings vary according to the different aims of meetings. Stapledon found that meetings were often conducted to discuss the issues of 'the latest financial results; current trading operations; trends in pricing; capital expenditure;

[34] IMA 2008 Survey (n 25) 16-8.

[35] IMA 2008 Survey (n 25) 17.

[36] Stapledon (n 29) 103.

[37] IMA 2006 Survey (n 22) 14.

[38] Ibid.

cash flow; gearing; etc.'[39] Institutions were more inclined to discuss general issues such as company's long-term strategy rather than short-term topics such as current trading.[40]

According to Holland's research, topics arisen in the meetings often fall into three main areas.[41] The first major area for institutions to talk in meetings is the company's 'prior strategic promises, recent strategic change, benchmark comparison with competitors and business management practices.'[42] Secondly, institutions are often concerned with management quality and personality. Information on these matters is seen as essential to understand financial performance and to value companies. Whether companies have *complied with* relevant corporate governance guidance is the third area of interest of institutions. Institutions focused on matters such as the separation of chief executive and chairman roles, board structure, remuneration and other good practices.

5.2.1.6 Effects of Meetings

Do these meetings make a difference to board decisions? The first evidence comes from one of the early US studies conducted by Carleton, Nelson and Weisbach which focused on the activities of Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF).[43] They found that the fund had successfully brought changes to board practice through private meetings. TIAA-CREF is one of the largest pension funds in the US. The study was carried out on the period from 1990-1992 during which TIAA-CREF had targeted 45 companies for the purposes of

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[39] Stapledon (n 29) 104.

[40] Ibid.

[41] J Holland, 'Financial Reports, Private Disclosure and the Corporate Governance Role of Financial Institutions' (1999) 3 Journal of Management and Governance 161, 168-170.

[42] Ibid.

[43] W T Carleton, J M Nelson and M S Weisbach, 'The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF' (1998) 53 Journal of Finance 1335.

seeking board changes on corporate governance. TIAA-CREF adopted a negotiation approach with investee companies in the hope of achieving a mutually acceptable settlement prior to a proxy vote. The research found that TIAA-CREF had generally obtained its desired changes. It had reached agreements with 42 of the 45 targeted companies. Most of these settlements were made without the issue ever coming to a shareholder vote and to public knowledge. Moreover, investee companies generally implemented agreements reached in negotiations.

The second source of evidence comes from Stapledon's study, where he found that in a majority of cases where institutions had conducted private meetings with company management, targeted companies had made changes under institutions' requirement without the need to requisition a general meeting. However, in four cases, meetings between institutions and company failed to reach agreements. In each of those four cases, however, when it became clear that institutions could win a vote on the issue, some or all of the impugned directors resigned prior to the actual EGM.[44]

Thirdly, researchers in London Business School focused on the way in which Hermes engaged in private meetings on governance changes with targeted underperforming companies.[45] During the period from 1998 to 2004, Hermes had targeted 30 of the 41 companies it invested in, primarily through private meetings, telephone calls, letters between fund representatives and executive directors, investment relation officers and other board members. The result suggested that Hermes had been successful in using private negotiation to bring governance change. Over half of its targeted companies, in some cases as many as 75%, had adopted Hermes's proposed changes.[46] Moreover, once the companies have followed up on Hermes' suggestions to make changes, the

[44] Stapledon (n 29) 126.

[45] M Becht and others, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2009) 22 Review of Financial Studies 3093.

[46] Ibid, 3111.

study found that their share price increased substantially, by as much as 6% immediately after the changes were disclosed to the public.[47]

Despite the above positive evidence on the effect of private meetings, there is evidence indicating that private meetings failed to achieve changes that institutional investors expected. The IMA survey shows that although institutions have engaged in meetings, their concerns have sometimes been ignored by the company management.[48] The case of Marks and Spencer illustrates how a board might turn a deaf ear to shareholders' requests.[49] In 2008, Marks and Spencer announced that its chief executive, Sir Stuart Rose, was promoted to the post of executive chairman. In doing so, Marks and Spencer failed to comply with the principle of the UK Corporate Governance Code.[50] The Code objects that the roles of chainman executive and chairman are exercised by a single person. Since the announcement, Marks and Spencer faced an investor backlash and was criticized for putting the long-term health and stability of the company at risk.

Institutions made efforts to negotiate with Marks and Spencer management to address their concerns. According to the IMA report, among 26 companies surveyed that had Marks and Spencer shareholdings, 23 had in aggregate 28 meetings with the company, nine companies had 15 meetings with the chairman and seven had seven meetings with the senior independent director/non executive.[51]

In spite of shareholders' effort, both in public and private, the board of Marks and Spencer did not change its decision, suggesting that shareholders' behind-the-scene negotiations with management failed to move changes for the company.

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[47] Ibid, 3097.

[48] IMA 2008 Survey (n 25) 3.

[49] K Burgess, 'Questions Raised over Combined Role Move', *Financial Times* (London 10 March 2008) <http://www.ft.com/cms/s/0/9175be7c-eef0-11dc-97ec-0000779fd2ac.html> accessed 10 September 2009

[50] A.2 of the UK Corporate Governance Code provides that 'the roles of chairman and chief executive should not be exercised by the same individual.'

[51] IMA 2008 Survey (n 25) 17.

5.2.2 Applying the Activism Model to Private Meetings

5.2.2.1 Step 1: Overcoming Free-riding for Private Meetings

5.2.2.1.1 The Decisiveness of Individual Shareholding

Private meetings offer a good opportunity for any particular institutional shareholder to be ‘decisive’. It involves a small number of shareholders and lets each of them have a chance to express their concerns directly in front of corporate managers. Directors are more likely to listen to institutions privately to understand whether they are confident on management. While a 1 or 2% of shares of the company cannot be sure that its own holding will be sufficient to determine the outcome of a resolution, such amount of holdings might nevertheless prove persuasive for executives/the board.

Moreover, the increased decisiveness of individual shareholdings in private meetings stems from the threatening effect of public opposition. The board is much more willing to resolve shareholders’ concern on meetings before the issue is placed in public confrontation. It is aware if it does not appear to take seriously the concerns raised by shareholders, the next step could be a public opposition. This threatening effect is well illustrated in the case of ‘Say on Pay’ in 5.2.2.2.3.

5.2.2.1.2 The Possibility of Concerted Action

It seems plausible to argue that concerted action is also more likely to be achieved through private meetings because of their behind-the-scene nature. As the risks from public confrontation are avoided, institutional shareholders are more willing to support others’ initiatives to form an alliance and bring combined pressure to the board privately.

5.2.2.1.3 ‘In process’ Benefits

Private meetings are also likely a good source of 'in process' benefits to institutional investors. First, private meetings provide an opportunity for institutional shareholders to establish a good relationship with portfolio companies. Furthermore, private negotiation directly with management enables institutional investors to understand better the company' long-term objectives, and thus to make better judgment when deciding how to vote at shareholders' meetings.[52] Moreover, subject to insider dealing rules, private meetings do give useful information to institutional shareholders whether to increase or decrease their future holdings in the company – so there is a private 'trading' benefit.

5.2.2.1.4 Normative Obligations

5.2.2.1.4.1 Regulatory Demands

In light of the importance of board-shareholder communication, regulators, policymakers, and trade organizations have all made many calls in favour of more frequent board-shareholder meetings, from both board and shareholder perspectives. For example, the UK Corporate Governance Code (UK Code) recommends that the board as a whole has a responsibility to conduct satisfactory dialogue with institutional shareholders to understand their issues and concerns.[53] It places particular responsibility on the chairman and to a lesser extent the non-executive directors and senior independent director to maintain sufficient contact with major shareholders.[54]

In the Stewardship Code, discussion with the company on a confidential basis is regarded as the first stage of intervention that institutions can undertake when they have concerns over their investee companies.[55] If institutional shareholders fail to get constructive response from the board, they can escalate their action, such as to meet

[52] Ibid.

[53] UK Corporate Governance Code, E.1.

[54] Ibid.

[55] Stewardship Code, Principle 4.

with senior independent directors, or intervene jointly with other institutional shareholders.

Guidance from trade associations all suggests institutional shareholders to seek regular dialogue with the investee company's board and senior management.[56] In addition, the International Corporate Governance Network also recommends that successful engagement should include maintaining dialogue with the board on governance issues before a crisis breaks out. Institutional shareholders should communicate with the board as part of their corporate governance policy.[57]

Indeed, I would draw here an analogy with Ayres and Braithwaite's famous book, in which they argued that most regulatory intervention should be modest, with more draconian or painful forms of regulatory intervention being reserved for cases where the first level of modest intervention does not achieve the desired result.[58] By analogy, private meetings represent that modest form of intervention. Open challenge through voting can then be reserved for those companies which fail to respond to the institutional shareholders' private arguments presented in private meetings.

5.2.2.1.4.2 Cultural Factor

Private meetings between the board and shareholders have traditionally been a part of UK corporate governance activism.[59] Whenever possible, UK institutions have a strong preference for quiet, behind-the-scene negotiations to bring changes to the board. They believe 'secrecy and trust are essential' and thus, are highly reluctant to put concerns for public battle unless negotiations failed to achieve their aims.

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[56] For example, see ISC, '*A Statement of Principle on the Responsibilities of Institutional Shareholders and Agents*' (2007) 4.

[57] International Corporate Governance Network, '*Statement of Principle on Institutional Shareholders Responsibility*' (2007) 4.4 ii.

[58] I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, NewYork: Oxford 1992).

[59] Black and Coffee (n 32) 2085.

Prior to the early 1960s, there were irregular meetings between fund managers and companies when specific issues arose.[60] Since the early 1970s, fund managers from the largest insurance companies, such as the Prudential, met with the management of their portfolio companies annually.[61] Meetings became regularly activities in the late 1970s. Of 994 listed UK companies, 76% of the largest 50 companies, and 43% of the largest 600 companies, held meetings periodically with some of their large institutional shareholders.[62] Obviously, a culture of exerting shareholders' control through private meetings has developed in the UK. And this cultural preference results in a relatively high level of shareholder participation in the form of private meetings.

5.2.2.2 Step 2: A Cost-benefit Analysis for Private Meetings

5.2.2.2.1 Benefits

Benefits of engaging in private meetings will be reflected on the share of total gains to the company and the personal in process benefits as mentioned above in section 5.2.2.1.3.

5.2.2.2.2 Costs

5.2.2.2.2.1 Direct Costs

Seeking changes through negotiation is suggested as cost-effective.[63] As shown in empirical evidence, specific negotiation methods, ranging from phone calls and letters to face-to-face meeting, all are relatively low-cost.

Moreover, private meetings initiated by the board incur few costs to institutional shareholders. Part of the burden of costs is likely shifted to the board as it will arrange

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[60] See data cited in Stapledon (n 29) 102.

[61] Ibid.

[62] Ibid.

[63] Yockey (n 6) 33.

everything for dialogue with institutions. As we have seen above, regulatory pressure seems to drive the board to seek a regular dialogue with its large institutional shareholders. A good example is the 'Say on Pay' rule, discussed in section 5.2.2.2.3.

5.2.1.3.2.1 Indirect Costs

5.2.1.3.2.1.1 Insider Dealing and Market Abuse

Private meetings could impose indirect costs on institutional investors as a result of potential liability for insider dealing and market abuse. Exchange of information – which may be 'price sensitive' – is necessary for private meetings.[64] However, the degree to which managers would disclose in the dialogue is restricted by related regulation.

In Chapter 4, I discussed what constitutes inside information. If insider information is involved in private meetings, the general requirement for disclosure by the FSA is that listed companies should report insider information to the Regulatory Information Service as soon as possible.[65] It leaves the company to make decisions on whether to publish an announcement or not, what information should be included and when it should be disclosed. It is the company's responsibility to determine what information is sufficiently price-sensitive and then establish effective arrangements, such as Chinese walls, to restrict individuals involved from dealing, and to keep information confidential until it is announced.[66] In assisting company to assess accurately

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[64] J Roberts *et al*., 'The Corporate-fund Manager Interface: Objectives, Information and Valuation' (2004) University of Cambridge Economic and Social Research Council Centre for Business Research Working Paper 293 (finding that private meetings are most important source of information for fund managers).

[65] FSA, Disclosure rules and Transparency Rule (DTR) R 2.2.1 R. Companies subject to the Disclosure and Transparency Rules and/or the Listing Rules are required, in a range of circumstances, to make announcements to investors. There are currently eight providers approved by the FSA that act as Regulated Information Service providers that companies making regulatory announcement can choose from. See <http://www.fsa.gov.uk/Pages/doing/ukla/ris/contact/index.shtml> accessed 23 April 2010.

[66] FSA, Market Conduct (MR) 1.3.5.E.

information, the DTR in the FSA handbook lay down a reasonable investor test to determine whether information is 'price significant'. Under this regime, the company should

> 'assess whether the information in question would be likely to be used by a reasonable investor as part of the basis of his investment decisions and would therefore be likely to have a significant effect on the price of the issuer's financial instruments'[67]

Under the reasonable investor test regime, significant information which is likely relevant to investor's decision includes information which affects:

> '(1) The assets and liabilities of the issuer; (2) The performance, or the expectation of the performance, of the issuer's business; (3) The financial condition of the issuer; (4) The course of the issuer's business; (5) Major new developments in the business of the issuer; or (6) Information previously disclosed to the market.'[68]

In the course of dialogue between the company and institutional shareholders, the managers should be well-prepared to make an initial assessment of whether particular information in the meeting amounts to inside information. The meeting participants, if dealing or encourage others to deal in price-affected securities based on insider information, as defined in CJA1993, will be guilty of insider dealing. Another risk that might be easily ignored, is that even if the meeting participants do not make use of insider information from dialogue to deal in securities, the company manager disclosing inside information to an institutional shareholder in private may commit an offence if he cannot justify himself as acting in the proper course of his employment, profession or duties. The FSA elaborates on this rule and sets out factors to be taken into account to decide whether managers are so acting:

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[67] FSA, DTR, 2.2.4 G (1).

[68] FSA, DTR, 2.2.6 G.

> 'whether the disclosure is accompanied by the imposition of confidentiality requirements upon the person to whom the disclosure is made and is:
>
> (a) reasonable and is to enable a person to perform the proper functions of his employment, profession or duties; or (b) reasonable and is (for example, to a professional adviser) for the purposes of facilitating or seeking or giving advice about a transaction or takeover bid; or (c) reasonable and is for the purpose of facilitating any commercial, financial or investment transaction (including prospective underwriters or places of securities); or (d) reasonable and is for the purpose of obtaining a commitment or expression of support in relation to an offer which is subject to the Takeover Code; or (e) in fulfilment of a legal obligation, including to employee representatives or trade unions acting on their behalf.'[69]

However, most institutional shareholders are unwilling to be made insiders because it will affect their ability to deal in the shares of the company concerned. In order to minimize the risk of inside information being released in meetings, most private meetings were conducted soon after an announcement of results.[70] Institutional shareholders expect investee companies to ensure that price-sensitive information is not disclosed to them without their agreement or without warning. Where institutions act jointly, they would establish an informal agreement not to deal in the company's shares during the time of the intervention.[71]

Some institutions, such as Fidelity, are able to accept price sensitive information through their corporate finance groups. The risk of dealing inside information is avoided as these corporate finance groups operate separately from dealing and fund management activities.[72]

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[69] FSA, MR 1.4.5 E.

[70] Stapledon (n 29) 105.

[71] Stapledon (n 29) 244.

[72] Fidelity, 'Fidelity and the UK Stewardship Code' <http://fidelity-international.com/about/fil_uk_stewardship_code.html> accessed 13 August 2010.

However, most institutions come to meetings to resolve their concerns rather than to receive inside information. To avoid the danger of insider dealing or improper disclosures, companies must be cautious to keep inside information confidential until it is published and must not allow this information to leak during private meetings. However, despite the fact that companies are not obliged to offer any information other than what is in the annual report and public disclosure, they could choose to present information to institutional shareholders to maintain a good relationship. To avoid any offense resulted from inside information, companies may selectively disclose non-public non-price-affected information to certain major institutional shareholders before making public announcement of the same information. It is clearly stated by the FSA that in the communication with third party, unpublished information will not necessarily be inside information.[73] In fact, what company can present and what institutional shareholders want to obtain is the selective briefing or so-called soft information. Subject to the willingness of company and legal restrains on inside information, such soft information can be disclosed to major shareholders through dialogue.

Such soft information, which is non-price sensitive in nature, gives institutional shareholders advantages over individual shareholders. Public information, mainly including company announcements and financial reports, are argued to be inadequate and constrain institutions' ability to engage in corporate governance.[74] By obtaining soft information through dialogue, institutional shareholders equipped with sophisticated and internal analysts, are likely able to conflate public information and unpublished soft information to make more accurate assessment of the company performance, management quality and the effectiveness of the board. Critics of this practice claimed that this favoritism of institutional shareholders is unfair to small investors and consequently damages the market's transparency, integrity and

[73] FSA, DTR 2.2.10G

[74] Holland (n 41) 162.

reputation.[75] However, given the importance of the role of institutional shareholders in corporate governance and the government's policy of increasing emphasis on this role, it seems that such practices will continue.

However, companies and institutional shareholders should also be aware that, if companies disclose unpublished information that is not inside information in nature, but which could enable shareholders to deal or arrange deals under a regular user's test, that will amount to market abuse for misuse of information.[76] This rule requires that information disclosed to institutions in the meeting cannot be easily used by a regular user to deal.

Hence, based on the above analysis, the risks of breaching insider dealing and market abuse regulations have the potential to hinder institutional shareholders from meeting with investee companies' board and senior management. Research concerned with US cases showed that similar regulation of insider dealing and disclosure in the US has a chilling effect in practice. Some companies refused to offer any material and non-public information to shareholders during the course of meetings, while some of them will conduct a listening model for meetings:[77] 'executives…have to make sure they don't say anything that could move the stock…'[78] As research has shown, companies have sought legal counsel to advise appropriate controls to the scope of their communications in accordance with regulations. One company under that research said it typically has counsel present during the discussions. Consequently, costs for private meetings increase, potentially reducing both the board and shareholders' incentives for dialogue.

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[75] A Al-Hawamdeh and I Snaith, 'Is 'Private Briefing' Illegal in the United Kingdom?'(2005) 13 *Corporate Governance: An International Review* 489, 493.

[76] FSA, MR 1.5.1.

[77] S Davis and S Alogna, 'Talking Governance: Board-Shareowner Communications on Executive Compensation' (2008) Millstein Centre for Corporate Governance, Yale School of Management 10 <http://millstein.som.yale.edu/documents/Communications-Summary_Findings.pdf> accessed 16th September 2009.

[78] Ibid.

5.2.1.3.2.1.2 Conflicts of Interest

The form of private meetings or dialogues is less 'conflict-prone' for institutional shareholders.[79] Without public confrontation, the reputational injuries to corporate managers from institutional shareholders' opposition can be significantly mitigated. Hence, institutional shareholders have fewer worries that private meetings could damage their business relationship with corporate managers. Meanwhile, the potential fall in the share price, which could be triggered by open conflicts between corporate managers and shareholders, is less likely to occur if their concerns are solved through private meetings. Thus, private negotiations are also helpful to avoid damage to the company's reputation.

Moreover, for executives and the board, dialogue helps them to build good relationships with institutional shareholders that would later support company in certain circumstances, such as crisis, or hostile takeover bid. As Holland discovered, the primary goal of some companies to have a dialogue with shareholders is to improve corporate financing capacity and defences against takeover threats.[80] For the above reasons, indirect loss resulted from conflicts of interest is relatively low when it comes to the form of private meetings.

5.2.2.2.3 Case Study: Say on Pay

The legal framework, on the one hand, as we have seen in section 5.2.1.3.2.1.1, can hinder private meetings. On the other hand, it can also facilitate them. And in particular, and perhaps paradoxically, legal requirements for mandatory votes can encourage prior private meetings, as will be illustrated by the 'Say on Pay'.

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[79] B Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 UCLA Law Review 811, 879.

[80] J Holland, *Corporate Communications with Institutional Shareholders* (The Institute of Chartered Accountants of Scotland, Edinburgh 1997) in Executive Summary.

In 2002, Britain's Labour Government had introduced an annual advisory vote on the directors' remuneration report, which came into effect in 2003.[81] This requirement, now found in section 439 of CA 2006, provides that:

> 'A quoted company must, prior to the accounts meeting, give to the members of the company entitled to be sent notice of the meeting notice of the intention to move at the meeting, as an ordinary resolution, a resolution approving the directors' remuneration report for the financial year.'[82]

This rule opened up a new opportunity for institutional shareholder engagement. The way directors are paid represents how a board attends to share value. Dialogue provides shareholders with an opportunity to offer input on remuneration-decision process and thus enhance the transparency and accountability of the board each year.

The first company in the UK to have its remuneration proposal rejected by shareholders in accordance with the Say on Pay regulation was the GlaxoSmithKline PLC (GSK), the Pharmaceutical giant.[83] In 2003, the year of introduction of the 'Say on Pay' regulation, GSK's board put its proposed remuneration report for a shareholders' advisory vote. Its resolution was defeated, with 50.72% of shareholders voting against it.[84] The widely-reported vote, although non-binding, triggered negative publicity against the company, deeply injurious to the board's reputation. Since then, the company has been actively seeking dialogue with shareholders to reconstruct a good relationship with investors. It now arranges two annual roundtables with about a dozen investor representatives on remuneration and governance.[85]

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[81] The Directors' Remuneration Report Regulations of 2002 (SI 2002/1986).

[82] CA2006 s 439.

[83] BBC, 'Glaxo Defeated by Shareholders' (19 May 2003) <http://news.bbc.co.uk/1/hi/business/3038381.stm> accessed 16 September 2008.

[84] Ibid.

[85] S Davis, 'Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable' Millstein Center for Corporate Governance, Yale School of Managment <http://millstein.som.yale.edu/Davis_Say_on_Pay_Policy_Briefing.pdf>16 September 2009.

This case had led other UK companies to realize the importance of board-shareholders communications and has produced an increase in the quantity and quality of dialogue between companies and institutional shareholders. [86]

> 'boards are aware that if they do not appear to be taking note of the signals that are being sent by shareholders, the next step could be to vote against members of the remuneration committee – which of course is a binding vote.'[87]

The ABI estimated the frequency of private meetings between companies and shareholders tripled after the introduction of 'Say on Pay'.[88] A number of companies further established a formal process for communication with their major institutional shareholders on 'Say on Pay'.[89] In most cases, the dialogue led companies to strengthen their remuneration plans in ways that closely tie pay directly to performance.[90]

To sum up, 'Say on Pay' serves as a good example showing the role of legal facilitation in increasing the level of institutional shareholder activism. It provides institutional investors with a new chance to get involved in corporate remuneration policies. Moreover, it brings regulatory pressure to the board, encouraging them to seek dialogue with its major shareholders prior to votes.

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[86] Ibid, 10; Also see Institutional Shareholder Services (ISS), 'What International Markets Say on PAY: An Investor Perspective' April 2007 <http://www.riskmetrics.com/node/135617> accessed 12 May 2009.

[87] Davis (n 85) 22.

[88] Ibid, 10.

[89] F Ferri and D Maber, 'Say on Pay Votes and CEO Compensation: Evidence from the UK', Working Paper, 2 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420394> accessed 20 May 2010; S Thompson, 'The Impact of Corporate Governance Reforms on the Remuneration of Executive in the UK' (2005) 13 Corporate Governance: An International Review 19.

[90] Ferri and Maber (n 89) 4.

5.3 Proxy Voting

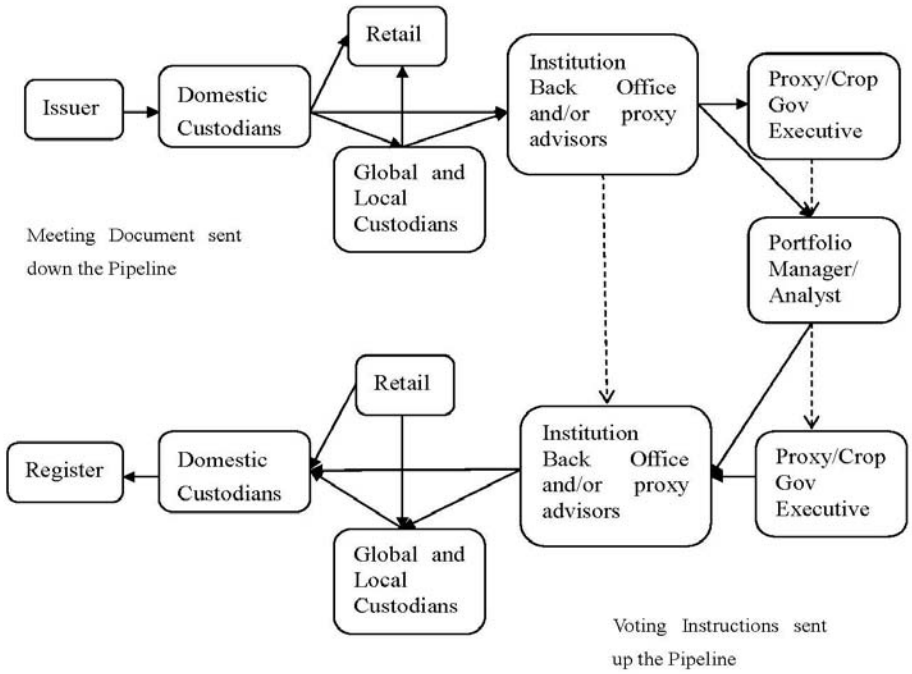
The residual control of shareholders over companies rests in large part on their ability to vote in companies' meeting. Shareholders rely on the vote to affect the governance of a company and to signal confidence or lack of confidence in its management. It is perhaps the most basic and most important tool attached to the shares. This section is structured in two major parts. Section 5.3.1 is devoted to examining empirical evidence of how institutional shareholders have engaged in proxy voting activism. Based on that evidence, section 5.3.2 applies the activism model to explain shareholder voting practice.

5.3.1 Empirical Evidence

5.3.1.1 Proxy Voting Process

The voting procedure for institutional shareholders is much more complicated than voting by individual investors, for it involves a large number of participants as the following diagram, by the International Investor Relations Federation (IIRF), illustrates.[91]

[91] International Investor Relations Federation,'Survey of Global Voting Trends Summary Report ' (2005).



In order to present a clear discussion regarding voting process, voting participants will be divided into three groups, namely, registered shareholders, voting decision-makers and issuers.

The voting process starts with the voting materials transfer from the issuers to the registered owner of the shares. Normally, the name of custodians' nominee company is registered on behalf of beneficial owners. In the UK, where a custodian is appointed to safeguard their assets, in accordance with related regulation,[92] he shall hold clients' assets, at least collectively, separate from his own assets. So, it is the nominee's name on the register of shares. However, it owns shares as a bare trustee and must exercise voting rights as instructed by the person specified in the fund-manager agreement.

In the second step, custodians will forward voting materials to persons who decide the way in which votes are cast. Those decision-makers could be investment managers, proxy agencies or other third parties. Fund-management agreements often provide

[92] The FSA's Client Assets Sourcebook.

that fund managers are the persons to make vote-decisions. Some investors would appoint proxy voting agencies or other third parties to vote on their behalf. Some might retain voting shares and vote shares themselves. Those decision-makers decide how to cast votes and then forward instructions to registered owners.

Third, the registered owners complete the proxy cards in accordance with instructions and then send them to the registrar.[93] The voting process will not end until the vote is recorded. For votes to be recorded, the actually number of shares voted and the number of voting entitlements should match in the register system. Otherwise, voting instructions will be rejected and votes are invalid. However, as will be discussed later, some votes could not be correctly registered due to some procedural difficulties, which result in the problem of 'lost votes'.

5.3.1.2 Voting Levels

Voting levels are an important indicator of shareholder activism. There is a growing body of evidence on the exercise of voting rights by shareholders, to which I now turn. One of the early studies dealt with shareholders' voting which was conducted by Mallin for the period November 1993 to September 1994.[94] This study covered 101 of the largest 250 listed companies in the UK and found that an average of only 35% of the issued ordinary shares of the sample companies was voted at AGMs.

After ten years, there was a remarkable increase in the voting level at company meetings. An analysis by Manifest[95] of the AGMs of 401 companies (accounting for about 80% of FTSE All shares) in 2005 suggested voting levels of around

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[93] In 1996 a national central securities depository system, called CREST, was introduced by LSE. This system was based on computer records to register title to shares and enable shares to be transferred , see D French, S W Mayson and C Ryan, *Mayson, French & Ryan on Company Law* (25th edn Oxford University Press, Oxford 2008) 213.

[94] The result of Mallin's study was cited in Stapledon (n 29) 90.

[95] Manifest' research result was cited in P Myners, *Review of the Impediments to Voting UK Shares* ((2005), London: Shareholder Voting Working Group, 1.

61.06%.(Myners 2005)[96] Similar levels were found in 2006, with 61% of FTSE 350 Index companies and 63% of FTSE 100.[97]

Additional evidence is provided by surveys conducted by institutional shareholder representative bodies. The earliest is probably the one conducted by NAPF for the period of 1990 to 1994. It found that 60% of fund managers expected to vote on contentious issues, and around 20% of institutions never voted.[98] The voting levels at that time were therefore relatively low.

That level has dramatically increased over the past few years. In a more recent NAPF survey, all respondents had voted their own shares or liaised with managers about voting at UK company meetings.[99] The report conducted by IMA in 2008 shows that 32 firms under the study appears to be voting around 95% resolutions.[100]

A point needs to be borne in mind when looking at evidence on voting levels in the UK. There is a discrepancy between the number of votes cast by institutional shareholders and the number of votes registered in companies. This discrepancy arises when institutional shareholders cast their votes but these votes cannot be recorded due to procedural problems. Some votes may be in effect lost. The IIRF's survey found that 76% of institutions believed votes failed to be registered as actual votes, either occasionally, or often.[101]

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[96] Ibid.

[97] It was cited in P Myners, *Review of the Impediments to Voting UK Shares* ((2007), London: Shareholder Voting Working Group, 1.

[98] NAPF, *Annual Survey of Occupational Pension Schemes* (NAPF, London 1994).

[99] NAPF, *Pension Funds' Engagement with Companies Survey 2007* (Hereinafter NAPF 2007 Survey in subsequent footnote) <http://www.napf.co.uk/PolicyandResearch/DocumentLibrary.aspx> accessed 23 December 2008, 26.

[100] IMA 2008 Survey (n 25) 3.

[101] International Investors Relationship Federal (n 91).

5.3.1.3 Voting Policies of Institutional Shareholders

A considerable number of institutional shareholders, especially large institutions, have now set out explicit statements about their voting *policies*. Actually, setting up voting policies is not a new practice. Early studies conducted by Mallin in 1996 found that a majority of institutional shareholders established policies to vote on all issues following the Government's recommendation and institutions representative bodies' guidelines, while some institutional shareholders had a policy to vote only non-routine issues. Very few of them tended not to vote at all.[102]

Based on different policy-makers, institutional shareholders' voting policies can mainly be categorized into three groups: representative bodies' voting guidelines, voting agencies' recommendations and their own engagement polices. It is worth noting here, however, these three categorizes may overlap. For example, some voting agencies will adopt industry organizations' guidelines as their voting policies. Or both of them will be implemented by institutions in different situations.

ISC Statement of Principle

Following Myner's recommendation,[103] many large institutional investors have incorporated the ISC's Statement of Principle into contracts with investment managers or into the funds' investment statements as their voting guidance. IMA found that 24 out of 33 major fund managers under its survey incorporated their voting policies in all new and existing contracts by 2006.[104] More recently, the 2010

[102] C Mallin, 'The Voting Framework: A Comparative Study of Voting Behavior of Institutional Investors in the U.S. and the U.K.' (1996) 4 Corporate Governance 107, 118.

[103] P Myners, *Myners Principles for Institutional Investment Decision-making: Review of Progress* (2005) London: HM Treasury.

[104] IMA (n 22) 7.

NAPF survey suggests that two thirds of 38 respondents have adopted the ISC' Statement of Principle as their voting policies.[105]

The ISC' Statement of Principle suggests institutional investors:[106]

1. vote all shares wherever practicable to do so. They are also suggested to 'not automatically support the board, if they have been unable to reach a satisfactory outcome through active dialogue then they will register an abstention or vote against the resolution'.
2. maintain a clear vote record, including the reason for voting against a resolution, for abstaining and for supporting with management.
3. establish a policy on public disclosure of voting and such policy should be published and regularly reviewed.

Voting proxy agencies' recommendation

Some institutional shareholders' voting policies come from voting agencies or other specialists outside their own funds. These voting agencies, employed by institutions to help with the engagement process, act alone or co-operate with institutions' own internal specialists to decide on voting policies. Some institutions review agencies' recommendations they receive and reject them on their behalf after taking account of the specific circumstances at the company concerned. Commonly, such decisions have been taken on the basis of in-house analysis or meeting the investee company directly to discuss the contentious issue.[107]

Institutions' own voting policies

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[105] NAPF, 'Pension Funds' Engagement with Companies Survey 2010' (Hereinafter NAPF 2010 Survey in subsequent footnote) <http://www.napf.co.uk/PolicyandResearch/DocumentLibrary.aspx> accessed 20 August 2010, 11.

[106] ISC (n 56) 4.

[107] NAPF, 'Pension Funds' Engagement with Companies Survey 2007' (Hereinafter NAPF 2007 Survey in subsequent footnote) <http://www.napf.co.uk/PolicyandResearch/DocumentLibrary.aspx> accessed 20 August 2010, 11.

In addition to above two types of voting policies, some institutional shareholders also have set their own voting policies. The following are some typical examples of voting policies:

Institutions	Voting Policies
Standard Life	'We vote all shares under our control at all shareholder meetings in the UK and Ireland, and we always vote our shares in a manner consistent with the best interests of our customers'[108]
Friends Provident	'Voting on all holdings worldwide and engaging in dialogue with companies to promote the adoption of best practice where this can protect or enhance shareholder value.'[109]
Fidelity	'We have a set of proxy voting guidelines which generally direct our voting behaviour although we do also take account of the particular circumstances at the company concerned…'[110]

5.3.1.4 Voting-decision Makers

In practice, very *few* fund beneficiaries would retain voting rights themselves. According to the IMA survey, only an average of 5% or fewer of beneficial owners had retained their voting rights.[111] These beneficial owners could make voting decisions themselves, or outsource to a third party, or direct the funds to follow the instruction of a particular agency.[112] In the remaining cases, clients give the funds discretion to vote on their behalf.

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[108] Available at <http://www.standardlifeinvestments.com/corporate_governance_and_socially_responsible_investing> accessed 10 August 2008.

[109] Available at <http://www.friendsprovident.co.uk/doclib/fcresponsibility.pdf> accessed 10 August 2008.

[110] Available at <http://www.fidelity-international.com/about/voting_policy.html> aaccessed 10 August 2008.

[111] IMA 2006 Survey (n 22) 21.

[112] Ibid.

In cases where voting-decisions rights are delegated to funds, the IIRF survey found that 29% of voting decisions are made by relevant portfolio managers, 22% of those are decided by corporate governance executives, and 14% of those are made by proxy voting executives.[113] In most cases, a combination of corporate governance officers and proxy voting executives make voting decisions rather than portfolio managers.[114] Around 8% of voting decisions are made by outside proxy advisors.

The NAPF 2007 survey provides a closer look at the use of proxy advisors. 14 out of 33 funds surveyed subscribed to one or more voting agencies. Some funds do not directly delegate to voting agencies, but still use fund managers' or specialists' recommendations, which in turn can be influenced by agencies' guidelines.[115] The most often subscribed agencies were RREV and PIRC. Others were Manifest and Glass Lewis.[116]

5.3.1.5 Voting Agenda

Meeting agendas are often dominated by certain types of issue. According to a survey jointly conducted by Manifest and Georgeson, directors' (re) election, and resolutions dealing with share capital or transactions in own shares, are the two most common meeting issues in UK listed companies, followed by auditors' (re) appointment and remuneration.[117] Board composition and directors' remuneration are the third most common issues presented in the meeting.

In term of issues over which institutional shareholders are most likely to vote *against* management, directors' remuneration tops the list of meeting issues.[118] Of the 21

[113] International Investors Relations Federation (n 91) 9.

[114] Ibid.

[115] NAPF 2007 (n 107).

[116] Ibid.

[117] Both Manifest and Gergeson are proxy voting providers. See, Manifest and Gergeson, 'Proxy Voting 2007 – A Pan-European Perspective', 63, on file with Gergeson.

[118] TUC, 'TUC Fund Manger Voting Survey 2009' < www.tuc.org.uk/extras/fundmanager2009.pdf> accessed 13 February 2010, Section two, 1.5; M Conyon, 'Shareholder Voting and Directors'

respondents, all but one mentioned remuneration as the most likely issue for opposition. Institutions have taken up most time engaging with the company on remuneration issue. The second most mentioned issue is board balance/director independence, followed by pre-emption rights.

5.3.1.6 Electronic Voting

Since Myners' call for electronic voting in 2004,[119] there has been a substantial increase in the number of companies that facilitate electronic voting and in the number of electronic votes. All FTSE 100 companies and 74% of FTSE 250 companies had introduced electronic voting by the year of 2006, while only 47% and 10% had adopted such system, respectively, by 2003.[120] The actual utilisation of electronic voting in FTSE 100 and FTSE 250 companies has risen from 22% and 14% in 2003, to 45% and 41% in 2006, respectively.[121] This growing trend is predicted to continue. Major proxy voting agencies, including Manifest and RREV are all offering electronic voting services to their clients. There is also evidence to show that electronic voting is positively and significantly related to the overall engagement level of fund managers.[122]

Remuneration Report Legislation: Say on Pay in the UK ' 18 Corporate Governance: An International Review 296, 296.

[119] Myners, *Myners Principles for Institutional Investment Decision-making: Review of Progress* (2005) (n 103).

[120] P Myners, *Review of the Impediments to Voting UK Shares* (2007) London: Shareholder Voting Working Group, 4.

[121] Ibid.

[122] R Martin and T Nisar, 'Activist Investment: Institutional Investor Monitoring of Portfolio Companies' (2007) 45 Management Decision 827, 836.

5.3.1.7 Voting: Substance

Most UK listed companies (92% of company meetings of the FTSE 100 in 2005 as reported by Myners)[123], provide three voting options on all issues: 'for' 'against' or 'abstain'. When the company disclose its poll results on its website, it must publish the number of votes for, against and abstentions (if counted).[124]

The TUC survey looked at institutions' voting on remuneration reports, incentive schemes and director election. It presents results in terms of the split in actual numbers of votes, for against and abstains, and their proportion.[125] It finds a clear divergence in investor approach to utilise their voting rights. There are a number of respondents who were largely or always supportive of management in all issues and similarly, there are some groups of respondents who are most likely to oppose management. Unfortunately, the survey does not provide an explanation for the different voting propensity among institutions.

The voting levels against corporate management's proposals were found to be rather low. IMA's study found the institutions surveyed voted against 3.3% of resolutions in 2008 and 2.3% in 2007 and consciously abstained on 1.7% of resolutions in 2008 and 2.3% in 2007.[126] The higher level of voting to oppose management or abstain often indicates there were more contentious issues than previous years.

5.3.1.8 An Analysis of Empirical Evidence

5.3.1.8.1 Voting Level

[123] P Myners, *Review of the Impediments to Voting UK Shares* (2005). London: Shareholder Voting Working Group.

[124] The Companies (Shareholders' Rights) Regulations 2009 (SI 2009/1632) 19 (3).

[125] TUC (n 118).

[126] IMA 2008 Survey (n 25) 23.

When the average voting turnout at UK general meetings was around 50% in 2003, the Secretary of State for Trade and Industry stated that it was not a desirable result and it should increase in the next couple of years.[127] In the wake of this sort of regulatory demands, the UK market has seen a 10% rise in the voting participation by shareholders. However, there are still 40% of shares that not voted in meetings. This gives rise to the question that whether institutional investors should be responsible for these non- voting levels.

As we have seen above, industry associations reported that most of their institutional members have voted their shares. Their surveys cover large institutions that collectively control a significant amount of all UK equity market capitalisations. For example, survey undertaken by IMA covered 33 funds managers responsible for 68% of the equities managed in the UK.[128] Therefore, it is fair to conclude that most large institutional investors have made a contribution to the current increased voting level. As to the remaining non-voting shares, Myners suggested that foreign and individual investors seeming to be under-represented in the voting process.[129] However, those non-voting shares may still include a small amount of institutional shares. Some institutions do not vote, while some institutions' votes are lost. Both issues are examined later in section 5.3.2.2.2.4.

5.3.1.8.2 The Substances of Voting

As noted, the exercise of voting rights has substantially grown from a fairly low base a decade ago to the current relatively high level. The growing interests in shareholder engagement amongst regulators and the public is likely to drive a further increase in the future. However, it should be borne in mind that we are not merely pursuing a high voting level in the UK, what we really expect is that institutional shareholders vote in a *considered* way. However, unlike the voting level, which can be observed

[127] Myners, *Review of the Impediments to Voting UK Shares* (2007) (n 120) 1.

[128] IMA 2008 Survey (n 25).

[129] Myners *Review of the Impediments to Voting UK Shares* (2005) (n 123).

easily, whether institutional shareholders make considered votes is a more subjective issue.

This part examines institutional shareholders' voting policy, coupled with their voting behaviour, to explore the actual substance of votes cast. As already shown, the majority of institutional shareholders have established their voting policies and follow those policies when they cast votes. We have seen that institutions tend to adopt proxy voting policies which allow them to vote with management in most cases. This might be defended on the ground that company managers are trying to act in the best interests of shareholders to promote the success of the company. And meanwhile, voting in favour and voting against management are both forms of activism. Of course, institutions' voting policies also state that they will take into account under some particular circumstances and vote against management when it is necessary.

The question remaining is whether those voting policies truly help institutions to align their interests with the long term value of investee companies. There are cases where institutional shareholders should oppose management for the benefit of shareholder value but simply adopted their 'vote-for' policy. The most high-profile case is perhaps the acquisition of ABN Amro by RBS. This acquisition is considered as one of the worst deals in UK corporate history. As the chair Philip Hampton stated in the RBS AGM this year, 'it can be seen as the worst price, the wrong way to pay, at the wrong time and the wrong deal'.[130] However, when this proposal was put to a vote at the AGM in August 2007, an overwhelming majority of shareholders voted in favour of it.[131]

Moreover, in reviewing the financial crisis, people question whether institutional shareholders had performed as responsible owners to brake management's risk-taking

[130] TUC (n 118).

[131] J Treanor, 'New RBS Chairman Calls for End to 'Public Flogging' of its Bankers' (3 April 2009) *Guardian*<http://www.guardian.co.uk/business/2009/apr/03/rbs-agm-protests-goodwin-pension> accessed 6 May 2009.

approach. If it is correct that remuneration contracts at the banks to some extent encourage managers' excessive risk-taking, then shareholders might not pay enough attention to directors' remuneration, as the TUC survey suggests remuneration was not a controversial issue at shareholders' general meeting in 2008.[132]

5.3.1.8.3 The Role of Voting Agencies

As the above evidence shows, many institutions frequently appoint proxy voting agencies to facilitate voting decisions. These third-party advisors therefore become an important link in the voting process by institutions and could potentially wield considerable influence in the outcome of proposals at shareholders' meetings. This perceived importance of proxy advice is illustrated by an estimation that if recommendations issued by RREV and PIRC were followed by their large number of clients, they could in total influence up to 35% of the votes at the annual meeting as reported in 2005.[133] They can sometimes determine whether or not a chairman will 'have an easy ride from shareholders' at the meeting'.[134] As a result, it is vital to shed light on what role voting agencies have played in institutional shareholder activism and point out issues that need further consideration.

There is little doubt that proxy voting advisors can bring multiple benefits to the current voting process. First, their services help institutional investors to overcome resource constraints on considered use of votes. As one has seen, some institutional investors do not have the resources to make considered voting decisions on every resolution at every company they invest in, nor have enough specialised knowledge to judge different types of corporate governance issues. Lack of resources can hinder their voting capability and limit their role in corporate governance. Under these

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[132] TUC (n 118).

[133] Ibid. A similar conclusion was drawn in respect of the influence of US proxy agencies on shareholder voting, see, P Rose, 'The Corporate Governance Industry' (2007) Journal of Corporate Law 887, 899-903.

[134] S Tucker, 'Advisory Services Sharpen Claws' *Financial Times* (9 June 2005) <http://www.ft.com/cms/s/0/ed35b37a-d882-11d9-8fa7-00000e2511c8.html> accessed 5 October 2008.

circumstances, to employ others to supply analysis, or make voting recommendations, can overcome shortage of resources. Moreover, as proxy advisors have developed their specialised team, it is likely they can make more accurate voting suggestions or engagement strategies for institutions. As mentioned, despite some institutions having set up their own internal engagement team, these staff may sometimes seek help from advisors to get professional analysis if the issues are complicated.

Second, the economic restraint of conflicts of interest can be mitigated through the use of third-party advisors. Since those advisors and their services are less likely to be directly connected with and affected by institutions' investee companies, they are arguably more independent from conflicts of interest. Delegation to the third proxy voting service thus helps fund beneficiaries to ensure the voting decisions are in line with their interests and the value of the investee companies.

Taken together, proxy voting advisors' professional reputations, coupled with their relatively independent role in engaging in corporate governance, lead to great potential that agencies can serve as watchdog over management.[135]

However, the usefulness of the proxy voting advisor is not undisputed.[136] Conflicts of interest are an issue frequently mentioned in the context of proxy voting services, particularly when some advisors provides services, such as corporate governance ratings, corporate governance advice and other research services to issuing companies, as well as to the companies' shareowners. The independence of advisors' recommendations is doubtful, for the company in question might also be a client of the advisor.

There are few studies to probe how this problem affects UK advisors, such as IVIS and PIRC, however, evidence on the US advisors suggest that they the interests of

[135] J Coffee, *Gatekeepers: the Professions and Corporate Governance* (Clarendon lectures in management studies., Oxford University Press, Oxford 2006) 3.

[136] Generally, see Rose (n 133) J Taub, 'Able but Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders' ' (2009) 34 Journal of Corporate Law 843.

corporate clients and that of investor clients are sometimes conflicted. For example, RiskMetrics, the largest of the proxy voting advisory services in the world, ranks over 8,000 companies through its Corporate Governance Quotient Service, which evaluates a company's governance systems and the quality of board of directors.[137] Although these companies do not pay to be ranked, some of them may subscribe to RiskMetrics services to help them improve their corporate governance standards. In the meantime, RiskMetrics provides investors with voting recommendations on these same companies. By observation of these potential conflicts, some large institutional investors in the US, such as the state of Colorado, chose to move from RiskMetrics to other less conflicted providers.[138]

In the UK context, despite the lack of reliable evidence, the thesis suggests that while conflicts of interest might occur, they are likely less severe than in US because advisors such as PIRC and IVIS only provide services to institutional investors.[139] In spite of that fact, in order to ensure voting recommendations made by advisors are consistent with the interests of institutional investors and their beneficiaries, on the one hand, voting proxy advisors should take measures to reduce the possibility of conflicts, such as setting up separate teams to deal with clients if interests conflict, or to enhance its disclosure system. On the other hand, institutional investors should carefully review advisors' analysis and report if it is not consistent with their interests.

An additional concern with the current proxy voting advisory services is that they might use 'one-size-fits-all' governance standards for different clients. Given the vast number of meetings each year and large number of clients that have to be analyzed in a short period of time, the accuracy of the recommendation is doubtful. According to

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[137] More information can be found in <https://www.riskmetrics.com/issgovernance/esg/uscgqcriteria.html> accessed 23 January 2010.

[138] M Thompson-Mann, 'Voting Integrity: Practices for Investors and the Proxy Industry' (2009) Policy Briefing No. 3 The Millstein Center for Corporate Governance and Performance < http://mba.yale.edu/news_events/CMS/Articles/6516.shtml > accessed 23 March 2010.

[139] More information can be found at< www.pirc.co.uk> and <www.ivis.co.uk/> accessed 10 August 2008.

a UK investment manager, proxy advisors have not covered some companies in the depth they should and the quality suffers and thus, 'there have been numerous times that I have disagreed with their opinion as they have not researched this meeting in sufficient depth.'[140] The NAPF' survey also shows that of the 14 funds subscribed to voting agencies, 8 had at some circumstances chosen not to follow the agencies' recommendation.[141]

In this regard, the crucial way to improve the quality of recommendations is that advisors should devote enough resources to apply their corporate governance to each company and company meeting in an individual context. Moreover, the communication between institution clients and proxy advisors is also helpful, as it facilitates advisors to work out whether the recommendation is fit for clients' specific circumstances.

In sum, evidence in regard to institutional shareholders' voting activities suggests an increasing important role played by proxy voting advisors in corporate governance. The above analysis, however, warns that their services are potentially subject to conflicts of interest as well as a lack of 'in-depth' quality. To ensure the independence and effectiveness of proxy voting services, in addition to enhancing monitoring from the government, related institutions and investors, rules about duties of analysts and disclosure of potential conflicts of interest should be considered if necessary.

Postscript: The Stewardship Code encourages proxy service providers to 'disclose how they carry out the wishes of their clients by applying the principles of the Code that are relevant to their activities.'[142] However, it is too soon to assess the empirical evidence of the effect of this part of the Stewardship Code.

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[140] IIRF (n 91).

[141] NAPF 2007 Survey (n 107).

[142] Stewardship Code, Preface.

5.3.2 Applying the Model to Proxy Voting

5.3.2.1 Step 1: Overcoming Free-riding

5.3.2.1.1 The Decisiveness of Individual Shareholding

Whether an individual shareholder is decisive in voting depends clearly on the portion of shares he has. So, the larger the shareholder's holding, the greater the chance that his votes may be decisive. However, it is also worth noting that 'decisiveness' is *inversely* related to voting levels. With low anticipated levels of voting, the relative strength of any exercised votes is much greater. As voting levels rise, any one shareholder's votes become even more diluted. In this sense, levels of voting might be somewhat 'self-regulatory'. And achieving ever higher levels of voting becomes increasingly difficult.

5.3.2.1.2 The Possibility of Concerted Action

Since voting results are binding on corporations, institutional shareholders opposed to management have strong incentives to form a coalition to vote down management's proposal. Moreover, the way in which shareholders cast votes reveals to others what institutions think about the performance of incumbent management. Under these cases, other small, retail investors, even where they do not join a formal coalition, are likely to vote in the same way as those large institutional investors owing to their professional reputation.

5.3.2.1.3 'In-process' Benefits

As said earlier, along with the growing awareness of corporate governance among the public, the willingness to participate in corporate governance has become a reputational issue which helps institutional shareholders to maintain their competitive position in the market. Voting offers a good opportunity for institutions to receive this kind of 'in process' benefit. Once they disclose their voting policies or records,

institutional shareholders are able to show the public that they do their bits to contribute to better governance in investee companies.

5.3.2.1.4 Normative/moral Obligation

The factor of normative obligation has become particularly strong in overcoming free-riding when it comes to voting. *First*, as will be discussed later, all corporate governance guidelines and governmental-reports have continually pushed institutional shareholders to exercise their voting rights on a regular basis in a considered way. *Second*, as voting is conducted in a visible way, the public is enabled to scrutinise whether institutional shareholders have exercised their voting rights as advocated by guidelines. *Thirdly*, voting resonates with democracy as it grants all members of the company a chance to make decision on corporate affairs. Hence, some institutional shareholders might view it as an important and valuable right. For all these reasons, voting appears to generate easily this sort of moral or normative demand that institutional shareholders must vote.

The subsection lists a selection of corporate governance statements in which voting has been emphasized. Firstly, all key self-regulation codes of good practices require institutional shareholders to cast their votes as active and responsible owners. For example:

Cadbury Report: 'Given the weight of their votes, the way in which institutional shareholder use their power…, is of fundamental importance', and encouraged institutional shareholder to 'make positive use of their voting rights and disclose their policies on voting'.[143]

[143] Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee&Co.Ltd, London 1992).

Hampel Report: 'institutional shareholders have a responsibility to make considered use of their votes'.[144]

Stewardship Code: 'Institutional investors should seek to vote all shares held. They should not automatically support the board. If they have been unable to reach a satisfactory outcome through active dialogue then they should register an abstention or vote against the resolution.'

NAPF: as early as 1995, it described the institutional shareholder's voting activism as the 'the powerful measure' and 'encourage-as a matter of best practice- the regular exercise of proxy votes by pension funds'.[145] In 1999, the NAPF and ABI jointly issued a guidance on voting in which it emphasises the importance of voting and recommends voting should be exercised in a reasonable manner.[146] Similar guidance to promote considered voting can also be found in ISC's Statement of Principe.[147]

Organization for Economic Co-operation and Development (OECD): in its Principle of Corporate Governance, it refers to the voting as a basic shareholder right and encourages the exercise of voting rights by stating that 'shareholders should have the opportunity to participate effectively and vote in general shareholders meetings and should be informed of the rules, including voting procedures that govern general shareholder meeting'.[148]

Regulatory demands appear to make institutional shareholders feel much less able to free-ride, as evidenced by the increase of voting level in recent years. For example, while by the late 1970s, institutional shareholders had conducted periodic dialogues

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[144] Hampel, Sir Ronnie, Committee on Corporate Governance: Preliminary Report, Gee&Co.Ltd., 1997, London.

[145] NAPF, *Annual Survey of Occupational Pensions*, (NAPF, London 1995).

[146] NAPF/ABI, *Responsible Voting – A Joint ABI-NAPF Statement*, (ABI/NAPF, London 1999)

[147] ISC, *A Statement of Principle on the Responsibilities of Institutional Shareholder and Agents*, 2, available at www.institutionalshareholderscommittee.org.uk/library.html, accessed August 2009.

[148] OECD, *OECD Principles of Corporate Governance* (OECD, Paris 2004) Part One, II C.

with company management in most large UK listed companies,[149] '[on] most occasions where the financial institution could vote, the ability to use the voting proxies [was] not exercised'.[150] The trend of low voting levels continued until the 1990s where only a average of 20% of shares were cast at AGMs of about 50 of FTSE 100 companies.[151]

However, impelled by regulatory demands, empirical evidence presented in Chapter 5.3.1 shows the general voting levels have been steadily increasing in recent years to the current 60%. Moreover, it is now extremely rare for institutional shareholders to have a *policy* of not voting. Most of them, even if not having a policy of voting on all occasions, will exercise voting on contentious issues.

A warning should be sounded. While normative obligations to vote have become common, they involve a risk of 'tick-box' approach, which the Government is unwilling to allow to happen. It is always easier to list things someone must do if those things can be easily 'ticked off' like a shopping list.

5.3.2.2 Step 2: A Cost-benefit Analysis

5.3.2.2.1 Benefits

The votes are binding and corporate management has to follow the decisions passed at shareholders' meeting. Institutional shareholders will receive benefits which are reflected (1) on the share of total gains and (2) the personal in process benefits as mentioned above.

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[149] Lord Carr, 'The Function of Ownership and the Role of institutional Shareholders', cited in K Midgley, *Management Accountability and Corporate Governance: Selected Readings* (Macmillan, London 1982)

[150] R Minns, *Pension Funds and British Capitalism: the Ownership and Control of Shareholdings* (Heinemann, London 1980) 105.

[151] ISC, Report on Investigation of Use of Voting Rights by Institutions (1993) para.4.1.

5.3.2.2.2 Costs

5.3.2.2.2.1 Direct Costs

Direct costs of voting could be (1) costs of acquiring information; (2) costs of processing that information (deciding how to vote); (3) costs of casting the vote.

As to the costs *(1)* of obtaining information, I have discussed in Chapter 4.2.2.1.1 that CA 2006 brought new rules to empower indirect investors by enhancing their information rights. Institutional investors are able to receive information regarding the matters to be addressed in shareholders' meetings directly from the company. The costs *(2)* of processing information are determined by individual shareholders as the ability to evaluate information varies between institutions. However, such costs will gradually reduce when an institution is familiar with the way of dealing with corporate governance issues. Where institutional investors have established specialized teams in corporate governance or appoint proxy voting services, they will evaluate the merits of proposed resolutions more quickly and efficiently.

Recent introduction of electronic voting has significantly reduced the direct costs *(3)* of casting shareholders' votes. The CA 2006 allows companies to use electronic means to communicate with shareholders as the default position, for example, companies can publish information on website and shareholders are allowed to vote their shares electronically.[152]

In addition, the CA 2006 widens the rights of proxies so that institutional shareholders acting as proxies to the registered owners can exercise all the shareholders rights which would otherwise rest in the registered owners alone.[153] It expands the rights conferred on proxies by CA 1985 by removing the rule that proxies are not allowed to vote on a show of hands. It further enhances proxy' rights by allowing a proxy of a

[152] CA 2006 s 333.

[153] CA 2006 s 324.

shareholder to speak at the meetings.[154] Moreover, shareholders are allowed to appoint more than one proxy if each proxy exercises rights over different shares.[155]

5.3.2.2.2 Indirect Costs

5.3.2.2.2.1 Conflicts of Interest

Indirect costs incurred as a result of conflicts of interest could be considerable higher when institutional investors vote against corporate management, for this behaviour is publicly visible. John Bogle, the founder and former head of Vanguard in the US, suggested that merely voting against management could 'jeopardize the retention of clients of 401(k) and pension account.'[156] Fund managers who vote against managers are likely to be vulnerable to retaliation which results in lost corporate business, or a failure to attract new business. Considering these losses, unsurprisingly, some institutional investors, such as HSBC, consider public confrontation between shareholders and management as a sign of failure in the governance process.[157] They prefer other less conflict-prone approaches, such as private meetings, as engagement strategies to solve their concerns over corporate management.

It is worth noting here that conflicts of interest can be mitigated to some extent if institutional shareholders delegate proxy voting agencies to make decision for them and this issue has already been discussed.

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[154] Ibid.

[155] Ibid.

[156] W Baue, 'Biting the Hand That Feeds: Mutual Fund Ties to Corporate Clients Can Affect Proxy Voting ' Social Funds <http://www.socialfunds.com/news/article.cgi/article1659.html>1 November 2009.

[157] HSBC, 'Engaging on Sustainability Issues: HSBC's Approach' <http://www.hsbc.com/1/PA_1_1_S5/content/assets/csr/080305_hsbc_investments_engagement_guidelines.pdf > accessed 23 August 2009.

5.3.2.2.2.2 Securities Lending

The second source of indirect costs stems from the practice of securities lending.[158] As mentioned in Chapter 3, when shares are lent the right to vote those shares passes from the lender to the borrower.[159] This fact, in two different ways, leads to a disjunction between the economic ownership of, and the exercise of voting rights within, a corporation. First, economic owners of the securities on loan are unable to exercise the votes attached to the shares, resulting in the problem of 'lost votes', and secondly, shares may be borrowed for the purpose of voting and be cast in a way that would not be in the economic interests of the company's true owners.

5.3.2.2.2.2.1 Loss of Votes

First, the effect of share lending is, *prima facie* at least, to deprive some owners of the company of their votes.[160] This might occur for two reasons. The first is less obvious. Where the borrower transfers to the lender shares the borrower already owns, as security for the shares it is borrowing, the borrower loses the voting rights attached to those shares. The second reason is more straightforward, and has been emphasised in the work of Myners.[161] The lender will lose the right to exercise the votes on shares so long as they are subject to a loan to the borrower.

This seems obvious, but it is worth pausing to note that if the shares are sold on by the borrower, the new owner may choose to exercise those votes, resulting in no overall loss of governance rights within the company. And whilst it may be undesirable for share borrowers to exercise voting rights attaching to the shares they have borrowed,

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[158] The practice of securities lending has been introduced in Chapter 3.6.

[159] Spitalfields Advisors, *An Introduction to Securities Lending* (Third edn Spitalfields Advisors limited, London 2006) 5.

[160] For example, see Trade Union Congress (TUC), *Trading Places: Changes in the Share-ownership of UK Companies* (TUC, London 2005). It is worth noting here that securities lending might lead to a 'over voting' problem – both beneficial and registered owners vote the same shares. For further, see F Partnoy, 'Corporate Voting Culture Has a Malignant Side' *Financial Times* (11 May 2006).

[161] P Myners, *Review of the Impediments to Voting UK Shares* (2004) London: Shareholder Voting Working Group, 20.

the same point does not of course apply to those to whom they sell those shares, who become 'true' economic owners.[162]

Lenders and borrowers can recall these securities by the pre-determined time if they wish to exercise their rights. However, recalling all shares for voting is a rare practice, likely only made when owners have strong incentives for shareholder engagement, or resolutions are continuous, such as a takeover bid. If all shares are recalled for voting it would affect market liquidity in a share.[163] Meanwhile, both borrowers and lenders have additional considerations for not recalling shares, even part of them, for voting. Lenders may choose not to recall securities for voting in that frequent recall might make them become less desirable lenders. In the event of recall, borrowers are forced to find alternative lenders and may be less likely to choose the lender to borrower securities in the future as a result of the inconveniences caused by the recall of securities. Besides, borrowers also have incentives to avoid recalls wherever possible in that frequent recalls may discourage borrowers from accessing portfolios.[164] Since recalling securities for voting might impose costs for little profit, some lenders and borrowers may give up their governance rights within the company resulting in 'lost votes'.

Moreover, exercising of voting rights in a considered way is not an obligation under the commonly used Global Master Securities Lending Agreement (GMSLA). It states that 'neither borrower nor lenders have any obligation to exercise voting rights in line with instructions of the other party, unless agreed between parties.'[165] Thus, even if there are instructions concerning the way of casting votes, the lenders, for example, will not always insist on borrowers following their voting guidelines. The GMSLA also does not provide sufficient incentives for borrowers to vote.

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[162] A similar point would apply where shares are being borrowed by market makers in order to fulfil buy orders.

[163] P Myners, *Review of the Impediments to Voting UK Shares* (2004) (n 161).

[164] Spitalfields Advisors (n159) 6.

[165] International Stock Lending Association, *Global Master Securities Lending Agreement*, Point 4.2, <http://www.isla.co.uk/uploadedFiles/Gmsla%202000%20version.pdf> accessed 23 August 2009.

Myners concluded that securities lending is one of the factors influencing voting level in the UK.[166] In a survey conducted by Institutional Shareholder Services concerning securities lending and corporate governance in 2007, among 355 respondents surveyed, the majority were US fund management companies, whilst 9.65% were from the UK. 65% lent securities, but nearly half of respondents (49.3%) indicated that their formal policy on securities lending was not part of their proxy voting policy.[167] Most institutions (58.9%) did not have standing instructions in place with their custodians to recall shares for proxy voting purposes.

Another survey conducted by the NAPF in 2007 found that 75% of funds surveyed lend stock. Only 45% of them said they recall stocks for contentious voting resolutions and 5% for all resolutions.[168] Half of them did not vote stocks on loan. A higher recall rate was observed in the IMA's survey. However, there are still firms that did not recall stock to exercise voting rights.[169]

To ensure active shareholder monitoring, codes of good practice issued by various bodies have promoted institutional shareholders to consider their corporate governance responsibilities in investee companies. For example, in July 2005, the International Securities Lending Association (ISLA)[170] issued a publication, *Securities Lending and Corporate Governance*, exploring how securities lending and good corporate governance can be aligned so as to minimise conflict. It suggests that all stakeholders should be informed of all necessary information about securities lending. Meanwhile, given the large increase of lending activity around the dividend

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[166] P Myners, *Review of the Impediments to Voting UK Shares* (2005) (n 123) 4.

[167] Institutional shareholder Services, 'ISS Share Lending Flash Survey Result' http://www.riskmetrics.com/system/files/private/Share_Lending_Flash_Survey_Results031207.pdf accessed 4 May 2008.

[168] NAPF 2007 Survey (n 99) 21.

[169] IMA, *Asset Management in the UK*, (IMA London 2007), 26.

[170] An independent trade association established in 1989 to represent the common interests of participants in the securities lending industry. It works closely with European regulators and in the United Kingdom has representation on the Securities Lending and Repo Committee, a committee of market practitioners chaired by the Bank of England.

record date, it recommends that record date should be separated from the shareholder meeting.[171] Moreover, the *Stock Borrowing and Lending Code of Guidance* which issued by the Stock Lending and Repo and Committee[172] also suggests parties should be aware of each others' attitude towards voting from the outset of securities lending.[173]

5.3.2.2.2.2.1 Borrowing Shares for the Voting Purpose

On the other hand, as observed by Hu and Black, the growth in the securities lending practice has led to the so-called 'empty voting' problem, where a shareholder's voting strength is greater than his economic ownership.[174] By means of securities lending, borrowers can get securities shortly before the record date (for a shareholders' meeting) and then return them afterward. If the borrower exercises the votes attached to the shares, then this can give rise to significant potential conflicts of interest. A borrower of shares might exercise their votes in a way that would be in their own interests, but harmful to the economic interests of the company's true owners. To take one example, a speculator who has shorted a share has an interest in driving down its value. If that speculator were to borrow other shares, it would then have an interest in using the votes on those shares to take decisions harmful to the company, with a view to depressing the share price.

So how much securities lending has occurred for voting purposes? Given much information is undisclosed, the extent is unclear. But according to Spitalfields, the

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[171] Spitalfields (n 159) 10.

[172] A UK-based committee consisting of market practioners, members of bodies such as CREST, the United Kingdom Debt Management Office, the Inland Revenue, the London Clearing House, the London Stock Exchange and the FSA.

[173] Stock Borrowing and Lending Code of Guidance, para 7.3.

[174] H T C Hu and B Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 156 University of Pennsylvania Law Review 625, 629. For further discussion of this issue, see generally, H T C Hu and B S Black, 'Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership ' (2007) 13 Journal of Corporate Finance 343.

normal levels of borrowing would seem to be in the 2% or 3% range, with extraordinary peaks to 5% or 6% coinciding with dividend dates.[175] The dividend date often corresponds with the record date of general meeting, and thus, the increasing of securities lending transactions in the period near dividend dates would at least indicate securities lending might be used for the purpose of voting. However, it is worth noting here that shares might also be borrowed for tax advantages.[176]

There are two examples of this practice within the UK. At British Land's 2002 AGM, Laxey Partners tabled a motion to unseat the board, and voted their 9% shares. It failed to vote down the resolution but, more importantly, it transpired that Laxey had raised its holding from 2.9% to 9% by borrowing securities over three days before the record date.[177] In the same year, some shareholders of P&O Princess favoured the bid of Carnival, borrowed securities and voted at an extraordinary meeting to approve the merge with Carnival.[178]

Borrowing shares for the purpose of voting to influence the outcome of shareholder meetings is not illegal. However, such practice is not recommended by industry good practice guidance. For example, Myners suggested that 'borrowing shares for the purpose of acquiring the vote is inappropriate, as it gives a proportion of the vote to the borrower which has no relation to their economic stake in the company.'[179] The *Stock Borrowing and Lending Code of Guidance* states that 'securities should not be borrowed solely for the purpose of exercising the voting rights'.[180]

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[175] Spitalfields (n 159) 44.

[176] A fuller discussion was provided in Chapter 3.6

[177] S Marks, 'British Land Slams Shareholder Laxey' (16 July 2002) *Evening Standard*.

[178] It was cited in H T C Hu and B S Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership ' (2006) 79 Southern California Law Review 811, 849.

[179] P Myners, *Review of the Impediments to Voting UK Shares* (2004). London: Shareholder Voting Working Group, 20.

[180] Securities Lending and Repo Committee, *Stock Borrowing and Lending Code of Guidance*, C Para 7.3, < www.bankofengland.co.uk/markets/gilts/stockborrowing.pdf > accessed 14 December 2009.

Moreover, in its *Securities Lending Code of Best Practice*, the International Corporate Governance Network (ICGN) has urged regulators to consider requiring disclosure of positions for blocks of shares even if the position comprised largely or entirely of borrowed securities.[181]

We now turn to consider a number of procedural *constraints* that make voting a more costly activity. These are: short notice, share register and record date.

5.3.2.2.2.3 The Problem of Short Notice

Before the convening of a shareholders meeting, companies are required to send notice of the meeting to shareholders in advance of certain time, so as to give shareholders time to consider how to exercise their votes.[182] Most investors under the IIRF survey rate the adequacy of notice as the most important issue in the decision on whether to vote.[183]

However, in practice, institutional shareholders are often left very little time to make voting decisions, as information passed through multiple participants is time-consuming. In some cases, delay in process may lead to fund managers being unaware of a proposed resolution. The IIRF survey confirmed this problem. Nearly all respondents claimed insufficient time to register their votes before the deadline and lost their changes to participate in corporate decisions.[184]

Past years have seen a rapid increase in utilization of electronic voting. It speeds up the information transformation among multiple participants and saves much time

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[181] ICGN, *Securities Lending Code of Best Practice*, (ICGN London 2007) Appendix I.

[182] CA s 307 provides that trade companies are required to call all general meetings on at least 21 days' notice, unless three conditions are satisfied, in which cases it can be held at 14 days. Exceptions are found in CA 2006, s 307A (2) (3) (4). The first condition is that the general meeting is not an annual meeting. The second condition is that the company offers the electronic voting means for all members and the third condition is that a special resolution has been passed reducing the period of notice to 14 days at previous AGM.

[183] IIRF (n 91).

[184] Ibid.

which would be consumed in manual way. To some extent, it mitigates substantially much of this concern on insufficient notice time. However, since there is large number of participants in the voting process, the process would still be slow if electronic voting means is not available in one of the links. Any delay of two or three days may in some cases be crucial. Moreover, there is a lack of evidence about the exact speed of the electronic system. In other words, there is no evidence indicating electronic system can *entirely* solve the problem of insufficient notice time. It is necessary, therefore, for regulators to find out the time taken for the voting process, and if the current notice time is insufficient, they should consider extending it.

5.3.2.2.2.4 Share Register

The problem of 'lost votes', which was noted above, is largely the product of procedural difficulties.[185] The UK voting process for institutional shareholders is characterised by complexity and multiplicity of participants. Any weakness in the voting process may in some cases be crucial. The subsections are concerned with two practical issues involved in the exercise of voting rights by institutional shareholders: register account system and record date.

As mentioned, shares are often registered under the name of a custodian's nominee company.[186] In practice, the way in which shares are registered varies. Majority of holdings of shares are registered in the name of one Nominee Company, without indicating the client's own name, for example, ABC Nominee Ltd. This is known as 'omnibus account system'.[187] The fact that shares are often registered in an omnibus account creates a potential for votes to be lost, because the issuers are unable to identify whose votes have been cast when the number of shares actually voted is not the same as the number of voting entitlements. A simple example helps to illustrate

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[185] See chapter 5.3.1.8.

[186] See chapter 5.3.1.1. Also see P Davies and J Rickford, 'An Introduction to the New UK Companies Act: Part 1' (2008) 1 European Company and Financial Law Review 48, 243.

[187] P Myners, *Review of the Impediments to Voting UK Shares* (2004) (n 161) 14.

this point. If the shares of 500 different clients are registered under 'ABC Nominees Limited', the issuer may not be aware of the identity of those 500 underlying beneficial owners. When the issuer finds it has received more voting instructions than the number of entitlements, it cannot determine who has voted and who has not since it can only identify the name of ABC Nominee Limited from the registry system.

Myners addressed the potential difficulty in voting posed by omnibus account system.[188] He proposed that institutional shareholders should consider using a designation account system instead of omnibus account system. Under this system, fund managers register the equity investment in a designated name relating to a specific investor, for example, ABC Nominees Limited-X pension fund, rather than in the name of one Nominee Company. In terms of voting, the benefit of this system is evident. It provides a clear identification of share owners which facilitates issuers to determine whose votes have been lost or not voted. However, Myners recognized that a move from an omnibus to a designation system is not straightforward.[189] The omnibus account system has been widely used because it delivers multiples benefits to market participants. It helps reduce costs and administration. Moreover, the number of shares owned by clients may be considered confidential and the use of the omnibus account system can respect this concern. Thus, while the change of omnibus account system to a designation system would promote good governance practice, it might conflict with market practices. A designation system is costly and provides no client confidentiality. Accordingly, Myners did not recommend a whole move from omnibus account to designation system. He suggested, I would argue correctly, that fund managers should give consideration to registering shares under a designation system when appropriate.[190]

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[188] Ibid, 14-15.

[189] Ibid.

[190] Ibid.

Finally, it is worth noting that in his later report, Myners found that main custodian now appear to use designation accounts in registering clients' shares.[191]

5.3.2.2.2.5 Record Date

The record date is defined as the date on which a member must be registered as a member in order to be entitled to vote. In the UK, in accordance with the Uncertificated Securities Regulations, the record date cannot be fixed for a date more than 2 days before the date of the meeting.[192] It is argued that the current record date is insufficient.[193]

Due to the time taken to pass information, voting decisions have to be submitted earlier than voting entitlement is set. In other words, the votes have to be cast before determining which persons are entitled to vote. At that time, those submitting voting instructions might be unclear as to the number of shares that are entitled to vote when they hand in their voting decisions. This can lead to discrepancies arising between the number of voting instructions and the number of voting entitlements. As a result, votes are lost.

The proposal for an extended record date were rejected by Myners, who only supported that weekends and bank holidays should be excluded in 48 hours length.[194] Despite the evident advantage in terms of clear identification of voting entitlements before votes being cast, Myners was concerned with the potential risks involved in a longer time framework. If given a longer period, there is a greater risk that a shareholder can vote his shares under the entitlement at the record date, but then transfers his shares and has no economic interest in the company.

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[191] P Myners, *Review of the Impediments to Voting UK Shares* (2007) London: Shareholder Voting Working Group, 5.

[192] Uncertificated Securities Regulations 2001 (SI/3755) s 41 (1) and (2).

[193] P Myners *Review of the Impediments to Voting UK Shares* (2004) (n 161) 17.

[194] Ibid, 18.

However, it is interesting that international practice on record date tends to have a longer time frame than the UK counterpart. Some countries, such as Australia, France, Germany, do not set a record date for voting. Some countries, such as Japan and US, have a considerably longer date than the UK - around 90 days in Japan and 35 days in the US.[195] These regulations are, presumably carefully arrived at, and it should be asked in the UK why a longer record date works in these other countries.

It is worth noting that CA 2006 excludes weekends or bank holidays when calculating the 48 hours time limit for the receipt of voting instruction.[196] However, no similar amendment has been made to the Uncertificated Securities Regulations for setting voting entitlements. To ensure the certainty and consistency of regulations, those Regulations should be amended in accordance with relevant requirements as the CA 2006.

In conclusion, there are a number of legal barriers that discourage shareholders from voting or make voting a difficult process. It is necessary for regulators to remove those regulatory obstacles so as to assist monitoring by those institutions that do have incentive to take action and encourage those who have not engaged to vote.

5.3.2.2.2.6 Further Reform: Mandatory Voting or Mandatory Voting Disclosure?

The issue of whether legislation shall impose a requirement to *vote*, or at least to *disclose* voting behaviours, in exercise of the Government's power under CA 2006, has been hotly debated in the UK.[197] The following part will examine these proposals carefully and explore whether they will bring desirable changes.

5.3.2.2.2.6.1 Is Mandatory Voting a Worthwhile Reform in the UK?

[195] Ibid, 17.

[196] CA 2006 s 330.

[197] CA 2006 ss 1277 to 1280.

In the UK, while it is the duty of a trustee 'to conduct the business of the trust in the same manner as an ordinary prudent man of business would conduct his own',[198] voting is not mandatory for fund managers. The advocates of mandatory voting take the view that voting is an asset which should be exercised on all issues on behalf of beneficiaries and thus voting should be made compulsory.[199]

I would argue, however, that the benefits from such proposal are unwarranted. To *begin*, while a mandatory voting obligation seems easy to satisfy, it is practically difficult to require institutional shareholders to vote in an *informed* manner.[200] We have seen that in the UK, due to the fund arrangement structure, the voting rights are more likely to be exercised by an agent rather than by funds themselves.[201] These agents or external fund managers vote on company resolutions based on voting policies provided by institutions. Given the diversity of company resolutions, voting policies issued by institutions are generally broadly stated, instead of detail instructions on every company or specific resolution. If voting were made compulsory, institutions have to issue very detailed voting policy statements taking into account every issue under different circumstances in their numerous investee companies. Or if voting policies were not made in detail, to justify their voting, external fund managers have to frequently consult funds on voting issues.

However, voting is a time-consuming process for institutions especially on company issues that are contentious or of major significance. Instead of fulfilling the obligation of mandatory voting through the above two approaches, it is likely that some institutions might simply 'box-tick' voting options without careful consideration. In such cases, a high voting level would not bring the expected benefit for improving the overall standard of corporate governance. Myners argued against mandatory voting

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[198] Speight v. Gaunt (1883) 22 Ch.D 727, 739-40.

[199] R Monks and A Sykes, 'Overcoming Mounting Anglo-American Shareholder Concerns' <http://www.ragm.com/hottopics/2002/ragm_sykes.pdf> accessed 19 February 2009.

[200] H Short and K Keasey, 'Institutional Voting in the UK: Is Mandatory Voting the Answer?' (1997) 5 Corporate Governance: An International Review 37, 43.

[201] See Chapter 3.2.

grounded on a similar reason, pointing out that such a rule might dilute the influence of voting decisions taken after careful consideration.[202]

One counter-argument to my analysis is that, if voting costs were to rise, then fund managers would likely reduce the number of companies in their portfolio and be more concentrated on long-term investment in the remaining portfolio companies.[203] However, such a benefit will only follow if pension funds are managed by external fund managers. Under such circumstances, external fund managers will consult trustees on voting issues and thereby, voting costs will indeed increase and this might then force fund managers to reduce the number of investee companies. Such positive effect, however, will not take place for all types of institutional shareholders. For wholly insured and internally managed funds, the increased costs from mandatory voting requirements will not be significant because they have a closer relationship between fund trustees and beneficiaries than externally managed funds.[204] Thus, the mandatory voting rule is less likely to produce the desired change in portfolio design. Meanwhile, institutional shareholders adopt different investment strategies to manage assets and some of them need flexibility in their portfolios, such as indexed funds. If they are forced to decrease the number of companies in their portfolio and change their investment strategies, while their long-holding positions could improve corporate governance in their investee companies, it is difficult to evaluate whether negative influence could occur on their management return.

Furthermore, as argued previously, in the UK, the institutional voting level is less of a problem since evidence suggests there is already much institutional voting involvement in UK companies. The average voting level in UK companies' meeting, although it appears not perfect, is not the fault of institutional shareholders. Any proposals for more institutional voting level might not make much sense. Once again,

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[202] Myners (n 161) 23.

[203] See generally, J Charkham. `A Larger Role for Institutional Investors', in N Dimsdale and M Prevezer (eds), *Capital Markets and Corporate Governance* (Clarendon Press, Oxford 1994).

[204] H Short and K Keasey (n 200) 42.

the thesis emphasises, the purpose to promote institutional voting, is having more informed votes rather than merely achieving a high voting level.

Helpfully, there is an analogue for the likely outcome of mandatory rule in the UK. In the US, private pension funds are mandated to vote their shareholdings by the Department of Labor under the Employee Retirement Income Security Act of 1974 (ERISA). It takes the view that 'the fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment' and 'fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock.'[205] It treats voting as an asset and makes clear that the fund managers owe the duty of care to their clients and thus they must consider the possibility of intervening in management when the value of clients may be enhanced by their intervention.

ERISA did indeed seem to significantly increase US voting levels. However, the US experience does not provide UK a terribly positive example. The first difficulty that the US Department of Labour confronts is monitoring. As discussed earlier, a fuller voting process hardly to guarantee that voted are cast in an informed and considered way. In the US, evidence suggests that some fund managers have produced formalized procedures, and window-dressing practices among some investment management are common.[206] Enforcement presents the second difficulty. Beneficial owners have little incentive to bring litigation against their fund managers for not voting. Even if they intended to take action for funds' failing to vote, it would be

[205] Interpretative bulletin relating to statements of investment policy, including proxy voting policy or guidelines, Code of Federal Fegulations Table 29 Chapter XXV, 2509.94-2, 1994.

[206] J Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277, 1353.

'extremely difficult' for them to establish causative link between the failure to vote and the losses suffered in fund management.[207]

Lastly, voting is a shareholder's fundamental right to claim their residual control, however, it is only one possible form of institutional shareholder activism to ensure management accountability. Normally, institutional shareholders are likely to address their concerns privately with management without it being publicized in order to reduce any possible negative impact. If institutional shareholders are forced by legislation to vote, their behaviour in participation in corporate governance is likely to be changed.[208]

For these reasons, it can be concluded that the benefits of mandatory voting would very likely be outweighed by the negative impact and it would not be a worthwhile reform.

5.2.2.2.2.6.2 Mandatory Voting Disclosure

As with the issue of mandatory voting, advocates of mandatory *disclosure* of voting behaviour are also inspired by the US experience. In the US, private pension funds governed by ERISA are also, by Interpretative Bulletin 94-2, since 1994 obliged to disclose information regarding voting activities. Registered management investment companies are also required to disclose their proxy voting policies and procedures, and their actual voting records since 2003 under the Securities and Exchange Commission (SEC)'s rules.[209]

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[207] G Stapledon, 'Exercise of Voting Rights by Institutional Shareholders in the UK' (1995) 3 Coporate Governance: An International Review 144, 150.

[208] C Mallin, 'Trends in Levels of Voting and Voting Disclosure' (2006) 14 Corporate Governance: An International Review 73, 74.

[209] Securities and Exchange Commission Final Rule: Disclosure of proxy voting policies and proxy voting records by registered management companies < http://www.sec.gov/rules/final/33-8188.htm> accessed 12 March 2009.

It has been argued that the UK, which has a similar share ownership structure, should have a similar requirement. As early as 1998, when the DTI[210] started the UK Modern Company Law Review[211], the DTI Minister, Margaret Beckett, announced before a conference sponsored by PIRC that institutional shareholders should vote all their shares and disclose annually their voting policies and records so that they may be held accountable. If they do not, Beckett warned that she would put such a requirement in the Companies Bill.[212] Three years later, a similar opinion was expressed in the Government's White Paper, issued in response to the recommendations of the Company Law Review (2001), at paragraph 2.47, where it states 'the government… believes that, in principle, it would be in the public interest for institutional shareholders to be required to disclose publicly how they have voted in respect of their shareholdings in British quoted companies.'[213]

This proposal was then adopted in the 2005 Company Law Reform Bill. Under the heading of 'information as to exercise of voting rights by institutional investors', clauses 1241 to 1244 refer to institutional investors' voting regulations requiring institutions 'to…provide specified information about the exercise of voting rights attached to shares…'

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[210] It is now renamed as BIS.

[211] Relevant documents regarding Company Law Review can be found at <http://www.bis.gov.uk/> accessed 24 July 2010.

[212] M Beckett, Speech held at the PIRC Annual Conference (March 4 1998) <http://www.ecgi.org/research/control_europe/documents/gpwvol2no10.pdf> accessed 12 March 2009.

[213] Company Law Reform Bill, Part II Modernizing Company Law – the Government's policy, Para 2.47 provides that 'the Government is minded not to pursue this recommendation but believes that, in principle, it would be in the public interest for institutional investors to be required to disclose publicly how they have voted in respect of their shareholdings in British quoted companies. However, as noted above, this is a complex area and there may be practical difficulties in implementing the Review's proposal through companies legislation. The Government is giving detailed consideration to the issues raised by the Review, and will set out its position fully in due course.
<http://webarchive.nationalarchives.gov.uk/tna/+/http://www.dti.gov.uk/companiesbill/part2.pdf/> accessed 12 August 2007, Para 2.47.

The UK was not alone in considering mandatory voting disclosure. The EU also discussed whether institutional shareholders should be subject to such obligation. The European Commission put forward a proposal as a medium-term objective (2006-2008) in its Action Plan '*Modernisation of Company Law and Enhancing Corporate Governance in the European Union – A plan to Move Forward*' in May 2003. It proposed that 'institutional shareholders should be obliged (1) to disclose…their policy with respect to the exercise of voting rights...and (2) to disclose to their beneficial holders at their request how these rights have been used in a particular case.[214] However, this proposal was strongly resisted and has not yet been adopted.[215]

Nor were the UK's proposals eventually adopted by the CA 2006. The Company Law Review stated that 'this is a complex area and there may be practical difficulties in implementing the Review's proposal through company's legislation.'[216] Instead of imposing mandatory rules, the CA 2006 merely grants reserve power to the Secretary of State to decide whether to require public disclosure of institutional shareholders' voting. This reserved power can be called upon if institutional shareholders' voluntary disclosure has not significantly increased. Until now, the Government has not used that reserve power.

The newly-issued Stewardship Code, which is operated on a comply-or-explain approach, requires institutional investors to disclose voting policies and voting records.[217] If institutional investors implement the Code effectively, the thesis

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[214] Commission of European Communities, Modernizing Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward <http://eur-lex.europa.eu/LexUriServ/site/en/com/2003/com2003_0284en01.pdf> accessed 12 March 2009.

[215] See objections summarized in Klaus Ulrich Schmolke, 'Institutional Investors' Mandatory Voting Disclosure-European Plans and U.S. Experience' New York University Law and Economics research paper working paper series No 06-43, 2 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=938116> accessed 10 March 2009.

[216] See (n 213).

[217] Stewardship Code, Principle 1 Guidance and Principle 6 Guidance.

believes that this approach will bring most benefits, at least costs. Nevertheless, it is necessary for the thesis to have an analysis on the potential benefits and costs of adopting a mandatory voting disclosure rules. In examination of these issues, a look at US' experience on adoption of mandatory voting disclosure rules in 2003 will be helpful. The US offers a good comparison: as in the UK, share ownership is relatively dispersed with a high percentage of shares held by institutional investors. Hence, it is not surprising that the concerns raised in respect of the UK mandatory disclosure proposal are similar to those raised with regard to the SEC's disclosure rules.

Proponents of mandatory voting disclosure, such as the TUC,[218] believe that several benefits might flow from mandatory voting disclosure proposal. The *first and primary* benefit is the greater transparency concerning how institutional investors exercise their voting rights. Compulsory voting disclosure provides a chance for beneficiaries to monitor whether managers are acting in their best interests.

It would also increase the accountability of institutional shareholders by reducing the risk of conflicts of interest which fund managers may face when they have a financial interest in portfolio companies.[219] Under such cases, the disclosure requirement may be an appropriate option to enable beneficiaries to ensure fund managers' voting decisions are exercised on the consideration of the interests of beneficiary rather than the interests of fund managers.

Meanwhile, voting disclosure would allow investors to monitor fund managers' performance, based not only on investment returns, but also the managers' voting

[218] In its 2008 annual fund manager voting report, the TUC found a substantial part of institutions still refused to reveal how they voted in company AGMs, and thus, the TUC warns that unless this changes soon, 'the Government must use its reserve power to force fund managers to disclose their voting records in a standard form.' See TUC, 'TUC Fund Manager Voting Survey 2008' <http://labourandcapital.blogspot.com/2008/06/tuc-fund-manager-voting-survey-2008.html> accessed 10 March 2009.

[219] For discussion on conflicts of interests, see Chapter 4.2.2.2.1.

records.[220] Thus, clients are provided with additional valuable information to evaluate a fund's overall performance.

Secondly, a mandatory voting disclosure rule will be potentially value-enhancing for institutional investors' portfolio companies. Fund managers under a strong external monitoring are likely to make better voting decisions to enhance the interests of portfolio companies. In this regard, mandatory disclosure of institutional shareholders' voting behaviour will strengthen the accountability of corporate management, and this in turn, will have a positive impact on the overall shareholder value.

The third potential benefit is the greater level of institutional shareholder engagement in their portfolio companies. Relevant issues have been discussed in Chapter 4 when the thesis considered the benefits arising from the Stewardship Code.[221] A few words are still necessary here. Once voting policies are disclosed, not only funds' own investors, but also other institutional shareholders will be concerned with the voting activism of the funds. Criticisms of free-riding by some passive institutional investors would pose reputational damages to their business. In this sense, the threat of shame would increase the cost of non-voting and make voting a more desirable activity.

However, such a proposal is not uncontested. The major argument put *against* voting disclosure is the potential high costs incurred by this requirement. The Association of Investment Trust Companies, for example, argued that disclosure requirement will burden institutions with high financial expenses.[222] Moreover, disclosure for voting activities is a time-consuming process and if fund managers spent time on disclosing information, they will be distracted from issues that could add clients' real value. Such costs from voting disclosure will be initially born by institutions but will finally

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[220] A Palmiter, 'Mutual Fund Voting of Portfolio Shares: Why Not Disclose?' (2002) 23 Cardozo Law Review 1423, 1477.

[221] See Chapter 4.

[222] Association of Investment Trust Companies, 'AITC against Voting Disclosure' (08 February 2006) <http://www.theaic.co.uk/en/Press-centre/AITC-ASKS-PRIME-MINISTER-TO-INTERVENE-OVER-DISCLOSURE-OF-VOTING-IN-COMPANY-LAW-REFORM-BILL/> accessed 19 March 2008.

pass on to individual investors. To impose additional disclosure costs, without certain value-enhancement on funds performance, will be contrary to the interests of ultimate beneficiary owners.

However, PIRC, a proxy service provider in the UK, argued that the high costs incurred by mandatory disclosure requirement were exaggerated.[223] Under its estimation, voting disclosure would be approximately between £1,000 and £ 1,500 per institutional investor per year. The process only involves data transferring from one system to another.[224] Alan Macdougall, the managing director of PIRC, therefore commented that the cost argument is just a 'red herring' and not sufficient to waive the duty to provide competent information for clients.[225] The Government, although it admitted it is difficult to quantify the benefits brought by mandatory disclosure rule, it provided an example that, 'if better governance led to just 2% of companies increased their rate of return to shareholders by 0.1% per annum, the annual benefit would be roughly £ 30 million p.a'. The costs, on the other hand, are expected to be in the order of £6 to £9 million p.a.'[226] Meanwhile, although the start-up costs for disclosure may be considered large, this cost, as pointed out by the SEC, would reduce over time.[227] Therefore, the argument that mandatory disclosure rule would cause high economic burden to institutions seems unconvincing.

Second, opponents also question whether retail investors are really interested in how votes are exercised because more concerns as to the disclosed voting will be raised by media and other social groups for politicization. In response to the SEC' rule, one fund's counsel, argued that over the last three years, his firm had only received one

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[223] PIRC, 'Proxy Voting Reviews October to December 2006' < http://www.pirc.co.uk/publications> accessed 12 March 2009.

[224] Ibid, 5.

[225] Ibid.

[226] DTI (as renamed as BERR), Transparency of Voting By Institutional Investors, Explanatory Material on Draft Clauses on the Exercise of Voting Rights by Institutional Investors, 4.

[227] SEC (n 209).

voting-related query from a investor and this request was related to the investor's employer.[228]

This consequence is likely to occur because retail investors tend to behave passively in monitoring fund managers' voting activities for two reasons. First, most individual investors, whose focus on funds is to gain low-cost diversity and high investment returns, are rationally less interested in funds' governance activism. Second, as we noted above, there are possibly numerous retail investors in fund arrangement and they are also facing a free-rider problem. Most of them hold a small stake in the fund and each investor hopes other investors act on behalf of every investor. Even if some retail investors have intentions to raise concerns on fund managers' disclosed voting information, they would not take further actions because their private benefits from monitoring might be lower than their costs while other retail investors would obtain the same benefits by the free-riding.

In respect of this concern, the SEC contended, I would argue rightly, that regardless of whether a large number of investors are interested in voting disclosure, it is investors' 'fundamental' right to know how fund managers exercise their voting rights under their fiduciary duty.[229]

There are, however, three issues that cannot be overcome easily in respect of the impact of mandatory voting disclosure. First, it is suggested that such rule will distort institutional shareholders' confidentiality of business strategy and place them in a risk of retaliatory actions by company managers – such as by means of denying access to corporate information. It is not an easy issue that can be overcome. Although SEC suggested that most voting policies disclosed by institutional shareholders are not confidential,[230] it could still happen that in some cases, disclosure of voting activity

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[228] R Teilelbaum, 'Mutual Funds Report for Funds, Disclosure is Hardly in Fashion' (5 January 2003) New York Times.

[229] SEC (n 209).

[230] SEC (n 209).

will undermine institutional investors' confidential investment strategy. Therefore, the thesis considers the 'comply-or explain' approach adopted by the Stewardship Code as an appropriate way since it ensures a certain level of flexibility.

The second relevant concern is that once voting records are disclosed, some non-shareholder interest groups, will 'politicize' the voting behaviours of fund managers based on considerations such as social and culture factors, rather than maximization of shareholder value. They would engage in publicity campaigns against institutional shareholders' voting records, which will divert a fund from management of its portfolio. A member from a UK insurance society admitted that after its proxy voting records had been disclosed, most queries came from media groups rather than the general public.[231] In the adoption of mandatory voting disclosure rules, the SEC has not given a clear evaluation on this issue in adopting the mandatory rule but left it to ongoing monitoring. Therefore, in this regard, the US experience cannot provide much valuable information about how UK can overcome this problem.

Thirdly, the empirical study examining the impact of US mandatory voting disclosure would not instil confidence into proponents of such rule in the UK. There is some empirical evidence suggest that the voting disclosure regulation makes no significant difference on funds' behaviours to corporate governance before and after the rule change. For example, mutual funds' support for management proposal did not decline after the imposition of mandatory voting disclosure rule.[232] Such a requirement therfore seems hard to achieve substantial change that governments expected.

Taking the above arguments together, imposing a mandatory voting disclosure will potentially achieve greater transparency than will voluntary disclosure and market

[231] PIRC (n 223) 5.

[232] M Cremers and R Romano, 'Institutional Investors and Proxy Voting: The Impact of the 2003 Mutual Fund Voting Disclosure Regulation Yale ICF Working Paper No. 07-10 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982493>12 March 2008.

forces, while it will result in unavoidable drawbacks. It is therefore perhaps not a most desirable method to promote responsible shareholder voting practice. On the one hand, the Government should ensure a certain level of flexibility, allowing institutional investors not to disclose when it is not in their interests. On the other hand, given the massive benefits of voting disclosure, the Government should encourage institutions to make every effort to inform the public about the exercise of their voting rights. Since voting disclosure has been regarded as a good practice in the Stewardship Code, the key to fulfil the above aims is the effective implementation of the Stewardship Code. The effect remains to be seen in the future.

5.4 Submitting Proposals

Submitting shareholders' resolutions (or shareholders' proposals) is the third type of activism which provides institutional shareholders with an opportunity to communicate with both corporate management and other shareholders.

The most distinct advantage of submitting proposals, compared with other types of shareholder activism, is that it allows shareholders to '*set the agenda*' – to raise their own points of concern at shareholders' meetings. It gives shareholders the ability to vote for the issues they want and not merely negatively against the executive agenda.

However, in the UK, it is not a popular type of shareholder activism in practice. Due to information limit, the discussion below will be short, compared with that of private meetings and proxy voting.

5.4.1 Empirical Evidence

There seems to have been four major studies of shareholder proposals in UK listed companies. The earliest study is that of Stapledon. He found out that almost all resolutions proposed at AGMs and EGMs were board-or management-initiated, rather

than shareholder-initiated.[233] Shareholder proposals only occur very rarely in listed companies.[234]

The second study involved a survey by PIRC of shareholder proposals at FTSE 350 companies in the late 1990s and early 2000s. It found that there were only three filed at FTSE 350 companies in 1998, and just 13 companies have been the recipient of such resolutions since 1995.[235] Further research on shareholder resolutions conducted by PIRC in 2002 showed that the situation had not improved very much. By observation of 523 general meetings from January to September 2002, PIRC found that there were only a handful of shareholder resolutions out of over 6000 resolutions discussed.[236]

The third study, which was conducted by Manifest, covered the shareholders' meetings at FTSE 250 and FTSE 100 companies in 2007.[237] They found that shareholder proposals represent only a small percentage of the total number of proposals dealt with by shareholder meetings in the UK and Europe. A total number of 5 shareholder resolutions were proposed in FTSE 250 in 2007, accounting for only 0.2% of all resolutions in the meetings. There were also only 5 shareholders proposals submitted in FTSE 100, representing 0.4% of all resolution in the meeting.

The fourth study was conducted by the TUC in its Fund Manager Voting Survey 2009. It reported that only 5 out of 59 proposals were filed by shareholders in 33 listed companies in which institutions surveyed invested.[238] The first four were filed by two institutional investors at Northern Rock, which sought to restrict management's freedom to undertake certain actions. The funds won the popular vote, however, as three proposals required 75% approval, only the move to prevent the board issuing

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[233] Stapledon, *Institutional Shareholders and Corporate Governance* (n 29) 85.

[234] Ibid.

[235] PIRC, 'Making Votes Count: PIRC Proposes Proxy Reform' (1999) PIRC Intelligence .

[236] PIRC, *Modernising Company Law: PIRC's Response to the White Paper* (PIRC, London 2002).

[237] Manifest (n 117).

[238] TUC (n 118).

new shares without shareholder approval was passed.[239] The final one was filed by TV chef Huge Fearnely-Whittingstall at Tesco, and sought to encourage Tesco to sign up to the RSPCA's 'Five Freedoms' in respect of the welfare of chickens sold in Tesco. This resolution gained just under 10% of votes at the Tesco's AGM in 2008.

5.4.2 Applying the Model to Submitting Proposals

Although these studies conclude that filing resolutions is rare in the UK, unfortunately, none has probed the reasons for this fact. One possible explanation is that the current threshold for submitting proposals imposed by UK law, requiring at least 5% or 100 shareholders as co-filers, is high for many institutional shareholders.[240] To satisfy these requirements, institutions have to incur much cost and devote time such as to get co-operation from other shareholders. As a result of these statutory hurdles, if institutional shareholders are dissatisfied with corporate management, they may seek other forms of activities, such as private meetings, or voting, which are much less restricted, instead of filing proposals. Therefore, submitting proposal is a less economic approach.

In addition, the uncertainty whether shareholders' proposals can be adopted increases the risk of this type of activism for any potential activist. As the above TUC's survey suggested, all five shareholder resolutions were defeated, with one achieving a vote in favour of just under 10% at the company's AGM.[241]

5.5 Derivative Action

Derivative actions are usually considered an action of last resort. Staplendon found that the vast majority of 17 UK institution he interviewed had never taken, or

[239] Ibid.

[240] CA 2006 s 338.

[241] Ibid.

'seriously considered taking', derivative action against corporate managers for breach of duties.[242]

5.5.1 Empirical Data

Currently, derivative actions are rarely pursued by institutional shareholders. Until now, there would appear to be only one case in which an institutional investor sought to bring a derivative suit against directors: *Prudential Assurance v Newman Industries (No.2)* [1982][243].

There are eight cases where minority shareholders brought derivative claims based on the provisions in CA 2006.[244] However, none of the claimants were institutional investors.

5.5.2 Applying the Model to Derivative Action

5.5.2.1 Step 1: Overcoming Free-riding

Since there is no requirement for any particular percentage of shareholding or any particular number of shares that the claimant has to hold to bring a derivative action, the factors to overcome free-riding – the decisiveness of individual and the possible of concerted action – do not apply here. 'In-process' benefits will be discussed later. And there is generally no regulatory encouragement for more derivative actions and thus the factor of normative obligation does not work here.

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[242] Stapledon, *Institutional Shareholders and Corporate Governance* (n 29) 131.

[243] *Prudential Assurance v Newman Industries (No.2)* [1982] 1 All ER 354.

[244] *Mission Capital Plc v Sinclair* [2008] BCC 866; *Fanmailuk.com Ltd v Cooper* [2008] B.C.C. 877. *Franbar Holdings v Patel* [2008] BCC 885; *Stimpson v Southern Private Landlords Association* [2010] BCC 387; *Iesini v Westrip Holdings Ltd* [2010] BCC 420; *Wishart v Castlecroft Securities Ltd* [2010] B.C.C. 161. *Stainer v Lee* [2010] EWHC 1539; *Kiani v Cooper* [2010] BCC 463.

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5.5.2.2 Step 2: A Cost-benefit Analysis

5.5.2.2.1 Benefits

5.5.2.2.1.1 Direct Benefits

We should bear in mind that a derivative action is taken to enforce the directors' duties on behalf of the company. Accordingly, if successful, it is the company that benefits from any compensation, including both recovery in the sense of financial compensation and the return of the company's property, not the derivative claimant. Any benefit for the derivative action is based on the *portion of shares he owns* in the company: if the derivative claimant owns 3% of the company then the benefit of his shares increases by an amount of 3% of the award of compensation.[245]

5.5.2.2.1.2 Indirect Benefits

Derivative action can generate some unique benefit from the process itself. Cox, Coffee and other scholars suggest liability rules, such as the threats of financial penalties, loss of reputational capital and 'social stigma' enforced by a successful derivative action can provide some level of *deterrence* against potential abuses by management, not only officers of the subject company but also other companies.[246] Even if the recovery benefits to the company in whose name the claim is brought do not outweigh the company's litigation costs, its shareholders still may benefit. It is because, firstly, such action deters other officers of the company from abusing their authority, and secondly, institutional shareholders are likely to have diversified holdings in other companies and they will benefit if a derivative action deters

[245] S Bhagat and R Romano, 'Event Studies and the Law: Empirical Studies of Corporate Law ' (2002) 4 American Law and Economics Review 380, 407.

[246] D Cox, 'Compensation, Deterrence and the Market as Boundaries for Derivative Suits' (1983) 52 George Washington Law Review 745, 764; J C Coffee, 'New Myths and Old Realities: The American Law Institute Faces the Derivative Action' (1993) 48 Business Lawyer 1407, 1428; A Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press, New York 2007) 51.

potential defendants who are situated similarity at other companies.[247] Therefore, shareholders as a class in general will benefit in the form of increased deterrence of managerial misconduct.[248] It is worth emphasizing here such deterrence will affect both ex ante expectations of wrongdoers as well as ex post liability for the total damages they incurred.[249]

However, it can be argued that this knock-on effect on other companies seems hard to be achieved in the UK. One factor (probably the most important factor), when the courts consider whether to grant permission to continue that action, is to ask whether a hypothetical director acting in the best interests of the company, would pursue this action. When the courts apply that test, however, the court will not take into account the fact that even though it wouldn't benefit this company much, it would send a clear signal to other companies in which this shareholder owns shares. The permission is unlikely to be given based on its wider educating effect.[250] And it is another reason why DAs are unlikely to go ahead in the UK.

5.5.2.2.2 Costs

5.5.2.2.2.1 Direct Costs

A practical hurdle that an institutional shareholder confronts, and one which acts as an overwhelming financial disincentive to taking any legal action against company director for breach of their duties, is the cost of bring derivative suit.[251]

Derivative claimants will be saddled with significant legal costs if they lose the case. Unlike the US where a contingency fees arrangement is applied, typically in the UK,

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[247] Cox, Ibid, 764; Coffee, Ibid, 1428.

[248] J C Coffee, 'Understanding the Plaintiff's Attorney: the Implications of Economic Theory for Private Enforcement of Law through class and Derivative Actions' (1986) 86 Columbia Law Review 669, 673.

[249] Reisberg (n 246) 51.

[250] Reisberg (n 246) 59-70.

[251] Dignam and Lowry (n 16) 197.

the losing litigant may have to pay not only his own legal costs, but the defendant's as well.[252] If the 'loser pay' principle applied to a derivative claimant, it will become an enormous deterrent to litigation.[253] However, the court may order the company to *indemnify* the claimant for his costs provided he acted reasonably in bringing the action. This is established in Wallersteiner v Moir (No 2) (1975) and is often known as a *Wallersteiner* order. The rule was codified in Civil Procedure Rule 19.9 E.[254]

The question of relevance is when the court will grant the derivative claimant a costs indemnification. Buckley LJ in Wallersteiner v Moir[255] made the point that the indemnification order is available only where an independent board-acting with the care that would be taken by an ordinary man in the exercise of his own affairs-would have brought the litigation.[256] Under the new derivative claim mechanism, Kershaw observes that the Buckley LJ's test is similar to the 'a person acting to promote the success of the company' criterion for granting permission to continue the action itself.[257] In most cases, then, an indemnification order will follow automatically if permission to continue the litigation is granted.[258]

Even the action is successful, it is a lengthy process. The potential time involved in a derivative action increases the riskiness of this type of litigation for any potential plaintiff. It is likely to take many months to reach a conclusion even if permission to proceed is granted by the court.

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[252] *Wallersteiner v Moir* (No. 2) [1975] Q.B. 373. For a detailed discussion on the US contingency fees and UK litigation fees arrangement see, Reisberg (n 246) 222-43.

[253] See further A Reisberg, 'Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation' (2004) Journal of Corporate Law Studies 345.

[254] Civil Procedure (Amendment) Rule 2007, SI2007/2204 (L20).

[255] Wallersteiner v Moir [1974] 1 WLR 991.

[256] It was cited in D Kershaw, *Company Law in Context* (Oxford University Press, Oxford 2009) 573. He noted that this approach was followed in Smith v Croft [1986] 1 WLR 580.

[257] Ibid.

[258] Ibid, 575.

Taken together, institutional shareholders clearly do not have incentives to incur the costs and inconvenience of derivative action which would tie up there fund managers time and result in costs that cannot be passed on to beneficiaries.

5.5.2.2.2.2 Indirect Costs

5.5.2.2.2.2.1 Conflicts of Interest

An institutional shareholder who brings a derivative suit has to suffer losses resulted from starkly institutional conflicts of interests. While other types of activism, such as voting against managers' resolutions, target the performance of the management team as a whole, derivative action involves a very personal attack on specific directors. It is therefore strongly detrimental to the business relationship between those directors and the institutional investor and its affiliated institutions. Meanwhile, a derivative suit could put the subject company's reputation at risk as it sends a signal to the public that the company was badly run by those directors. For those reasons, institutional shareholders are reluctant to rely on derivative actions as an activism strategy.

Taken the above factors into consideration, even if free-riding can be overcome, derivative litigation is not a worthwhile action for activism since the potential costs incurred will be higher than the received benefits. Various empirical studies have concluded that while the total amount of recovery may be significant, it is generally *de minimis* on a per share basis and likely to be smaller than the costs the claimant shareholder incurs.[259] As a result, institutional shareholders will continue to channel their energies into other activism approaches as this thesis has considered.

5.6 A Recap of Proposals for Reform

The part has sought to apply the model of institutional shareholder activism to the different forms that activism may take. In doing so, it has presented empirical

[259] Bhagat and Romano, (n 245) 413.

evidence of the extent and nature of institutional shareholder activism in the UK, analyzed the factors that affect current activism levels and explored the possibilities for more institutional shareholder activism in the UK. My task was primarily descriptive and explanatory – to describe levels of shareholder activism and to explain these in terms of the model of factors set out in Chapter 1. However, in the course of my discussion, we also encountered a number of regulatory impediments to shareholder activism, and from these we considered possible improvements to reduce these barriers. It will be useful to recap the reforms that I have suggested,

1. Securities Lending

   To ensure votes are cast in a responsible way when shares are on loan:

   a. Institutions conducting securities lending should disclose all necessary information about their positions and policies for securities lending;
   b. Lenders should recall shares on loan to vote when a resolution is contentious;
   c. When lenders have good reasons not to recall the shares, they should set up a clear voting policy or instruction in regard to how shares should be voted consistently with their economic interests, and should ensure it is implemented by the borrowers.

2. Procedural barriers to voting

   To build a more efficient voting process and prevent votes from being ‘lost’:

   a. Participants in the voting process, such as institutions, issuers and voting agencies, should further introduce electronic voting capacity to enhance the efficiency of voting
   b. The issuers should publish the total number of votes or proxies received, to help to identify any ‘lost’ votes in the process
   c. Regulators should consider extending current notice time and record date if found they still give insufficient time for institutions to cast their votes

3. Acting in concert

   In order to facilitate collective shareholder action, regulators should further clarify provisions in respect to ‘acting in concert’. In particularly, they should give further explanation on what constitute ‘a long-lasting policy’ and ‘board control-seeking proposals’.

4. Voting disclosure

   To achieve greater transparency in respect of institutional shareholder voting:

   a. Institutional investors should disclose both their voting policies and voting records when appropriate. This will enhance the transparency and accountability of institutional shareholders and help to promote greater institutional shareholder engagement.

5. Voting agencies

In exercising their voting rights, many shareholders have to rely on third party agents for information, and in this area, recent experience from the US points out to a concern that those agents may be subject to conflicts of interest with a resulting bias to produce a voting recommendation. There has not been much reported case or research on this area. In spite of this, it is necessary for Government to consider whether it is time to lay down rules about professional duties of analysts and how to handle conflicts of interest, such as full disclosure of this conflict may be necessary. With the implementation of the Stewardship Code, proxy service agencies and consultants should be encouraged to comply with the Code and report if against it.

5.7 Conclusion

This chapter has completed the analysis of the UK by applying the model established in Chapter 1 to four different types of activism. It was first concerned with the

empirical evidence on the level of each type of activity and found out that institutional shareholders preferred private meetings and proxy voting over submitting proposals and bringing derivative actions. Through applying the model, we found that such differences are determined by the different strengths of the factors contained in the model.

In analyzing the first step of overcoming free-riding, we have noted that it is easier for institutional shareholders to overcome free-riding when they choose private meetings or voting. Private meetings provide a good opportunity for institutional shareholders to be decisive and to act together. Moreover, such meetings also secure significant 'in process' benefits and are culturally preferred. The *normative* obligation has become particularly strong when it comes to voting. Institutional shareholders are compelled by a mass of growing regulatory demands to cast their votes and thus, are less able to free-ride. To submit proposals, institutional shareholders have to satisfy certain shareholding requirements which make it an undesirable action. These factors do not work much in respect of derivative actions.

While the benefits secured from different types of action are often broadly similar, the costs vary greatly. The primary cost incurred by private meeting is the potential liability for insider dealing and market abuse. Voting imposes both direct costs, resulting from procedural difficulties, and indirect costs-produced by conflicts of interest and impact on securities lending by shareholders. Costs incurred by submitting proposals are hardly explored due to lack of evidence. Bringing a derivative action involves expensive litigation and losses resulting from stark conflicts of interest which make it very a costly form of activism.

Finally, in applying the model, we have noticed that there are measures that regulators should consider to promote a more active and effective shareholder engagement. These include: improvement to securities lending, removal of procedural barriers to voting, clarify regulations on insider dealing and acting in concert, to require

disclosure of voting policies and records and monitor the voting activities of proxy agencies.

We are now in a position to leave the UK behind, and move our research on to China.

Part III Institutional Shareholder Activism in China

Chapter 6 Corporate Governance in China

This chapter looks at the corporate governance framework in China. It begins with an overview of some relevant aspects of Chinese listed companies in section 6.1, including the typology of companies, the historic development of listed companies, the classes of shares and the agency problem in listed companies. Section 6.2 turns to describe the multi-layered regulatory framework for the corporate governance system, followed by a discussion of the internal governance structure of Chinese listed companies in section 6.3. In particular, section 6.3 provides an analysis of the monitoring role played by institutional shareholders to discipline upon the majority shareholders. Chapter 6 concludes with a brief summary in section 6.4.

6.1 Data on Chinese Listed Companies

6.1.1 Typology of Companies

Chinese company law makes a distinction between two forms of company: Joint Stock Companies (JSC) and Limited Liability Companies (LLC), which roughly corresponded to the UK's distinction between public and private companies.[1] The form of JSC is usually adopted by large companies which intend to offer shares to the public, while LLC is incorporated by small businesses. Therefore, for a company to get listed, it must be incorporated as a JSC either through promotion or public subscription, with a required registration capital of at least RMB 5,000,000 (roughly £500000).[2]

For a JSC to be listed on a stock exchange, it must satisfy a number of key requirements laid down by securities law and listing rules relating to their statues,

[1] See Chapter 2.1.1.

[2] Company Law 2005 (hereinafter CL 2005) s 81.

shares, business record and management. For example, the total share capital should be no less than RMB 30 million.[3] The public shareholding shall account for more than 25 per cent of its total stock.[4] For an issuer whose total share capital exceeds RMB 400 million, such percentage is 10 percent.[5] As in the UK, companies must meet other requirements such as information disclosure, and audit conditions.

Chinese listing requirements, however, lay down one requirement that is clearly different from the UK. Any public offer by a JSC satisfying the listing criteria must gain approval from the Chinese Securities Regulatory Commission (CSRC) – the major regulator in Chinese securities market.[6] This requirement indicates that the listing process of companies is ultimately controlled by the state in China. The position is different from the UK, where the Financial Services Authority (FSA) does not have discretion over which companies can issue or list shares: the listing requirements are set out in the Financial Services and Markets Act 2000 (FSMA 2000), FSA Listing Rules and London Stock Exchange (LSE)' relevant rules and companies satisfying those criteria are entitled to get listed.

Comparing the UK and Chinese stock market, as Table 6.1 shows, the listed companies sector is a significant part of the economy in China as it is in the UK, but the number of listed companies and total value of shares traded in China are much less than the UK. Meanwhile, the turnover ratio for stocks traded in Chinese securities market is only half of that of UK market, which suggests China has a less liquid market.

Table 6.1 A Comparison between the UK and Chinese Stock Market (2008)

	Listed	Market	Stocks traded[7],	Stocks traded, turnover

[3] Securities Law 2005 (hereinafter SL 2005) s 50 (2).

[4] SL 2005 s 50 (3).

[5] Ibid. For discussion of the CSRC, see section 6.2.2.

[6] Securities Law 2005, s 23.

[7] Stocks traded refers to the total value of shares traded during the period.

	domestic companies, total	capitalization of listed companies (% of GDP)	total value (% of GDP)	ratio[8] (%)
UK	2,405	69.3	242.5	226.9
China	1,604	64.6	126.4	126.3

Source: The World Bank, available at < http://data.worldbank.org/> accessed 25 June 2010.

As of April 2010, data from the World Federal Exchange show that there have been 1837 Chinese listed companies on mainland stock exchanges. Although the number of listed companies is less than in the UK, the total domestic market capitalization of the Chinese sector is larger. The capitalization amounted to RMB 23 trillion (roughly £2.3 trillion), ranking third in the world.[9]

6.1.2 Historic Development of Chinese Listed Companies

Unlike the UK, where most public companies are converted from private companies, most Chinese listed companies were *transformed* from former State-Owned Enterprises (SOEs) which were incorporated in a totally different organizational form. This unique feature affects nearly all aspects of today's corporate governance system and it is therefore necessary for this thesis to explain some background about former SOEs, why and how they transformed into today's listed companies.

Since the founding of the PRC in 1949, the Chinese Government adopted the central planned economy, under which enterprises were owned and controlled by the State as

[8] Turnover ratio is the total value of shares traded in a year divided by the average market capitalization for the period.

[9] World Federal Exchange, Statistics: Number of Listed Companies& Domestic Market Capitalization, available at <http://www.world-exchanges.org/statistics/ytd-monthly> accessed at 5 June 2010. All listed companies are domestic Chinese companies.

a basic unit to implement production plans and provide social welfare.[10] On behalf of the State, different level of state agencies, which might be a ministry, provincial government or local government, exercised rigid supervision and control over SOEs under centralized planning.[11] Managers were directly appointed by these government agencies and had almost no independence of management, since the Government determined prices, production outputs, input and retained any profits that might accrue from the SOEs.[12] Within this system, managers' performances were not linked to economic benefits of enterprises, as the aim of running enterprises was to fulfilling the assigned production plan rather than maximizing profits. These enterprises were not formed and organized as modern corporations that we are familiar with today. The basis on which to build a (market-based) corporate governance system was therefore non-existent.

This centralized planning system had led SOEs to suffer from inevitable and insurmountable problems such as inefficiency and low productivity for more than 30 years, which forced Chinese policymakers to explore reforms to improve SOEs' performance in the late 1970s.[13] In attempts to align the interests of managers with the SOEs, the Government adopted a series of measures to increase company and managerial autonomy, including reducing centralized control and intervention in enterprises' operations, allowing managers to retain some after-tax profits, and introducing a contracting system in which managers could rent the SOEs from government in return for an agreed-upon amount of profits and taxes.[14] These earlier

[10] C Xi, *Corporate Governance and Legal Reform in China* (Wildy, Simmonds and Hill Publishing London 2009) 6.

[11] Ibid.

[12] G Yu, *Comparative Corporate Governance in China: Political Economy and Legal Infrastructure* (Routledge, London 2007) 24.

[13] For a more detailed discussion of these early reforms, see C Shi, 'Governance of State-Owned Enterprises in Post-WTO China' in R Tomasic and others (eds), *Corporate Governance:Challenges for China* (Law Press, Beijing 2005) 398-412.

[14] Z J Lin, L M Liu and X Zhang, 'The Development of Corporate Governance in China' (2007) 28 Company Lawyer 195; J Chen, *Corporate Governance in China* (RoutledgeCurzon, New York 2005) 39. For example, under the contracting system, the manager of enterprise and the government made

experiments since 1980s led to some degree of success in increasing productivity and efficiency of SOEs, however, they all failed to bring fundamental changes to the central planned system. The performance of SOEs remained poor in the early 1990s.[15] In 1990 losses incurred by SOEs amounted to 34.8 billion RMB.[16] Thus, further reforms were crucial.

Ultimately, the ground-breaking SOE reform in China was initiated with the leader Deng XiaoPing's triumphant visit to south China in 1992, when he called for opening up the Chinese economy. Later, in November 1993, the Third Plenary Session of the 14th Party Congress issued the '*Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure*' ('Decision') and officially adopted the policy of establishing a socialist market economy.[17] Among other things, the priority in creating this system was given to enterprise reform. Under the Decision, the orientation of enterprise reform is to create a '*modern enterprise system*' which has 'clarified property rights, designated authorities and responsibilities, separated government and enterprise functions, and established scientific management'.[18] After many years' trials, the Decision signaled that the Government officially endorsed the modern

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contract that specified the enterprise's performance target and production quota, and financial obligation to the state. Apart from these conditions, the manager was free to run their business, such as, producing over-quota goods, setting salaries. However, this system soon led to substantial widespread corruption. Many managers expropriated state's assets by pursing short-term profits under their contract term.

[15] These early initiatives also produced new, unexpected problems, such as speculative investments, asset stripping, diversion of enterprise funds to the managers for discussion of the problems which had in the past SOEs , see Organisation for Economic Co-operation and Development (OECD), *Reforming China's Enterprises* (OECD, Paris 2000) 64. Also, see Y Mai and F Perkins, 'China's State Owned Enterprises - Nine Case Studies' (1997) Briefing Paper Series, No. 7, East Asia Analytical Unit, Department of Foreign Affairs and Trade .

[16] Project Group of the China Academic of Social Sciences, 'Several Problems related to the Establishment of a Modern Enterprise System' (1996) 17 Social Science in China, 20.

[17] Zhonggong Zhongyang Guanyu Jianshe Shehui Zhuyi Shichang Jingji Tizhi Ruogan Wenti de Jueding [Decisions of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economy System], adopted by the Third Plenary Session of the CPC Fourteeth National Congress on 14 November 1993.

[18] Ibid, section 2.

corporation system as an important measure to reform SOEs.

The reform was pursued mainly in *three* steps.[19] *First*, the introduction of business organizations: in 1992, the nation's first Company Law, was promulgated as a legal foundation for the establishment and operation of modern companies. It recognized and created mandatory standard form of two types of company: JSC and LLC. For the first time, Chinese Company Law legally lay down that the objective of a corporation, whether state-owned or not, is to increase productivity and economic benefits, in other words, to maximize the wealth of that corporation.[20] *Secondly*, the Government launched restructuring movement by incorporating former SOEs into the forms of company governed by the Company Law, as introduced above, namely, JSC and LLC – a process generally referred to '*corporatization*'. The corporatization separates the State from SOEs, at least theoretically, as the State became the shareholder of a corporation rather than the direct owner and controller. *Thirdly*, having corporatized themselves into share-capital companies, in order to generate funding from the public, to diversify SOE risks and (to some degree) to separate government administration from SOEs management, most large SOEs gained listing on domestic and international stock exchanges. Therefore, given the large number of SOEs transformed from traditional enterprises, 'listed companies' in China could actually mean listed SOEs.[21]

The process of reform, as put by Deng XiaoPing, is 'crossing the river by feeling each

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[19] For a full discussion of Chinese enterprise reform, see, OECD, *Reforming China's Enterprises* (n 15); and World Bank, *China's Management of Enterprise Assets: The State as Shareholder* (World Bank Country Report, Washington DC 1997); And, I Macneil, 'Adaptation and Convergence in Corporate Governance: the Case of Chinese Listed Companies' (2002) 2 Journal of Corporate Law Studies 289, 297-30; Also, see W P Mako and C Zhang, 'State Equity Ownership and Management in China:Issues and Lessons from International Experience' OECD Paper <http://www.oecd.org/dataoecd/35/23/31226002.pdf>12 October 2008., 2-5.

[20] Section 5(2) of 1993 Company Law.

[21] Lay-hong Tan and J Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-owned Enterprises: Issues and Challenges in A Transitional Economy' 7 Journal of Corporate Law Studies (2007) 143, 147.

stone' which indicates the reform has to undergo a unique Chinese approach. Indeed, the reform is clearly one with 'Chinese characteristics'. In contrast with the corporate and market reforms in Russia and some East European countries, the approach being taken by China is to reconstruct SOEs into private commercial firms, but still under *tight* state control.[22] During the listing process, only higher quality assets of former SOEs were allowed to be listed on stock exchanges under the Government's listing quotas, with the remaining SOEs turned into holding companies. The holding company, which might be organized as the LLC or JSC, became the parent company and the major shareholder of the listed companies. The non-state investors, although allowed to share control over the company, have to be minority shareholders.[23]

6.1.3. Classes of Shares

Under the Company Law, a Chinese listed company may have only one class of share: ordinary share with each share carrying one vote. There are, nevertheless, several types of share in Chinese listed companies, in terms of different shareowners and trading rules.

One primary distinction is that between tradable and non-tradable shares. Tradable shares are shares that can be freely sold to the general public on various stock exchanges. Tradable shares can be sub-divided into several distinct types. 'A' shares, analogous to ordinary shares in the UK, are the most common kind of share. Similarly, they entitle holders to receive dividend and to vote in the shareholders' meeting. However, originally, A shares differed from the UK ordinary share in that they were exclusively available to Chinese national investors. As one shall see later, since the launch of Qualified Foreign Institutional Investors (QFIIs) program in 2002, qualified foreign institutions can buy 'A' shares within the quotas allocated by the

[22] OECD (s 15) 64, major approach being taken by other transitional countries is massive privatisation.

[23] See discussion in sections 6.1.3 and 6.1.4.

Government.[24] The A share market is China's biggest stock market.

The rights attached to 'B' shares are similar to the UK ordinary shares but only available to foreign individuals and institutions.[25] They are subscribed and traded in foreign currency instead of RMB. In addition buying B shares, foreigners can invest in Chinese listed companies by buying shares listed on foreign share exchanges. The most common example is 'H' shares (being shares listed on the Hong Kong Stock Exchange).

A, B and H shares are the main types of tradable shares in Chinese listed companies. In a 2000 survey of 257 companies listed on the Shanghai Stock Exchange, 252 companies issued A shares, 21 companies issued A and B shares, 5 companies issued only B shares.[26] These data suggest that, as in the UK, although listed companies could issue several classes of share, A share or ordinary share is the dominant category. It is worth noting that a small part of China's stocks can also come in the forms of so-called 'red chips', 'L' shares, 'N' shares and 'American Depository Receipts' (ADRs).[27] Red chips are stocks issued by Hong Kong registered companies that have a mainland Chinese shareholder holding at least 35% of the shares. It is traded on the Hong Kong Stock Exchange and is available to international investors. L shares are Chinese shares issued by a small number of Chinese companies listed on the LSE. N shares and ADRs are issued by Chinese listed companies traded on the New York Stock Exchange. These overseas listings require the approval of Chinese Government.

The remaining group of non-tradable shares – although carrying same rights as tradable shares – are subject to strict restrictions on tradability. This unique class of

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[24] See Chapter 7.2.4.

[25] Since 2001, a small number of eligible domestic investors are allowed to trade B shares, however, they are not the concerns of the thesis.

[26] S Tenev, C Zhang and L Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (World Bank Publications Washington 2002) 76.

[27] Chen (n 14).

share is a by-product of China's gradualist approach to its economic reform and it was used as a tool to retain Government control over listed companies. During the process of SOEs reform, the Government intended to resolve SOEs' inefficiency and to raise capital from the public through listing. However, it was afraid to lose its central control if all shares could be freely sold.[28] The State finally adopted a split share structure ownership in listed companies: it holds a large portion of SOEs shares as non-circulating shares, with the remaining portion going to the public. In other words, only part of SOEs' shares in an IPO can be freely sold to the public.

The remaining shares that were prohibited from being sold, were generally designated 'state share', if retained by the state, 'legal person share' if owned by government-related organizations with legal personalities, or 'employee share' if owned by the collectively body of company employees.[29]

The transfer of state and legal person shares can only be conducted through private negotiation following approval by the securities regulatory authorities. Employee shares have to be held for 6 to 12 months after an IPO, and can then be traded on stock exchanges with Government's approval.[30]

Non-tradable shares represent a significant portion of the total equity of listed companies. By the end of 2004, nearly 64% of listed companies' shares were not in circulation. 74% of them are state-owned shares. Despite a lack good data, at present, the percentage of non-tradable shares in listed companies has decreased as a result of split structure reform – to which I now turn.

6.1.3.1 The Split Share Ownership Structure Reform

The split share ownership structure in Chinese listed companies is widely seen as an

[28] Macneil (n 19) 300.

[29] The number of employee shares is gradually falling since 1998 when the government issued a circular in relation to discontinuing the issuance of employee shares, see Tenev, Zhang and Brefort 78.

[30] Tenev, Zhang and Brefort (n 26).

impediment to further development of the stock market. As admitted by the Government, the split-share ownership hindered the development of the market in terms of

> 'distorted pricing mechanism, resource allocation inefficiency, invalidation of the market share price as an innate factor that promotes efficiency and limits the power of the substantial shareholders and management of listed companies, lack of common interest as the basis for corporate governance, the price discrepancy between negotiated non-tradable share transfer and competitive quotation of tradable shares, deficient market condition for exercise of capital operations'.[31]

To bring non-tradable shares on to the market, the Government made three early attempts in – 1996, 1999 and 2001 – to invite companies to convert their non-tradable shares to tradable shares. However, the lack of a well-designed mechanism to compensate tradable shareholders who bought their shares at a higher price, triggered significant declines in the stock market.[32] For example, in 2001, the announcement of the reform trigged a collapse of Chinese stock markets, wiping 43% and 53% off the Shanghai and Shenzhen composite index respectively.[33] These consequences forced the Government to withdraw those reform plans.[34]

A further reform was initiated in May 2005.[35] Two official documents: *Guidance*

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[31] Guidance Notes on the Split Share Structure Reform of Listed Companies, Clause 2, issued on August 23, 2005, jointly by the CSRC, the State-owned Assets Supervision and Administration Commission (SASAC), the Ministr of Finance, the People's Bank of China and the Ministry of Commerce <http://www.csrc.gov.cn/n575458/n4001948/n4002120/4069773.html> accessed 12 March 2009.

[32] S L J Lee, 'From Non-tradable to Tradable Shares: Split Share Structure Reform of China's Listed Companies' (2008) 8 Journal of Corporate Law Studies 57, 65.

[33] Ibid, 64.

[34] Ibid.

[35] For detailed discussion of the reform, see Lee (n 32) and X Jia and R Tomasic, *Corporate Governance and Resource Security in China : the Transformation of China's Global Resources Companies* (Routledge, London 2010) 6-10.

Notes on the Split Share Structure Reform of Listed Companies (Guidance)[36] and *Measures on the Administration of Split-share structure Reform of Listed Companies* (Measures) were issued by the Government to guide split share structure reforms. The Guidance specially emphasized that the aim of the reform was *not* to sell-off state-owned shares, but rather to give the shares owned by the Government the same rights and responsibilities as the tradable shares held by the general public.[37]

The Measures laid down rules to govern operational issues in the split share structure reform. Listed companies are required to proposal a reform scheme to transfer non-tradable shares to tradable shares and to provide a compensation package for existing tradable shareholders in return for the right to sell their shares on stock exchange.[38] According to the Measures, only tradable-shareholders are allowed to exercise their votes on the reform proposal at the shareholders' meeting and the reform will be adopted with two-thirds of tradable shareholders approval.[39]

By the end of 2008, the vast majority of listed companies had completed the process of converting non-tradable shares to tradable shares.[40] However, a large quantity of shares after converting was still subject to lock-ups and not yet available in the market. According to the Measures, for 12 months from the date of implementing the reform scheme, these shares cannot be traded.[41] Thereafter, the shareholders of these shares holding 5% or more of the total amount of shares of any listed company, can sell no more than 5% of the total amount of shares of the company within 12 months and no

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[36] See (n 31)

[37] Guidance Notes on the Split Share Structure Reform of Listed Companies, 2.

[38] Measures on the Administration of Split-share structure Reform of Listed Companies, issued by the CSRC in September 2005 <http://www.csrc.gov.cn/n575458/n4001948/n4002120/4069846.html> accessed 12 March 2009.

[39] For a more detailed discussion of share compensation see, Y-H Yeh and others, 'Non-Tradable Share Reform and Corporate Governance in the Chinese Stock Market' (2009) 17 Corporate Governance: An International Review, 457.

[40] W H Yeung, 'Non-tradable Share Reform in China: A Review of Progress' (2009) 30 Company Lawyer 340, 345.

[41] Measures on the Administration of Split-share structure Reform of Listed Companies, s 27.

more than 10% within 24 months.[42]

The reform represents one of most significant steps that China has taken to develop its stock market and particularly has important bearings on the development of Chinese institutional investors. The release of non-tradable shares requires sufficient demand from the market. Amongst the public, institutional investors, including pension funds, insurance companies and QFIIs are key to generating a stable market environment for state shares. Along with their growing power, institutional shareholders could set up and increase the level of engagement with their portfolio companies.

6.1.4 Agency/governance Issues in Chinese Companies

Institutional shareholders of Chinese listed companies are confronted with two types of agency problems: majority shareholder-minority shareholder agency problem and manager-shareholder agency problem. *First and most important*, investors have to deal with the problem resulting from the current concentrated shareholding structure – the *exploitation of minority shareholders by controlling shareholders*.[43]

Kim and Qiu found that for the period 1996-2003, share ownership in most listed companies is highly concentrated with a single, large owner associated with the Government or Government-run and related enterprises.[44] Moreover, in these samples, 43% of all shares outstanding are held by a single shareholder and about 66% of these largest shareholders in their samples are associated to the Government.[45] More recent research from the Chinese Academy of Social Science in 2009 shows that 77

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[42] Ibid.

[43] There is massive literature concerning minority-majority conflicts problem, for example, see S Claessens and J P Fan, 'Corporate Governance in Asia: A Survey'(2002) 3 International Review of Finance 71; R Tomasic and N Andrews, 'Minority Shareholder Protection in China's Top 100 Listed Companies' (2007) 9 Australia Journal of Asian Law 88.

[44] F A Gul, J-B Kim and A Qiu, 'Ownership Concentration, Foreign Shareholding, Audit Quality and Firm-Specific Return Variation: Evidence from China ' <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984142>17 October 2009..

[45] Ibid.

companies of top 100 Chinese listed companies have their 5 largest shareholding constituting more than 50% of total shares.[46] The largest shareholder in 86% of the top 100 listed companies is the state or state-related institutions. In the non-state share group, as we will see in Chapter 7, institutional shareholdings amount to half of the total equity, with the rest held by individual investors.

The owner of the state or state-related share, of course, is the state. However, it has only a conceptual existence. Prior to 2002, the agencies representing the state owning the equities are the central government, local governments and the parent SOEs of listed companies. However, the multiplicity of agencies has generated many high-profile problems,[47] which led to the establishment of State-owned Assets Supervision and Administration Commission of the State Council (SASAC) as one single authority to represent the Government as the owner in listed companies.

To sum up, most Chinese listed companies have 'insider/control-oriented' structures, where the State acting as 'block-holder' owns a sufficiently sizeable fraction of the voting shares to exercise considerable control over the managers, by contrast with the 'outsider/arms-length' corporate structure in the UK.[48]

The *second* type of agency conflict encountered in Chinese listed companies is the manager-shareholder agency problem. It has been mentioned earlier that the separation of owner and manager in modern corporations results in there being an agency problem between the shareholders as the principal and the managers they

[46] Institute of world economic and political in Chinese Academy of social science, 2009 nian Zhongguo Shangshi Gongsi 100 qiang gongsi zhili pInjia [Corporate Governance Assessment Report on the Top 100 Chinese Listed Companies For 2009] <http://www.iwep.org.cn/> accessed 14 September 2009.

[47] For example, the multi-tiered network of institution caused many insider problems, such as false reporting of profits or soft loans to augment poor cash-flow. The interference by numerous, uncoordinated government agencies also hinder the efficient decision-making of companies. See, OECD (n 15) 65.

[48] Discussions regarding the share ownership in UK listed companies can be found in Chapter 1 and 3.

employed as agent.[49] Since Chinese listed companies also adopt a share-capital corporate structure similar to the UK, they seem to be no exception to the puzzle of how to *hold self-serving directors accountable to shareholders as a whole*.

6.2 The Chinese Corporate Governance Regulatory Framework

As discussed previously, the regulatory framework of a country significantly affects the level of shareholder activism. An effective one will enfranchise institutional shareholders by enabling them to engage in corporate governance. By contrast, legal barriers will increase the costs of activism and thus reduce shareholders' incentives for engagement.

Before turning to introduce Chinese corporate law and its corporate governance framework, it is necessary to provide a brief description of Chinese legislation hierarchy, since it sharply differs from the UK legal system.

In contrast to the UK, China adopts a continental legal system, which suggests only statutes are in effect.[50] Generally, the legal system can be divided into three layers, depending on various legislative bodies and legislative effect. Different organs hold different legislative powers and as such, the enactments they make have different binding authority. The top layer is the state law which can only be enacted by the central authorities. Under the Chinese Constitution, the National People's Congress (NPC) with its standing committee is authorized as the highest legislative power of the State.[51] Only legislations enacted by the NPC and its standing committee can be defined as basic law. Major laws in this level dealing with Chinese corporate governance are the Company Law and Securities Law.

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[49] See Chapter 1.1.

[50] For a more detailed account on Chinese legal regime and its historic development, see Jianfu Chen, Chinese Law: Context and Transformation (Brill, Leiden 2008).

[51] Legislation Laws of the People's Republic of China (Hereinafter Legislation Law) s 7.

The second layer is administrative regulations and rules made by the State Council – the central government – or the Ministries under the State Council.[52] The various Ministries and Commissions of the State Council are permitted to formulate rules within the respective limits of their power.[53] Of the State Council's 28 ministries and commissions, the one that is most relevant to corporate governance is the CSRC, which is responsible for enacting rules governing companies such as corporate structure, information disclosure, listing of companies, shareholder protection and directors system. In terms of designation, the regulations can take the forms of 'provisions', 'guidelines', 'measures', and 'opinions'.

The third level is the local regulations and rules by local government.[54] The local legislation will be concerned with matters not yet governed by national laws or regulations or matters to implement national laws and regulations. In the area of company law, local enactments played an important role in Chinese legislation history. Before the promulgation of national company law in 1993, Shenzhen, one of the special economic zones established in 1980 in accordance with Deng Xiaoping's developing socialist market economy policy, enacted regulations for corporate experiments in 1986 as the first local authority.[55] In these days, national regulations and rules were rapidly developing to cover almost every aspect of corporate matters, resulting in fewer demands for local rules. However, it is still suggested that they are necessary to fill gaps left by national rules and to accommodate local circumstances.[56]

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[52] It is authorized to formulated legislation to govern the following matters: (a) when matters requiring the formulation of administration regulation to implement the provisions of law (b) when regulations are needed to govern matters are within the administrative functions and powers of the state council as stipulated by the Constitution (c) when NPC and its standing committee authorized the state council to formulate administrative regulations for matters originally under the responsibilities of NPC and its standing committee. Legislation Law, Section56

[53] Legislation Law s 71.

[54] Legislation law, ss 63, 71.

[50] J Wang 'An Overview of Chinese Corporate Law Regime'(2008) <http://preprodpapers.ssrn.com/sol3/papers.cfm?abstract_id=1222061&rec=1&srcabs=893962> accessed 23 May 2009.

[56] Ibid.

Besides the above three levels, the rules made by Chinese stock exchanges in relation to listing requirements as well as trading rules are binding on the companies listed. They play an important role in the legislation governing securities market and some of them are directly relevant to institutional shareholder activism. As stock exchanges' rule making authorities are empowered by the Securities Law, I will term rules at this level as 'delegated rules-making'.

6.2.1 Updates of Company Law and Securities Law

Law is at the core of the Chinese corporate governance framework. The most significant legislation in the regime comprises of the Company Law 2005[57] (CL 2005) and the Securities Law 2005 (SL 2005)[58]. Both are applicable to Chinese listed companies' corporate governance systems, but with different emphasis. The CL 2005 contains rules governing the creation of corporations, internal governance mechanisms, shareholders' rights, directors' duties and other matters concerning the operation of companies, while the SL 2005 stipulates rules to regulate securities market, such as listing requirements, share offering and information disclosure.

As this thesis does not intend to give a detailed introduction on all aspects of Chinese corporate legislation, the following part will only be concerned with recent updates to explore whether institutional shareholders are empowered to participate in corporate governance in a more facilitative legal regime. Some rules will be discussed in greater detail later.

Changes made by the CL 2005 relevant to corporate governance include:

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[57] Enacted by the Standing committee of the NPC on 29 December 1993, first revised on 25 December of 1999, Second revised on August 2004, the third and most recent revision on 27 the October 2005, effective on 1 January 2006, compulsory for LLCs and JSCs registered in China.

[58] Enacted by the standing committee of the NPC on 29 December 1998, first revised on 28 August 2004, second and most recent revised on 27 October 2005, effective on 1 January 2006. Applied to the issuance and transaction of stocks, corporate bonds as well as any other securities as lawfully recognized by the State Council within the territory of the People's Republic of China.

1. Minority shareholder protection: Enhances the protection of minority shareholders, such as by permitting shareholders to use cumulative voting system when electing directors and supervisors,[59] entitling shareholders to view financial statements and allowing shareholders to bring derivative suits.[60] Moreover, it requires that shareholders should not abuse their voting powers to the detriment of the company or other shareholders.[61]
2. Information rights: Introduces new rules to entitle shareholders to consult and copy the articles of association, minutes of the shareholders' meeting, resolutions of the board of directors, resolution of the board of supervisors, and financial reports.[62] Furthermore, it allows shareholders to bring forward suggestions or inquiries regarding the operation of the company. Section 151 empowers shareholders to elicit accurate information from directors, senior officials and supervisors. It demands that directors, senior managers and supervisors answer shareholders' enquiries.
3. Supervisory board: Increases the power of the board of supervisors, such as granting powers to make proposals to the general shareholders' meeting and bringing lawsuits against directors and senior managers.[63]
4. Directors' duty: Lays down diligence and loyalty duties on directors, including an obligation to comply with laws and a prohibition on bribery and embezzlement.[64]
5. Independent director: Introduces a statutory basis for independent directors.[65] Independent directors owe 'duties of good faith and due diligence towards the listed company and all the shareholders'.[66] In particular, independent directors

[59] CL 2005 s 106.

[60] CL 2005 s 34,152.

[61] CL 2005 s 20.

[62] CL 2005 s 98.

[63] CL 2005 s 54,119.

[64] CL 2005 s 148.

[65] On 16th August 2001, the CSRC issued the 'Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, requiring that at least one third of board should to be independent directors by June 2003. CL 2005 formally endorses this position in section 123.

[66] Code of Corporate Governance for Listed Companies s 50.

shall be concerned with protecting the interests of minority shareholders from being infringed.[67]

Compared with its predecessor, the 1998 Securities Law, the SL 2005 made some progresses to clamp down on securities irregularities and improve investors' protection. It requires listed companies to establish a protection fund for stock investors.[68] The fund would offer some compensation to individual investors if they suffer losses due to a financial crisis or bankruptcy of a broker. It specifies that funds derived from the settlement of transactions of investors be deposited in commercial banks, prohibiting investment banks from manipulating these investor funds or securities as part of their own funds.

On the front of information disclosure, section 68 draws on US experience (in the Sarbanes-Oxley Act) by providing that the directors and senior managers of listed companies must provide their opinions in the periodic reports of their companies and guarantee the authenticity, accuracy and integrity of the information as disclosed in these reports. The SL 2005 expands the notion of material information for the purpose of continuous information disclosure,[69] and the scope of the category of insiders for the prohibition of insider trading.

All in all, these reforms bring Chinese corporate governance close to those in developed countries and are critical to future corporate governance practice in China. Some reforms, such as cumulative voting and derivative suits, have far-reaching implications for shareholder activism. Despite these achievements, there are concerns about the lack of detailed and functional measures to supplement the application of CL 2005 and SL 2005.[70] For example, while the CL 2005 empowers shareholders'

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[67] Ibid.

[68] SL 2005 s 134.

[69] SL 2005, ss 67,74, For further discussion, see B Wang and H Huang, 'China's New Company Law and Securities Law: An Overview and Assessment ' (2006) 19 Australian Journal of Corporate Law 229.

[70] Ibid, 242.

rights to participate in governance, the real effect is compromised by the failure to set out adequate sanctions and remedies. Moreover, inefficient legal enforcement has long been a problem for Chinese lawmakers and as a result, the law reform may be of more symbolic than practical value.[71] Take the example of the system of independent directors, introduced in 2001, where empirical evidence suggested that the practical success is limited.[72]

6.2.2 Chinese Securities Regulatory Commission (CSRC)

The central regulatory institution for corporate governance of Chinese listed companies is the CSRC. It was established by the State Council in October 1992 to serve as the country's main regulator of the newly created securities markets.[73]

Unlike the UK's FSA, which is organized as an independent non-governmental company, the CSRC is a ministry-level unit that answers only to the State Council. The main duties of the CSRC include supervising the issue and the transaction of securities, regulating market intermediaries, such as institutional investors, issuing licenses to professional institutions such as auditors and stock brokers, and promoting and monitoring corporate governance in the market.

The CSRC sees good corporate governance as linked to the confidence of investors to

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[71] B Wang, 'Competition and Development: The Theme of Corporate Law Reform' in B Wang et al (Eds), *Quanqiu Jingzheng Tizhi xia de Gongsifa Gaige [Corporate Law Reform for a Global Competitive Economy]* (Social Sciences Documentation Publishing House, Beijing, 2003) 170.

[72] For example, JinXin Securities Research Institute, 'Xianzhuang Diaocha: Duli Dongshi Zenmeyang Le? [A Survey of the Current Independent Director System]' *Zhengquan Shibao [Securities Times]* (August 2003); and D Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125. These studies found that due to practical limitations, the effectiveness of independent directors system is doubtful.

[73] It is worth note here that it was not until 1998 that the CSRC became the central regulator of the Chinese securities market. Its regulator was formally established in the 1998 Securities Law. See R Tomas and J Fu, 'The Securities Law of the People's Republic of China: An Overview' DATE?10 Australia Journal of Asian Law 268.

invest in Chinese listed companies.[74] It has been seeking to improve Chinese corporate governance standards mainly through issuing various regulations, circulars, standards, and guidelines that have been important to the establishment of a detailed corporate governance framework for China. These include：

(1) August 2001 *Guidance Opinion on the Establishment of an Independent Directors System in Listed Companies*;

(2) January 2002 *Code of Corporate Governance for Listed Companies (discussed in detail later)*;

(3) December 2004 *The Provisions on Strengthening the Rights and Interests of Public Shareholders*;

(4) March 2006 *Guidelines on Articles of Association for Listed Companies*;

(5) March 2006 *Rules on the General shareholders' meeting of Listed Companies.*

To ensure compliance with the regulations, the CSRC has a range of different sanctions, depending on its assessment of the level and the scope of the infraction. It may give internal warning, public criticism, public condemnation, official warning, monetary fines, or ban a company from the market. Punishment such as warning, penalties, and disqualification can also be issued to corporate officer, including directors, supervisors and secretaries of the board of directors. In 2002, the CSRC announced the establishment of the 'good faith file' system for securities market participants.[75] According to then-vice president of CSRC, if directors, supervisors, and senior officers who violate 'good faith' will, according to the Listing Rules, their qualifications for their position will be restricted.[76] Moreover, listed companies and financial intermediaries who breach good faith will find that when the CSRC accepts

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[74] L M Cha, 'The Future of China's Capital Markets and the Role of Corporate Governance' Luncheon Speech at China Business Summit, 18 April 2001, available at
< http://www.csrc.gov.cn/n575458/n4001948/n4002030/4064448.html> accessed 5 March 2008.

[75] Zhongguo Zhengjian Hui Jiang Jian Chengxin Dangan [CSRC Establishes Good Faith File System], Renmin Wang [People Net] (27 April 2002)
<http://www.people.com.cn/GB/paper39/6077/605476.html> accessed 19th January 2009.

[76] Ibid.

reports on various matters, it would 'consider' their good faith records to increase the cost for violations.[77]

To date, many actions taken against Chinese companies are related to financial reporting. From 1999-2003, Chen shows that 64% of them involved a failure to disclose information, delay in disclosure or false statements.[78] Among the infraction from 2002 to 2007, the CSRC issued a total of 211 punishment decisions. Of those, 99 were for disclosure violations involving listed companies and senior managers.[79]

6.2.2.1 Code of Corporate Governance for Listed Companies in China

In January 2002, the CSRC issued a *Code of Corporate Governance for Listed Companies* in China (Chinese Code). It was based to some extent on the OECD's Principles of Corporate Governance, as modified to reflect China's own special situation.[80] In contrast to the UK Corporate Governance Code, which adopts a 'comply or explain' approach, the Chinese Code is mandatory for companies listed on China's stock exchanges. Whilst it is not possible to undertake a comprehensive analysis of the Chinese Code here, a discussion of the way shareholders are treated will suffice for the purpose. Section 2 of the Chinese Code states:

> 'The corporate governance structure of a company shall ensure fair treatment toward all shareholders, especially minority shareholders. All shareholders are to enjoy

[77] Ibid.

[78] G Chen and others, 'Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions' (2005) 24 Journal of Accounting and Public Policy 451.

[79] D Clarke, 'The Ecology of Corporate Governance in China' (2008) The George Washington University Law School Public Law and Legal Working Paper No.433 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1245803> accessed 20 November 2009, 42.

[80] For a detailed comparison between the OECD code and Chinese code, see R Tomasic, 'Comparing Corporate Governance Principles: China, Australia and the OECD' in Tomasic and others (eds) (n 13) 1-31.

equal rights and to bear the corresponding duties based on the shares they hold.'[81]

Section 3 further points out that a listed company shall set up effective channels of communication with its shareholders. In particular, whilst it may be seen as more theoretical than real, section 19 of the Chinese Code establishes a fiduciary duty owed by controlling shareholders to minority shareholders. It states that 'the controlling shareholders shall be prevented from damaging the company or other shareholders' legal rights and interests.'[82] However, in practice, it is hard to enforce this fiduciary duty partly because there lack rules regarding procedures to enforce it and the remedies for violations.[83] Moreover, the Chinese Code calls for institutional shareholders to play a role 'in the appointment of company directors, the compensation and supervision of management and major decision-making processes'.[84]

6.2.3 Stock Exchanges

China has two stock exchanges: Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE). They were established in 1990 and 1991, with eight and six listed companies, respectively. Since then, as we have seen, the Chinese capital markets have grown rapidly over the past decade generated by the steady opening up of the Chinese economy. SSE and SZSE ranked respectively the first and fourth fastest-growing exchanges in terms of market capitalization in 2006.[85]

Similar to many other stock exchanges, the roles that SSE and SZSE play are to provide a market for sellers to raise new capital and trade company securities, and for investors to buy shares. There are, however, some differences between the listing

[81] Chinese Code s 2.

[82] Chinese Code s 19.

[83] J-Q Qiu, 'Corporate Governance in China:From the Protection of Minority Shareholders Perspective' (2006) 2 Corporate Governance Law Review 311, 331. Also see Jia and Tomasic (n 35) 21-28.

[84] Chinese Code s 11.

[85] World Federation of Exchanges, 'Annual Report of Statistics of 2006', <http://www.world-exchanges.org/ > accessed 12 August 2008.

markets provided by SSE and SZSE. In 2004, SZSE launched a Small and Medium Enterprises (SME) which designed as an exclusive market segment to facilitate small and medium size companies to trade on the exchange.[86] Since then, while there seems no fixed thresholds differing the size of listing companies on the two exchanges, smaller companies satisfying the requirements for listing were exclusively traded on SME board, while companies listed on SSE tend to be larger and have more Government connections than those listed in Shenzhen.[87]

In addition to providing listing market, the exchanges undertake a number of regulatory tasks. Like the LSE, they make trading rules as well as a variety of other rules and standards relating to listing standards, information disclosure, investor protection and corporate governance, and monitor listing companies' compliance of these rules. These rules provide detailed obligations and rights for participants in securities market and play a significant role in the legislation on listed companies and securities trading. Relevant instruments here include:

1. *Trading Rules of Shanghai Stock Exchange*[88] and *Trading Rules of Shenzhen Stock Exchange;*[89]

2 *Rules Governing the Listing of Stocks on Shanghai Stock Exchange*[90] and *Rules Governing Listing of Stocks on Shenzhen Stock Exchange;* [91]

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[86] 'Briefing of Small and Medium Enterprises Board', Shenzhen Stock Exchange, 2004, available at http://www.szse.cn/main/en/smeboard/aboutsmeboard/200408316286.shtml, accessed 4 April 2008.

[87] B Liebman and C Milhaupt, 'Reputational Sanctions in China's Securities Market ' (2007) Columbia Law and Economics Working Paper No. 318 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=999698> accessed 27 December 2009.

[88] Available at <http://static.sse.com.cn/sseportal/en/c01/c09/c01/p1075/c15010901_p1075.shtml >accessed 20 March 2009.

[89] Available at http://www.szse.cn/main/en/rulseandregulations/sserules/ accessed 20 March 2009.

[90] Ibid.

[91] Ibid.

3. *Guidelines on Protection of Investor Rights and Interests for SME Board*[92]

For violation of trading rules, exchanges have available five sanctioning methods, which are, in ascending order of seriousness, (1) circulating a notice of criticism among members; (2) publishing a public censure in CSRC-designated media; (3) suspending or restricting trading; and (4) revoking trading qualification or canceling membership.[93]

It seems that Chinese stock exchanges play similar roles in securities markets as the LSE. In fact, however, Chinese exchanges are significantly different from the LSE in that they are not independent of the state despite their self-regulatory nature as defined by the SL 2005. The UK model of an exchange established as an independent business organization with limited government interference does not apply to China. The stock exchanges are under the direct supervision of the CSRC, with the senior personnel, such as chairman and vice chairman, appointed by it. It is often said that these stock exchanges are more like 'two subsidiaries of the CSRC'.[94] Unsurprisingly, there are concerns that they lack sufficient autonomous regulatory authority to enforce their roles in securities markets. In the context of corporate governance, again, the exchanges lack real power and sufficient resources to monitor compliance effectively and punish non-compliance.[95] For example, given that corporate governance is only a recent object of attention in China, the exchanges provide educational courses for listed companies to raise the awareness of corporate governance. Interestingly, due to absence of authority, the educating role provided by the exchanges was even ranked higher than the role of monitoring corporate governance practice among the

[92] Ibid.

[93] Trading rules of Shanghai Exchange, Chapter X, 10.1.

[94] C Hua, 'Bonding, Law Enforcement and Corporate Governance in China ' (2007) 13 Stanford Journal of Law, Business, and Finance 82, 114.

[95] For a full account, see generally R Tomasic and J Fu, 'Legal Regulation and Corporate Governance in China's Top 100 Listed Companies' (2006) 27 The Company Lawyer 278.

exchanges' list of priority, according to the study conducted by Tomasic and Fu.[96]

6.3 The Internal Governance Structure of Chinese Listed Companies

In regard to the internal governance structure of listed companies, Chinese corporate legislation relies heavily on a *mandatory approach* to prescribe a clear allocation of decision-making power among shareholders' meeting and the board of directors, instead of the 'permissive regime' adopted by the UK.[97]

Three governance organs are required to be established under the CL 2005: shareholders' meeting, board of directors and board of supervisors. This section introduces each of them and compares their authorities with their UK counterparts.

6.3.1 Shareholders' General Meeting

Chinese listed companies are required to hold shareholders' general meetings annually.[98] CL 2005 empowers the general meeting as an 'organ of power' which suggesting that it has the highest decision-making authority of a company.[99]

Table 6.2 summarizes the power of the general meeting in listed companies under CL 2005.

Table 6.2 The power of the general shareholders' meeting

[96] Ibid, 14

[97] See Chapter 2.3.

[98] CL 2005 s 40.

[99] CL 2005 s 37.

(1)Deciding the operational policy and investment plan of the company;[100]

(2) Electing or replacing directors and supervisors who are not representatives of the staff and workers, and to decide on matters concerning the remuneration of the directors and supervisors;[101]

(3) Examining and approving reports of the board of directors;[102]

(4)Examining and approving reports of the board of supervisors or the supervisors;[103]

(5) Examining and approving the annual financial budget plan and final accounts plan of the company;[104]

(6) Examining and approving the company's plans for profit distribution and for recovering losses;[105]

(7) Adopting resolutions on the increase or reduction of the registered capital;[106]

(8) Adopting resolutions on the issue of corporate bonds;[107]

(9)Adopting resolutions on the merger, division, dissolution, liquidation or transformation of the company;[108]

(10) Amending the articles of association;[109]

[100] CL 2005 s 38(1).
[101] CL 2005 s 38(2).
[102] CL 2005 s 38(3).
[103] CL 2005 s 38(4).
[104] CL 2005 s 38(5).
[105] CL 2005 s 38(6).
[106] CL 2005 s 38(7).
[107] CL 2005 s 38(8).
[108] CL 2005 s 38(9).
[109] CL 2005 s 38(10).

(11) Deciding the appointment or dismissal of an accounting firm;[110]

(12) Examining and approving the matters relating to guarantees as prescribed in Article 41 of the Guidance for the articles of listed company;[111]

(13) Examining such proceedings as the purchased and sold assets in one year by the company exceed 30% of the audited total assets of the company of the latest term;[112]

(14) Examining and approving the usage of the collected fund;[113]

(15) Examining and approving stock-based incentive plan;[114]

(16) Examining other proceedings prescribed in laws, administrative rules, regulations or the company's article of association to be decided by the shareholders' meeting.[115]

Note: Based on the 2005 Company Law and the Guidance for the Articles of Association of Listed Companies

These rights are clearly more extensive than those enjoyed by shareholders of UK companies. Unlike their UK counterparts, shareholders of Chinese listed companies can decide the company's management policy and investment plan. The shareholders also examine and approve the company's plan for the distribution of profits and recovery of losses. In contrast, UK company law grants those decision-making powers exclusively within directors' authority.

The extensive power accorded to shareholders under the Company Law, is consistent

[110] Guidance for the Articles of Association of Listed Companies (2006) s 40 (11).
[111] Ibid, s 40 (12).
[112] Ibid, s 40 (13).
[113] Ibid, s 40 (14).
[114] Ibid, s 40 (15).
[115] Ibid, s 40 (16).

with the Government's desire not to relinquish ownership or lose ultimate control over companies. By assigning management authority to the board of directors, while holding majority of shares as a strong owner, the state can retain the significant level of control through exercising the extensive power as provided in company law.

6.3.2 Board of Directors

The Chinese company law follows closely the pattern of the German Model and adopts a two-tier board, in which a board of directors and a board of supervisors are mandated for listed companies. The purpose of a two-tier board is to create a clear distinction between the management and monitoring organs within a company. This section first deals with the board of directors. Directors are elected by, and responsible to, the shareholders' meeting.[116] The Chairman of the Board of Directors is designated as the *legal representative* of the company – a concept that does not exist in the UK company law, which imposes the legal liability of the company on a human agent. The power of the legal representative can be delegated but generally, he bears greater liability than other ordinary directors in a Chinese company or directors in the UK company. The board appoints General Managers, a role similar to an executive director in the UK, to decide on business matters related to the company. Their powers are as follows:

Table 6.3 The powers of the board of director

(1) Convening the meeting of the shareholders assembly, and reporting on its work to the board;[117]
(2) Implementing resolutions adopted by the shareholders; assembly;[118]

[116] CL 2005 s 47.

[117] CL 2005 s 47(1).

[118] CL 2005 s 47(2).

(3) Deciding on operational plans and investment plans;[119]

(4) Formulating the annual financial budget plan and final accounts plan;[120]

(5) Formulating plans for profit distribution and plans for making up losses;[121]

(6) Formulating plans for the increase or reduction of the registered capital and the issue of corporate bonds of the company;[122]

(7) Formulating plans for the merger, division, dissolution and transformation of the company;[123]

(8) Deciding the establishment of the internal administrative bodies of the company;[124]

(9) Deciding the appointment or dismissal of the manager of the company and the matters concerning his remuneration and, upon recommendation of the manager, deciding on the appointment or dismissal of the deputy manager(s) and persons in charge of the financial affairs of the company, and on the matters concerning their remuneration;[125]

(10) Deciding the basic management system of the company;[126]

(11) Formulating proposed amendments to the company's article of association;[127]

[119] CL 2005 s 47(3).
[120] CL 2005 s 47(4).
[121] CL 2005 s 47(5).
[122] CL 2005 s 47(6).
[123] CL 2005 s 47(7).
[124] CL 2005 s 47(8).
[125] CL 2005 s 47(9).
[126] CL 2005 s 47(10).
[127] Guidance for the Articles of Listed Company s 117 (12).

(12) Making proposals to the general shareholders' meeting as the hiring or replacement of an auditing firm;[128]

(13) Other functions and powers stipulated by the company's articles of association.[129]

Note: Based on the 2005 Company Law and the Guidance for the Articles of Association of Listed Companies

As seen above, the boards' function and powers are largely analogous to those in UK companies. As China adopts a continental law regime, CL 2005 does not recognize the concept of 'fiduciary duty'. In spite of this difference, the terms used to describe directors' duty such as 'fidelity and diligence' in Chinese company law bear resemblances to fiduciary duties of that in the UK.[130]

There are, however, some differences. A comparison between the power of the board of directors given by Table A in the UK and that of in the China shows that while both countries assign authority to the board of directors as the agent of shareholders to run the company, the Chinese approach is clearly more restrictive. Unsurprisingly, when the shareholders' meeting in Chinese listed companies is allocated more powers, of which some fall into the authority of directors in the UK, the scope of power of directors is narrowed down.

6.3.3 Supervisory Board

The supervisory board comprises representatives of employees and shareholders and has a minimum number of three. No less than one-third of members must be elected by employees, with the remainder elected by shareholders.[131] Managerial personnel

[128] Ibid, s 117 (14).
[129] CL 2005 s 47(11).
[130] CL 2005 s 148.
[131] CL 2005 s 53.

such as directors and managers are excluded from serving as supervisors.[132] The power of the supervisory board is as follows:

Table 6.4 The power of the board of supervisors

(1) Examining the financial affairs of the company; Examining and submitting the regular report prepared by the board of supervisors;[133]
(2) Supervising the acts of directors and senior managers in respect of the performance of their duties, and putting forward proposals for removal of directors or senior managers who violate laws, administrative regulations or the company's articles of association, or the resolutions adopted by the shareholders assembly;[134]
(3) Demanding directors or senior managers to rectify when their acts damage the interests of the company;[135]
(4) Proposing convening an interim meeting of shareholders and to convening and presiding over the meeting when the board of directors fails to perform the duty of convening and presiding over such meeting as provided for by this Law;[136]
(5) Submitting proposals to shareholders' meeting;[137]
(6) Bringing law suit against directors or senior managers in accordance with the provisions of Article 152;[138]
(7) Conducting investigation when irregularities in the company's management are found. When necessary, employing such professional institutions such as

[132] CL 2005 s 118.
[133] CL 2005 s 54(1).
[134] CL 2005 s 54(2).
[135] CL 2005 s 54(3).
[136] CL 2005 s 54(4).
[137] CL 2005 s 54(5).
[138] CL 2005 s 54(6).

accounting firms, law firms for assistance, the expense of which shall be borne by the company, and;[139]

(7) Exercising other functions and powers stipulated by the company's articles of association.[140]

Note: Based on the 2005 Company Law and the Guidance for the Articles of Association of Listed Companies

The role envisaged for the supervisory board is similar to that for non-executives suggested by the UK Corporate Governance Code.[141] In comparison with the UK board, the Chinese supervisory board is granted larger scope of power to monitor executives. Some power held by the Chinese supervisory board, such as convening shareholders' meeting, or submitting proposals in shareholders' meeting, are not given to UK non-executives.

However, just as the effectiveness of UK non-executives is often doubted, the Chinese supervisory board has been criticized as window-dressing. Although the supervisors seem to have extensive monitoring powers in law, there is a huge gap between the law and its implementation in practice in terms of the role of supervisory board. In practice, the effectiveness of the board is undermined by its composition.[142] The members of the supervisory board who are nominated by the board of directors and elected by shareholders are typically representatives of the dominant shareholder, or close friends to senior managers. They are reluctant to, and rarely do, speak against management.[143] Employee members of the supervisory board are even less effective, because they are dependent on management for their jobs and welfare. These difficulties make the actual monitoring role of the supervisory board much weaker

[139] Guidance for the Articles of Association of Listed Companies s 144 (8).

[140] Ibid.

[141] UK Corporate Governance Code A.4.

[142] Tan and Wang (n 21) 166.

[143] Jay Dahay Yusuf Karbhari Jason Zezong Xiao and Mei Yang, 'The Usefulness of the Supervisory Board Report in China' 11 Corporate Governance 2003.

than it is in law. As a theme of this thesis, we should note that, for China, the lack of sufficient board supervision makes more effective monitoring by institutions even more crucial.

6.3.4 The Extent of the Governance Problem in Chinese Listed Companies

As mentioned in section 6.1.4, the basic objectives of Chinese corporate governance are firstly, to address the shareholder-manager agency problem, and secondly, to prevent expropriation of minority shareholders by majority shareholders. We have now gained a general understanding of Chinese corporate governance framework. It is essential to ask here: does the framework achieve these aims? Unfortunately, a large body of evidence suggests that Chinese listed companies are far away from a sufficient governance standard.

As regards *manager misconduct*, many managers of Chinese listed companies are found to pursue their private interests by using the companies' assets. As described by the SSE' report, expropriation of shareholders by managers in Chinese listed companies including using company's resources for personal consumption, or developing personal connections by using companies' resource,[144] and using management buy out to transfer listed companies' assets to themselves.[145]

Moreover, managers sometimes bribe government officers to get deals authorized. Recent evidence shows that 106,000 Chinese officials were found guilty of bribery in 2006, worth more than 1 million RMB, an increase of 19% over the year.[146] Among

[144] For example, nepotism and appointing corporate staffs based on criterion of the manager' interest rather than the company's interest, see the footnote below.

[145] Shanghai Stock Exchange, *Gongsi Zhili Baogao [Corporate Governance Report]* (Fudan University Press, Shanghai 2003) (hereinafter SSE Report) 17, 18; and, Xi (n 10) 60; Also, Qiu (n 83) 316-322.

[146] BBC News, 'Corruption up Among China Government Officials' <http://news.bbc.co.uk/1/hi/world/asia-pacific/8448059.stm> accessed 19 January 2010.

those officials, many are senior executive which are investigated or have been convicted as guilty of bribery or other crimes. The notorious one in China is the former head of oil giant Sinopect, Chen Tonghai. He was sentenced to death in 2009 for taking nearly RMB 240 million in bribe.[147]

The *majority-minority* shareholder problem is perhaps even more pressing, as the scale and magnitude of expropriation by controlling shareholders exceeds that of managers' expropriation.[148] Meanwhile, where the State acts as the controlling shareholder, the way it pursues its own interests differs compared to where managers do so. In China, the State has multiple strategic goals, of which many are social and political that need not coincide with those of other investors in the company. For example, a major objective of the Communist Party of China (CPC) – the ruling party, has been to maintain 'social stability' or today's 'harmony society' by maintaining social equity, ensuring full employment and refraining from taking such profit enhancing measures as asset divestiture and job cuts.[149]

In pursuit of these interests, the State could exert political control through several channels. The f*irst* and *perhaps most dangerous one is* the method of making rules in favor of itself, in other words, it could potentially legitimate its expropriating behaviors or political interests since the State serves a dual role as major shareholder and regulator.[150] It has been noted that during the legislative process for the Securities Law in the early 1990s, members of the NPC had involved in and brought in a number of diverse voices based on political considerations.[151] As a result, the 1998 Securities Law was very concerned about outside speculators, but rather relaxed about

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[147] Ibid. Chentonghai's sentence has been suspended for two years, which suggests it might be commuted to life jail.

[148] For a good discussion of minority shareholder protection in Chinese listed companies, see R Tomasic and N Andrews, 'Minority Shareholder Protection in China's Top 100 Listed Companies' (2007) 9 Australia Journal of Asian Law 88.

[149] S Yiyi, X Dean and P P H, 'Principle-principle Conflict in the Governance of the Chinese Public Companies' (2008) 4 Management and Organizaiton Review 17, 19.

[150] SSE Report (n 145) 14.

[151] B Naughton, 'The Politics of the Stock Market' (2002) 3 Chinese Leadership Monitor , 9.

the problems of CCP or government control of an enterprise.[152]

Section 19 of CL 2005 could also serve a prime example to suggest that CPC is justified to play an important part in the governance of Chinese companies.

> 'An organization of the Chinese Communist Party shall, according to the Charter of the Chinese Communist Party, be established in the company to carry out activities of the Chinese Communist Party. And the company shall provide necessary conditions for the activities of the Chinese Communist Party'.

Moreover, as we already seen, company law grants wide ranging decision-making powers to the shareholders' meeting. By doing so, the State's control over companies is guaranteed by its majority position in shareholders' meeting. It is also found without a clear division of these roles, the State can make economic decisions in 'administrative-order nature.'[153]

Hence, although China has announced its intention to march towards a 'socialist rule-of-law state' for many years, it appears that law is still sometimes seen as a means to serve the interests of political ends, at least in the corporate governance context as discussed above.[154]

Second, the managerial personnel in listed companies are largely appointed by the controlling shareholder. A majority of board seats in most listed companies are held by state representatives appointed by the largest shareholders and therefore, unsurprisingly, financial institutions and individual investors play only a relatively minor role in the selection of directors.[155] The senior managers on the board, such as the chairman or General Manager, are often also serving as he Secretary of the Party

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[152] Ibid.

[153] SSE Report (n 145) 14.

[154] R Peerenboon, China's Long March toward Rule of Law (Cambridge University Press, New York 2002) 1.

[155] S Yiyi, X Dean and P P H (n 149) 19.

Committee within listed companies.[156] The manager appointed by the State to exert its control refers to so-called 'key person' who is often the CEO, the chairman or a senior executive manager of the company.[157] The key person has significant *de facto* control rights over both strategic planning and management. With strong Government involvement, these state-related directors are educated to interpret their fiduciary duties in the light of the state.[158] In cases if there were a conflicts of interest between the pubic and the private investors, it is perhaps not surprising that he is likely to prefer the state's interests.

The criteria to select managers are often decided not by their financial performance but their connections with government.[159] People with good connections with government are more likely to gain a competitive position. This practice, commonly referred to as 'guanxi', has been deeply rooted in Chinese culture for centuries and plays a central role in business as well as other aspect of social life.[160] As a result, it seems hard to align managers' incentives with companies' performance, which in turn, is the most important concern of minority shareholders. This problem only can be mitigated if more shareholders are allowed to have a say on appointment. (*Or* if managers were appointed by the state based on companies' financial performance.)

Given the above potential conflicts, there are voluminous documented cases where the controlling shareholders have engaged in the expropriation, or so-called 'tunneling'.[161] An early study by the SZSE revealed that, as at 30 June 2001, expropriations by controlling shareholders or related enterprises has been found in 95

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[156] Tomasic and Fu, 'Legal Regulation and Corporate Governance in China's Top 100 Listed Companies' (n 95) 6.

[157] Tan and Wang (n 21) 150.

[158] S Yiyi, X Dean and P P H (n 149) 20.

[159] SSE Report (n 145) 14.

[160] I will discuss Chinese culture and associated issue of 'guanxi' in Chapter 9.2.2.2.3.

[161] As summarized by Tenev, Zhang and Brefort, tunneling in China may take three forms: First, soft loans from listed companies on a long-term basis, secondly, the use of listed companies as guarantors to borrow money from banks, and thirdly, widespread of use of related-party transaction, for example, the large shareholders sell assets to listed companies at an unfair price. See ibid. (n 26) 101.

listed companies among the 516 companies listed on Shenzhen Stock Exchange, with an average misused assets of RMB 0.16 billion.[162]

6.3.5 The Role of Institutional Shareholders

Given the weaknesses in the governance mechanisms described above, what role can institutional shareholders play to improve matters?

As to the manager-shareholder agency problem, this section will not give a further discussion here, as Chapter 1 has described shareholder activism as a link in a web of constraints on managers and discussed potential benefits of such activism. The potential for shareholder activism to mitigate those problems applies here (although, of course, working out how best it can do so in China requires much further analysis, as later chapters develop). In the above section, we have seen that the more pressing hazard in Chinese listed companies is the expropriation of minority shareholders by majority shareholders due to the concentrated share-ownership. Hence, the unique and perhaps currently more urgent role of institutional shareholders in Chinese listed companies is to hold majority shareholders accountable to minority shareholders.

How can institutional shareholder engagement work to alleviate the majority-minority agency problem in Chinese listed companies? *Firstly*, institutional shareholders can play a catalytic role in activating the use of various corporate governance mechanisms already established in the Chinese regulatory framework.[163] In the above parts, we have seen that a variety of monitoring mechanisms are established in the Chinese framework to ensure the independence of companies from controlling shareholders. However, the effectiveness of those mechanisms, such as board of directors and disclosure, depends clearly on parties having enough incentives to use them. Otherwise, they are likely to remain decorations without real functions. Institutional

[162] He Jianliang 'Lun Shangshi gongsi de Guanlianjiao jiqi jianguan'[Related-party Transaction in Listed Companies], *Securities Market News*, 2002.

[163] Tenev, Zhang and Brefort, (n 26) 160; Also, Mako and Zhang (n 19) 13.

shareholders are expected to make active use of the shareholders' legal rights to ensure these mechanisms work for the benefit of shareholders at a whole, and in the process provide some protection to other minority shareholders. For example, they could elect the directors who represent the minority shareholders' interests. Their participation will require increased transparency and disclosure. While the regulatory framework encourages companies to adopt, for example, a cumulative voting system to empower minority shareholders, such system is merely a formality if institutional shareholders do not make use of it.

Secondly, institutional shareholders will enforce good corporate governance as a way of replacing direct regulatory control from the State. Given the limitations imposed by the dual role played by the state, the Government will have to gradually decrease its regulatory and political control over listed companies, while in the meantime, strengthening market forces as a discipline over companies.

In that process, the institutional shareholder is a key to develop a market that expects, demands, and rewards good corporate governance practice. Institutional investors have direct economic interests in the companies in which they invest, owing relatively large and sophisticated management teams, which all make them likely to become sanction power when the State's direct intervene reduces. The State can then enhance its regulation over institutional investors, such as internal governance structure, adequate disclosure, voting policies, as an indirect method to control listed companies sector. This point will be discussed in greater details in Chapter 10.[164] In this regard, institutional shareholder engagement is also a means to enhance the regulatory capacity of the Government.

The above discussion on the benefits of institutional shareholders rests largely on their having sufficient ability and power to exercise shareholders' rights. In Chapter 7, one will see that the group of institutional shareholders has become the largest group of equity holders in the Chinese tradable-share markets. With on-going non-tradable

[164] See Chapter 10.2.2

share reform, institutional shareholders are likely to become still more powerful to counterbalance majority shareholders and bring benefits to the development of corporate governance in the future.

6.4 Conclusion

This chapter has provided an overview of the corporate governance framework in China. It examined some relevant aspects of listed companies, reviewed the Chinese company regulatory framework, explored the extent of the governance problem and discussed the role of institutional shareholders in the framework.

By way of conclusion, it is desirable to draw some points from the above discussion to assess the bearing of corporate governance system on institutional shareholders activism. First, the dominance of the State as shareholder is likely to become the main hurdle to institutional shareholder activism. It holds a controlling block of stakes in listed companies which often enable it to determine corporate affairs without the participation of other non-state investors. Institutional shareholders' ability to discipline companies is therefore significantly weakened. Consequently, they are less likely to overcome the free-riding and have fewer incentives to engage in investee companies than the UK counterparts. This thesis will return to this point in Chapter 9 and 10.

Secondly, corporate governance has become a concept that has increasingly engaged the minds of corporate regulators and stock exchanges in China. We have seen many regulations and mechanisms are in place to promote managerial accountability and to protect the interests of minority shareholders. However, the serious extent of both managerial malfeasance and expropriation by majority shareholders in listed companies cast doubt on whether these mechanisms are more than symbolic.

Thirdly, the thesis argued that the future development of Chinese corporate governance will to some extent rely on institutional shareholder engagement. It is

because firstly, institutional shareholders will play a catalytic role in activating the use of various corporate governance mechanisms that already established in regulations, and secondly, they are needed to enforce good governance to reduce the direct regulatory control of the Government.

The role of institutional shareholders mentioned above will become yet more important when non-tradable share reform releases state-owned non-tradable shares to the market. The reduced state stakes are likely to fall into the hands of institutional investors and lead to an increase in the level of institutional shareholding in Chinese listed companies. The following Chapter 7 turns to present an overview of the institutional landscape in China.

Chapter 7 The Landscape of Institutional Investment

Before proceeding to the discussion of Chinese institutional investment, a point must be emphasized here. Some institutions introduced in the UK part – including industry trade associations, securities lending participants and proxy voting services – do not exist at all, or to anything like the same extent – in China. The thesis therefore focuses on the major types of institutional shareholders themselves.

This chapter is structured as follows. Section 7.1 briefly describes the recent growth of institutional investment to demonstrate institutions' ability and power to affect corporate governance. Sections 7.2, 7.3, 7.4 and 7.5 survey the major types of financial institution in China, namely, securities investment funds, insurance companies, pension funds and Qualified Foreign Institutional Investors. Each section investigates the historical development of those institutions, their structural organization and legal or institutional arrangement, followed by a discussion on their further growth potential. Section 7.6 concludes.

7.1 The Growth of Institutional Investment

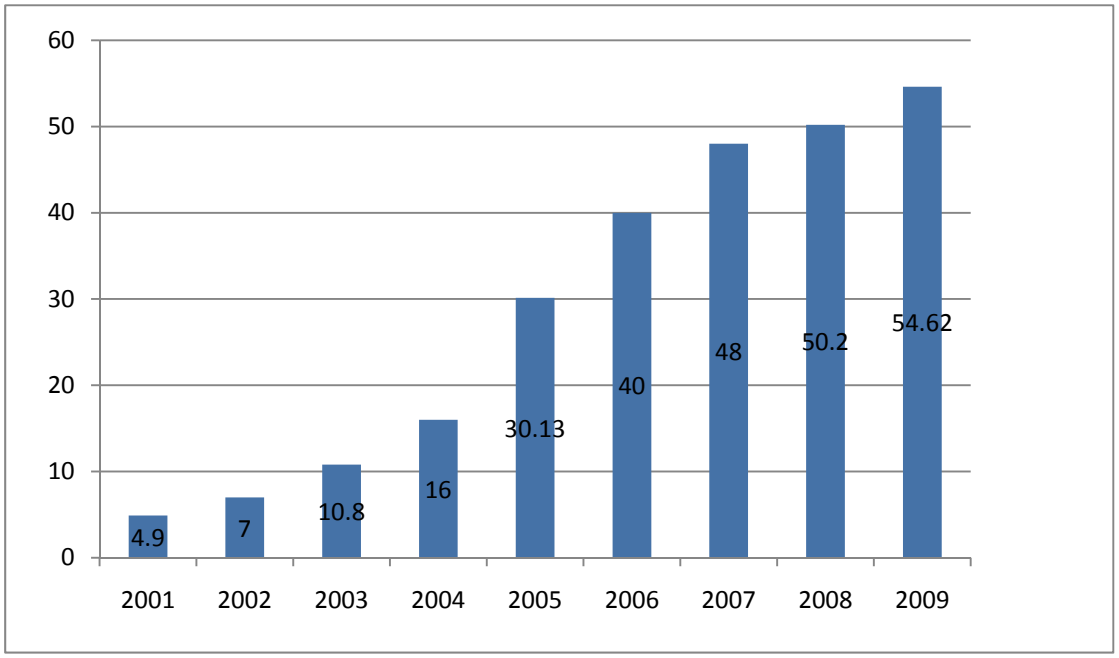
The increase of Chinese institutional investment gathered pace from the year of 2001. Figure 7.1 shows a sizeable increase over 2001-2007 from approximately 5% to nearly 30% in 6 years. This change was mainly associated with two factors: (1) the Government's facilitation of development of investment funds; and (2) non-tradable shares are gradually transferred to tradable shares since 2005. This trend continues and at the end of 2009, institutional shareholding account for more than 50% of total tradable shares.[1] (However, as one will see in Chapter 8, institutional ownership still only accounts for a minority portion of the total equity in Chinese listed companies.[2])

[1] Vice-president of the CSRC, Yaogang reported at 'The Eighth Chinese Securities Investment Funds International Forum ', cited in Hong Kong Wenhui News (3 December 2009) in Chinese < http://paper.wenweipo.com/2009/12/03/FI0912030025.htm> accessed 20 December 2009.

[2] See Chapter 8.1.2.

With the on-going non-tradable share reform, it is reasonable to predict that institutional investment will further grow in importance in the near future.

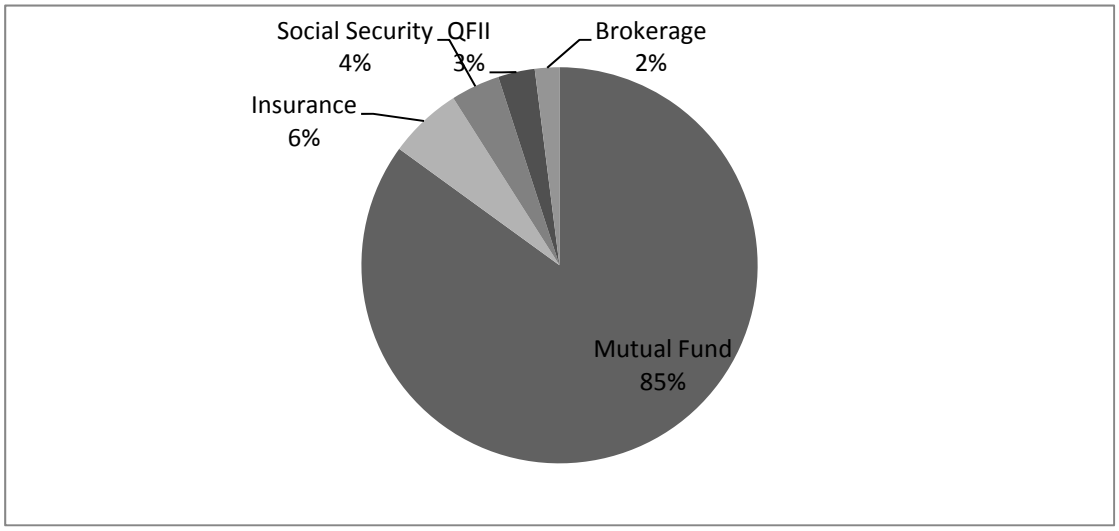
Figure 7.1 The percentage of tradable shares in Chinese publicly listed companies owned by institutional shareholders, over 2001-2009



Source: Data drawn from the CSRC <http://www.csrc.gov.cn/pub/newsite/sjtj/ > accessed 12 January 2010.

The key institutional shareholders in China comprise of securities investment funds, insurance companies, pension funds, qualified foreign institutional investors. The composition of institutional investors is shown in Figure 7.2.

Figure 7.2 Composition of institutional investors in China, by Market Capitalization



Source: Wind Data quoted in Y Kang, L Shi and E D Brown,'Chinese Corporate Governance-History and Institutional Framework' (RAND Corporation, Santa Monica 2008)

Comparatively, the Chinese institutional market differs sharply from the UK in the much greater presence of mutual funds.[3] In China, mutual funds are the largest participants, with 85% of total institutional shares. This compares with approximately 11% in the UK.[4] Pension funds and insurance companies only account for a small portion (around 10%), compared to 70% in the UK. This difference mainly results from China's undeveloped insurance and pension markets and the Governments' strict restriction on portfolio investment.[5]

The composition of institutional investors has significant *bearing on the level* of institutional shareholder engagement in a country. As I have observed in Chapter 4, long-term institutions, such as pension funds and insurance companies have more incentives for engagement because it is easier for them to overcome free-riding, and generates greater benefits. Thus, the activism model established in Chapter 1 would predict that the smaller presence of long-term institutional investors should lead to *a lower level* of engagement in China. As we shall see below, empirical evidence

[3] See UK part, Chapter 3.1.

[4] See Chapter 3.1, Table 3.1.

[5] See discussion in section 7.3 and Chapter 9.1.1.1.

confirms this prediction.

In essence, the function and structure of Chinese institutional investors are akin to their UK counterparts. They are performing as financial agencies on behalf of individuals to diversify investment risk and increase return. However, they are shaped by China's unique economic system and are in significant ways unlike UK counterparts. Understanding the characteristics of institutions is crucial to understanding the strategies they adopt in corporate governance. The following will survey each type of Chinese institution in detail.

7.2 Securities Investment Funds

Mutual funds or so-called securities investment funds (SIF) represent the largest group of institutional investor in the stock market. There were in total 621 securities investment funds, with assets of RMB 2,676 billion (roughly £267.6 billion) by the end of 2009.[6] SIFs' holdings accounted for 14.85% of the Chinese A-share market.[7] By virtue of their large presence, SIFs are the major participants in institutional shareholder activism.

Compared with the UK's mutual fund industry which started in the mid-19th century, China's fund industry is quite young, with less than two decades existence. The birth of China's fund industry took place soon after the establishment of stock exchanges in the early 1990s. Despite this late start, with the rapid expansion of the Chinese stock market, the industry has since grown at an impressive pace and emerged as a significant investment tool for investors in the stock market. Generally, the industry has developed in two stages divided by the promulgation of the first regulation on the

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[6] China Galaxy Securities Research, 'Report on China's Securities Investment Funds in 2009', 6 (in Chinese) <http://www.Chinastock.com.cn/research/ResearchHYYJ.shtml> accessed 19 January 2010. China Galaxy Securities Research is a lead securities research institute in China which was founded in 2000.

[7] Ibid.

industry in 1997.[8]

7.2.1 Historic Development of SIF

The first two security investment funds in China, the Shenzhen Nanshan Risk Investment Fund and the Wuhan Securities Investment Fund, were found in October 1991, marking the beginning of the fund industry.[9] Since then, investment funds surged. Those funds established before 1997 were operated in an absence of regulation and thus were referred to as 'old funds' as opposed to the 'standards investment fund' established after the law was promulgated.[10]

At the first stage, these old funds prospered under the desire of capital markets and the facilitation of the Government. By the end of 1997, there were 75 old funds with more than 5.8 billion RMB in net asset value and 10 billion RMB in market value.[11] Most of those funds were established as close-end funds and invested in real estate, industrial projects as well as securities. The supervisory authority at that time was the People's Bank of China (PBOC).

The rapid growth of Chinese securities funds was at the cost of being ahead of the legislative and regulatory framework. The industry lacked a standardized national regulation as well as a centralized supervising authority, resulting in many high-profile problems within these old funds which hampered its innovation and further development.[12] For example, the structure of those old funds was far from

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[8] Provisional Measures for the Administration of Securities Investment Funds，issued by the CSRC on November 1997, and abolished on October 2004.

[9] Z Yin, 'Wo Guo Zhengquan Touzi Jijin de Fazhan Lichen HuiGu [The Historic Development of Chinese Securities Investment Funds]' (2008) 10 Yinhangjia [The Banker] 24.

[10] See (n 8).

[11] Yin (n 9).

[12] T Tao, 'Burgeoning Securities Investment Fund Industry in China: Its Development and Regulation' (1999) 13 Columbia Journal of Asian Law 203, 211; Also Zhongguo Jijinye Lishi Huigu Yu Fazhan Sikao [History of China's Fund industry and a Discussion of its Development], Zhongguo Zhengquan Bao [China Securities] (4 December 2004).

standard. Designed to reduce investment risk, a standardized investment fund should have a manager, who is responsible for managing fund assets, and a fund trustee who keep the assets safe. The manager and trustee should be mutually independent. However, it was not unusual for the role of fund manager and fund trustee to be performed by the same company or agency. In some cases, old funds even had one company or organization to act as fund promoter, fund manager and fund trustee.[13] Therefore, national legislation was urgently needed.

The first national regulation was issued by the CSRC in 1997: the *Provisional Measures for the Administration of Securities Investment Funds* (Provisional Measures),[14] signaling the beginning of the second stage of Chinese fund industry. Funds incorporated after the promulgation of the Provisional Measures are generally known as 'new funds'.

The following years witnessed significant steps towards the development of the fund industry. At the initial development stage of China's securities market, market misconducts were rampant partly because of the small presence of institutional investors. Hence, right from the beginning, Chinese regulators had placed many efforts to facilitate the development of fund management industry as a tool to curb price manipulations. On the one hand, regulators began to restructure old funds to new funds. On the other hand, it adopted a series of measures to nurture new funds, which were still in their infant stage. For example, it allocated 20% of all new-issued SOEs' shares to fund management companies.[15] New, regulated funds have been established and old funds restructured and consolidated under the instruction of the Government. By April 2001, all old funds had been successfully restructured into 25 standardized new SIFs.[16] With the approval of the CSRC, Shanghai-based Hua'an Fund Management Company launched the country's first open-end fund, marking the

[13] Tao, ibid.

[14] See (n 8)

[15] T T Xiaohu, *Fund Management in China* (China Knowledge Press 2005) 16.

[16] Ibid.

arrival of a new era of the development of the SIFs industry.[17] The creation of open-end funds marked a great change to the structure of investors in the securities market, and attracted a large number of stable, long-term investors. Since then, few new close-end funds have been established and existing close-end funds started to transform into open-end funds. By the end of 2009, only 31 SIFs were organized as close-end funds, accounting for 4.63% of total funds assets, with the remaining 590 SIFs established as open-ended funds.[18] Meanwhile, a greater variety of SIFs have emerged, for example, bond funds, index funds, guaranteed funds and balanced funds.

Given this fast rate of growth in the SIFs market, it is imperative to put in place an adequate legal and regulatory framework. As a result, on October 28, 2003, the *Securities Investment Fund Law* (Fund Law), which draft took four years and seven months to complete, was finally passed in the fifth session of the Standing Committee of the Tenth National People's Congress. Currently, the Fund Law is at the core of China's legal framework for SIFs. It stipulates the provisions with regard to fund managers, custodians, the investment activities of funds, subscription and redemption of funds, information disclosure, rights and interests of fund holders, supervision and administration of funds, and legal liabilities. Moreover, the CSRC also issued many regulations and rules to supplement and clarify the Fund Law. Examples include (1) Circular on Issues concerning Warrant Investment by Securities Investment Funds in the Split Share Structure Reform, (issued in 2005); and (2) Provisional Code of Corporate Governance for Securities Investment Fund Management Company, (issued in 2006).

With the facilitation of the Government and also fuelled by the demands of securities market, after nearly ten years' huge expansion in the number and types of funds, securities funds are now the largest kind of institutional investor in China's stock market. It is also perhaps one of the fastest growing businesses in the world, which

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[17] Ibid.

[18] China Galaxy Securities Research (n 6) 5.

increased more than 80 times from 1997 to 2008.

The following part turns to discuss SIFs' structural arrangements according to the Fund Law. There are important to the understanding of shareholder activism, for conflicts of interest among different funds' participants affect funds' incentive for involvement.

7.2.2 Fund Structure

7.2.2.1 Fund Management Company

Under the Fund Law, only fund management companies approved by the CSRC may establish a SIF. In order to make the young fund management industry develop safely, the Government is taking a cautious attitude by setting out strict thresholds for the participation in this industry. For example, the company must have a registered capital of at least RMB 100 million.[19] It must have a principal or key Chinese shareholder with the highest stake in the company, who must have at least RMB 300 million registered capital.[20] This principal shareholder may be a securities company, a securities investment consultant, a trust management company or other financial institution approved by CSRC.

Following China's accession to the WTO in December 2001, foreign participation in the fund management company is allowed. Specifically, the *Establishment of Fund Management Companies with Foreign Equity Participation Rules* (Foreign Rules)[21] has set out some requirements applying to foreign shareholders in joint venture fund management companies. First, foreign investors cannot hold more than 49% stakes in a fund management company, which is in line with anticipated higher limit under

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[19] Fund Law s 13 (2).

[20] Fund Law s 13 (3).

[21] Establishment of Fund Management Companies with Foreign Equity Participation Rules, issued by the CSRC on June 2002 and took into effect in July 2002.

China's commitment to WTO.[22]

Second, the foreign shareholder must be a financial institution with experience in asset management. It must have a registered capital of at least RMB 300 million and its country must have established channels of cooperation with the CSRC.[23]

China's booming fund industry is attracting foreign investors to take part in the local business. By the end of 2009, there were 60 fund management companies, with 34 of them having the participation of foreign investors.[24] The industry is concentrated, with 49.74% of funds assets controlled in the hands of top 10 companies.[25] The assets managed by the largest company, Huaxia, account for 9.93% of total assets.[26]

7.2.2.2 Fund Manager, Fund Custodian and Fund Unit Holders

Fund manager, fund custodian and fund unit holders are three most important players involved within a SIF. The role of fund manager in China is somewhat akin to the UK counterpart. Their responsibilities are to raise the fund, handle the offering, subscription, redemption and registration of fund shares, and establish funds investment portfolio and strategies.[27] Fund managers are required to be appointed by the fund management companies and must obtain qualification to engage in the fund industry.

Commercial banks licensed by the CSRC may act as fund custodians. Similar to their UK counterparts, fund custodians are responsible for safeguarding the security of fund assets, opening and maintaining bank accounts, and handling the clearing and settlement of investment orders of the fund manager pursuant to the stipulations of

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[22] Foreign Rules s 8.

[23] Ibid, s 6 (3).

[24] China Galaxy Securities Research (n 6) 5.

[25] Ibid.

[26] Ibid.

[27] Fund Law s 19.

fund contracts.[28] Fund custodians must also supervise fund manager's investment behaviors and prevent the manager from infringing the fund unit holders' interests. For example, fund custodians must report to the CSRC if they found fund managers' behaviors violate the law or the terms of a fund contract. By the end of 2009, there are 14 commercial banks acting as custodians for investment funds. 91.57% of funds assets are handled by five state-owned commercial banks – the Bank of China, the China Construction Bank, the Agricultural Bank of China, the Industrial and Commercial Bank of China and Bank of Communications.[29]

Fund unit holders are the ultimate owners of fund assets and therefore, the Fund Law gives their interests high priority. For example, unit holders who separately or in aggregate constitute more than 10% of the fund's total shares may convene a general unit holders' meeting to decide funds matters. Fund units are authorized to sue fund managers and/or custodians whey they are in breach of their duties.

7.3 Insurance Companies

Insurance companies form the second largest group of institutional shareholder in the Chinese securities market although its size is sharply smaller than SIFs. The insurance market consists of the non-life, and the life, insurance sector. As of September 2009, China had 120 insurance companies.[30] The industry is concentrated in the hands of relatively few big insurance companies. For example, the largest life insurance company in China – China Life Insurance – has about a 35% share of the life insurance market. The insurance assets company it owns is also one of the largest institutional investors in China.

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[28] Fund Law s 26.

[29] China Galaxy Securities Research (n 6) 6

[30] W Dingfu, 'Xin Zhongguo Baoxianye Fazhan bolanzhuangkuo 60 Nian [The developement of insurance industry in the past 60 years]' (2009) China Insurance News <http://business.sohu.com/20090923/n266934430.shtml> accessed December 23 2009.

7.3.1 The Development of Insurance Market

China's insurance industry started in the late 1970s when economic system reform began. The Insurance Law of 1995 (Section 104) states that insurance company assets may be invested only in safe investment instruments, such as bank deposits, government and financial bonds, and other assets approved by the State Council. At the end of 1999, insurance companies were permitted to indirectly invest in equities up to 15% of their total asset through SIFs. [31] Thus, every expansion of permissible investments required a new authorization from the Government. Since returns from equity investment were more often profitable than that from conservative investment channels, many insurance companies soon became large holders of SIFs. As of 2002, the investment amount of insurance companies in securities market through SIFs reached RMB 31.2 billion, accounting for 21.98% of total value of the publicly offered SIFs.[32] Nearly 25% of the tradable shares market in China at that time were (indirectly, through SIFs) in the hands of insurance companies. The investment in SIFs by insurance companies accounted for 13% of their overall investment portfolio, up from 2% in 1999.[33]

As a result of rapid asset expansion and increasing demand for access to securities market, insurance companies were allowed to invest directly in the securities market and manage their own investment portfolio since 2004, subject to a maximum 10% of

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[31] According to Interim Measure on Administration of Insurance Company's Investment in Securities Investment Funds, the upper limit of each insurance company have to approved by the China Insurance Regulatory Committee. Generally, the investment subject to 5% to 15% of the total assets of the insurance company. See D Zhimin, *Zhengquan Shichang Jigou Touzizhe Guifanhua Fazhan Yanjiu [On the normal development of institutional investors in China' securities market]* (Zhejiang Daxue (Zhejiang University), Hangzhou 2008), 20.

[32] E Sekine, 'China's Insurance Companies Step Up Outbound Portfolio Investment' (2007) 10 Nomura Capital Market Review 41, 46.

[33] Ibid.

total assets investment limit.[34] More recently, the newly issued Provisional Measures on Administration of Operation of Insurance Capital by the China Insurance Regulatory Committee (CIRC)[35] on August 5, 2010, which came into effect on August 31, 2010, raised the cap to 20%.[36] Meanwhile, the practice of indirectly investing in stock through SIFs remains and thus, the amount of shares held by insurance companies in the total institutional investment shall be much larger than suggested (6%) in Table 7.2.

Over the past decade, the Chinese insurance industry has experienced rapid expansion. As of end 2009, the total assets of insurance companies have reached RMB 4000 billion, up nearly 25% over 2008.[37] The profits generated in the past year reached RMB 53.06 billion.[38] Investments have become more diversified, in step with gradual lifting of restrictions on investments in securities market and real estate. Bank deposits and government bonds have accounted for a declining share of these investments, while asset allocations on securities have been increasing.

Despite that trend, in comparison with UK insurance companies where a large portion of assets are allocated to stocks, Chinese insurance companies invest the majority of their assets in safe vehicles such as government bonds. At end-November 2006, 33.2% of assets were held in bank deposits, while cumulative amount of stock acquired account for only 4.59%.[39] As of September 2009, bonds investment alone accounted

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[34] Provisional Measures for the Administration of Stock Investment by Insurance Institutional Investors, jointly issued by the CSRC and China Insurance Regulatory Commission on October 24, 2004.

[35] The CIRC will be introduced in section 7.2.2 below.

[36] Provisional Measures on Administration of Operation of Insurance Capital s 16 (4).

[37] Xinhua, '2009 Nian Baoxian Gongsi Lirun Zonge dadao 530.6Yi Yuan [The Total Profits has reached RMB 53.06 billion]' *Xinhua News* (21January 2010) <http://news.xinhuanet.com/fortune/2010-01/21/content_12848126.htm> accessed 24January 2010.

[38] Ibid.

[39] E Sekine, see (n 32).

for 50.6%.[40] Moreover, in developed countries like the UK and US, insurance companies are one of the most important long-term investors in capital markets. In the UK, as pointed out earlier, insurance assets represented nearly 17% of total assets of securities market.

In spite of the huge differences above, the potential growth for insurance companies is enormous. Further relaxing on investment, together with increasing demands from the market, will promote insurance companies to become an important equity holder as well a major participant in corporate governance.

7.3.2 Regulatory Framework for Insurance Companies

Chinese insurance companies are governed by Insurance Law, which was promulgated in 1995 and recently revised in 2009. The law lays down the regulatory principles and operation framework for the insurance industry. It covers insurance contracts, incorporation, investment and supervision of insurance companies. The registered capital requirement for establishing insurance companies is double that of fund management company, where it must have a registered capital of RMB 200 million.[41] The law stipulates that the investment scope of insurance companies' assets includes listed stocks, real estate, government bonds, bank deposits and other channels laid down by the insurance regulator, and that the assets allocation of insurance companies portfolios should follow the relevant requirements of the regulator.[42]

Under the Chinese policy of 'separate business, separate regulation', insurance companies are regulated by different organ from SIFs. Currently, CIRC is the

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[40] Xinhua, 'Chinese insurance regulator stresses supervision on insurance investment ' *Xinhua News* (16 November 2009) <http://news.xinhuanet.com/english/2009-11/16/content_12463912.htm> accessed 24 January 2010.

[41] Insurance Law s 68.

[42] Insurance Law s 106.

regulatory and supervisory institution for the insurance industry. CIRC was established on November 1998 as a ministerial institution directly under the State Council. The Insurance Law entitles a number of regulatory authorities to the CIRC, for example, the right to supervise the insurance market, to make qualification requirements for the senior managers of insurance companies, and to grant approval for insurance agencies.[43] As we have seen in section 7.2.1, regulations that relaxed insurance companies' equity investment limits were all made by the CIRC.

7.4 Pension Funds

Apart from SIFs and insurance companies, the major institutional fund source comes from certain parts of the Chinese pension fund system. That system is relatively complex. It is composed of a number of separate so-called 'Pillars'.[44] To understand these, and their implications for institutional investment, it is necessary to provide a brief introduction of Chinese pension system since it differs substantially from the UK counterpart.

China's pension system was initially established in 1951 and has undergone significant reforms in the past several decades. China had, until the late 1980s, maintained an urban-and state-owned enterprise-based Pay-As-You-Go (PAYG) pension system. At that time, the pension system was part of 'iron rice bowl' – pensions were directly provided by SOEs, supported by fiscal subsidy.[45] 1997 is the benchmark year for China's pension system in which a new unified three-pillar

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[43] Insurance Law s 120.

[44] The Multi-Pillar pension system only provides funding for urban workers. Rural residents are covered by separate rural pension system, or the Minimum Life Security System. They are unfunded program and thus, will not be discussed in the thesis.

[45] China Ministry of Human Resources and Social Security (MHRSS) 'China's Old-age Insurance System and Review of its Reform' (2009) <http://www.mohrss.gov.cn/Desktop.aspx?path=Desktop.aspx?PATH=/sy/ZYYLBXZT/ZYYLBXZT_infoView&gid=d926b73d-5ab8-400d-8a51-eb72a9d68195&tid=Cms_Info> accessed 10 May 2010.

pension system was set up broadly in line with the recommendation of World Bank.[46] The new system aimed to establish a multiple-pillar scheme combining social pooling and individual accounts, where the Government, employers and employees all share the burden of providing an individual retirement security. The framework of this system was issued by the State Council in Documents 26, 'Decision on Developing Unified Basic Old Age Pension System for Enterprise Employees'.[47]

Basically, the pension system has three-pillars. They are (1) Pillar I, comprised of 2 tiers, namely – tier 1: a basic pension or defined benefits PAYG pillar, financed entirely by enterprise contributors; and tier 2: a mandatory, defined-contribution individual system funded by employees contributing 8% of their monthly income; (2) Pillar II: a voluntary or supplementary defined contribution system set up by eligible employers, also known as 'Enterprise Annuities' (EAs) or corporate pension funds (CPFs); and (3) Pillar III: voluntary schemes which managed by private companies or insurance companies, for employers whose size cannot justify the enterprise annuity format.[48]

Table 7.1 Summary of the Multi-Pillar System

	Contributions	**Benefits**
Pillar I (Tier 1)	Mandatory Employer contribution of 20% of employee's wages (max 300% min 60% of provincial wages).	35% of average monthly income (after 15 years of employment)

[46] S Leckie and N Pan, 'A Review of the National Social Security Fund in China ' (2007) 12 Pensions: An International Journal 89, 91.

[47] The State Council's Document No. 26: 'Decision on Developing Unified Basic Old Age Pension System for Enterprise Employees , promulgated in 1997.

[48] Y Kim, I S M Ho and M S Giles, 'Developing Institutional Investors in People's Republic of China' (2003) World Bank Country Study Paper, 8.

Pillar I (Tier 2)	Mandatory employee contribution of 8% of monthly income	Target replacement rate of 24% of average monthly income
Pillar II (EA) (or Corporate Pension Fund)	Voluntary contributions by employers and employees	Individual account
Pillar III	Voluntary contributions by employees	Individual account

Source: F Salditt, P Whiteford and W Adema, 'Pension Reform in China: Progress and Prospects' (2007) *OECD Social, Employment and Migration Working Papers*.

Although China has set up a multi-pillar pension system, in many less-developed provinces, cities and counties, the social securities system is not adequate. In the meantime, the severe aging population has increased the burden of the pension system. There is an urgent need for the Government's support and the National Social Security Fund (NSSF) was therefore established in 2000 as a complementary vehicle to support the social security system in China. The NSSF does not form part of the above state pension pool but work as a back-up reserve fund, or '*fund of last resort*' to cover unfunded liabilities in the PAYG system. It aims to install a national long-term reserve fund to offset the gap between the pension system's expenses and the future demands of China's rapidly aging population. The fund is not ready to make any major expenditure in the medium term.[49]

So far, although Chinese pension system consists of three Pillars, the operation of Pillar I and Pillar III are limited to conservative investment tools, such as government bonds. Only CPFs (Pillar II) and the NSSF are permitted to invest assets in stock market subject to some upper limits and only these two of them will be included as institutional shareholders in the thesis.

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[49] NSSF reports that expenditures are not foreseen for the next 15-20 years until 2025-30. <http://www.ssf.gov.cn/zyjh/ldjhhbg/> accessed 12 December 2009.

7.4.1 Corporate pension fund (CPF) (Pillar II)

The CPF was first introduced in the 1990s when the Government started to reform the old pension system towards the multi-pillar model as I described above.[50] However, it was not until 2004 that this term was formally endorsed in regulations. In 2004, the Ministry of Labor and Social Security (MLSS) released: (1) *Interim Measures for Enterprise Annuities* (IMEA); and (2) *Interim Measure for the Management of Enterprise Annuities Fund* (IMMEA),[51] with the purpose of consolidating the Chinese CPF markets and enhancing supervision.

Under the IMEA, the CPF has to be run under a trust model.[52] The plan trustee (which can be company internal trustee or a third party professional trustee) appoints other CPF service providers – plan administrator, custodian and investment manager approved by the MoLSS.

The IMMEA impose quantitative limits on the investment of CPFs, such as assets allocation, portfolio requirement. For example, investment in government bonds alone shall not drop below 20% of net assets.[53] The maximum investment in stocks is limited to no more than 20% of net assets.[54] The thesis will return to these limits in Chapter 9.1.1.1. However, there is lack of good data on investment activities of Chinese CPFs. Actual asset allocation in the CPFs systems is not disclosed by the Government. As the majority of fund managers appointed by CPFs' trustees act through fund management companies and insurance companies, the participation of

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[50] For a discussion on the reform, see, B Zheng, 'Reforming Complementary Enterprise Pensions: Overview, Assessment and Prospect' in D Deng and C Liu (eds), *China's Economic Reform in the Past 30 Year: Overview, Assessment and Prospect* (China Social Science Publishing House, Beijing 2009).

[51] Interim Measures for the Management of Enterprise Annuities Fund (Order No. 23 of the Ministry of Labor and Social Security) jointly by the MLSS, the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC) in 2004.

[52] IMEA s 15.

[53] IMMEA s 47.

[54] Ibid.

CPRs in the securities market is largely hidden. It is also reported that CPFs asset managers largely adopt conservative investment strategies, investing in financial instruments such as governmental bonds and banks.[55]

The CPF system is embryonic but has already grown significantly. By the end of 2009, the total assets of CPFs are an estimated RMB 230 billion, up 30 billion in a year.[56] The potential for future growth is considerable due to the very low current coverage.[57] Until now, many corporations and employees lack awareness of the significance of CPFs, how they are operated and what benefits they can get.[58] It is estimated that CPF market will grow to RMB 14.4 trillion by 2030.[59] Given their potential large economic scale, CPFs will become an important category of institutional investor in the Chinese securities market.

7.4.2 National Social Security Fund (NSSF)

The operation of the NSSF is overseen and managed by the NSSF Council – a ministerial level entity directly reporting to the State Council. The assets of the NSSF mainly come from four sources: (1) the funds allocated by the central government's budget; (2) capital derived from reduction or transfer of state-owned shares – a proportion of the IPO proceeds arising from the public offering of state-owned enterprises; (3) sales of lottery tickets; and (4) return on investment.[60]

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[55] G Impavido, Y-W Hu and X Li, 'Governance and Fund Management in the Chinese Pension System' (2009) IMF Working Paper No. 09/246, 30.

[56] Caijin Wang [Caijin Net], '2009 Nian Zhongguo Qiye Nianji Guimo Yuji 2300 Yi yuan [The Assets of Chinese Enterprises Pension Funds are Estimated to Reach 230 Billion]' (2010) Caijin <http://www.caijing.com.cn/2010-01-21/110363001.html> accessed 27 January 2010.

[57] Impavido, Hu and Li (n 55) 29.

[58] S Dunaway and V B Arora, 'Pension Reform in China: The Need for a New Approach ' (2007) IMF Working Paper No. 07/109 .

[59] Y Hu, F Stewart and J Yermo, 'Pension Fund Investment and Regulation: An International Perspective and Implications for China's Pension System' (2007) OECD, 11.

[60] NSSF, About the National Council for Social Security Fund, <http://www.ssf.gov.cn/Eng_Introduction/ >Accessed 24 June 2009.

Fiscal subsidies from the central government used to be the largest source of NSSF. This proportion has been in decline from 100 per cent of the NSSF's assets to 17% due to the diversified sources.[61] The second largest source of NSSF is the reduction of state-owned shares at IPO seeking an overseas listing, accounting for about 20% of fund assets in 2006 and it would continue to serve as the main source for the NSSF.[62] According to a State Council Regulation issued in 2001 entitled '*Provisional Measures for Raising Funds for NSSF from Divestiture of SOE Assets*', SOEs must contribute 10 per cent of all initial public offerings to the NSSF. This requirement was originally applied to both domestic and international offering, but it was suspended for domestic offerings in June 2002 because of adverse reaction from the domestic market.[63] As a result of the IPO transferring policy, the NSSF is the largest institutional investor on the Hongkong Stock Exchange.

In June 2009, the transfer of shares from domestic offerings was resumed, and according to *Measures for the Transfer of Some State-owned Shares from the Domestic Securities Market to the National Social Security Fund*, a total of 131 SOEs that conducted domestic IPO since July 2005 were required to transfer the equivalent of 10% of their total IPO shares to the NSSF.[64] The Ministry of Finance estimated the total market capitalization of those companies to be RMB 63.93 billion ($9.35 billion).[65] As such, the NSSF will become the largest institutional shareholder of those companies.

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[61] NSSF Council, 'Caizheng Bori Quanguo Shehui Jijin Zijing Qingguobiao' [Assets source of the NSSF] <http://www.ssf.gov.cn/web/NewsInfo.asp?NewsId=682> accessed 13 July2008.

[62] Ibid.

[63] J Anderlini, 'China may shift shares to fund pensions' *Financial Times* (London 29 February 2008) <http://www.ft.com/cms/s/0/d173cc2c-e6fc-11dc-b5c3-0000779fd2ac.html?nclick_check=1> accessed 14 April 2008

[64] Measures for the Transfer of Some State-owned Shares from the Domestic Securities Market to the National Social Security Fund issued by the Ministry of Finance, State-owned Assets Supervision and Administration Commission, China Securities Regulatory Commission and National Council for Social Security Fund, 19 June 2009.

[65] Song Yanhua, 'Listed Companies to Transfer State-owned Shares to Social Security Fund', *Caijing*, 26 June 2009.

The investment activities of the NSSF are mainly governed by *Interim Measures on the Administration of the Investment of National Social Security Fund issued by the MoLSS and MOF in December 2001*(NSSF Measures). The NSSF Measures provide quantitative investment limits for strategic asset allocation. In-house asset management is limited to bank deposits and government bonds. Any other forms of investment, such as tradable securities investment funds and stocks, need outsourcing to external fund managers.[66]

As safety has been the priority of fund investment, the NSSF has adopted a conservative investment strategy. Prior to 2002, most of the fund assets were managed internally and in low-yielding instruments such as cash and government bonds. Nominal gross returns for this cautious management way were particularly low given China's low interest environment.[67] With the rapidly ageing trend, the NSSF has gradually broadened its investment channels and developed new investment instruments with higher return and low risk. Since 2003, the NSSF appointed six domestic fund managers, considered among the best in the Chinese fund industry, to invest fund assets in the securities market.[68] As at the end of 2003, the amount of assets managed by the appointed domestic fund managers was RMB 31.8 billion, or approximately 24% of the total assets.[69]

The NSSF has increasingly allocated assets to external fund managers and broadened investment channels from the domestic market to overseas markets.[70] The portion of

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[66] Interim Provisions on Administration of NSSF Investment, issued by the MLSS in 2003, s 25.

[67] Impavido, Hu and Li (n 55) 24.

[68] The six fund management companies are Boseri, Changsheng, Huaxia, Harvest, Penghua and Southern.

[69] The NSSF Annual Report 2003, available at http://www.ssf.gov.cn/tzsj/ accessed 12 June 2008.

[70] In 2006, The National Council of the NSSF issued Interim Provisions Concerning the Administration of Overseas Investment, allowing fund managers to investing in foreign financial tools subject to limits.

assets outsourced increased from 24.07% to 46.65% during the period 2003-2009.[71] From 2003 to 2007, the annual investment return of the fund hit 10.7%. By the end of 2009, assets under management of NSSF reached RMB 776.5 billion, up 38% from the previous year.[72]

Nevertheless, social security funds only account for a small portion of the securities market in China. This is a sharp contrast to developed countries. For example, as early as 1997, pension fund investment in the US had already accounted for 55.7% of the stock markets.[73] However, the Chinese pension market has developed rapidly and has high potential to become a major institutional shareholder in the securities markets because (1) since the 1970s, the Government adopted the one-child policy to conduct birth-control. One of the most severe consequences is that China faces an increasingly ageing population. By November 2008, China had about 150 million people aged 60 or above, 11.6% of the population.[74] By 2050, it is estimated that one in four people will be 60 or above.[75] Thus, building up a sustainable pension system to benefit this population tops the agenda of the Chinese Government. According to the World Bank, China will be the world's third-largest pension fund market by 2030, worth $1.8 trillion.[76]

The expected large overseas IPOs of a number of SOEs in the coming years will make a substantial contribution to the NSSF. The NSSF will become a long-term investor in

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[71] Data collected from NSSF annual reports, available at http://www.ssf.gov.cn/tzsj/ accessed 20 June 2010.

[72] Xinhua, 'China's Social Security Fund Managed Assets Reach 776.5 bln Yuan *People's Daily Online* (15 January 2010) <http://english.people.com.cn/90001/90776/90882/6869751.html> accessed 25 January 2010

[73] Y Kang, L Shi and E D Brown,'Chinese Corporate Governance-History and Institutional Framework' (RAND Corporation, Santa Monica 2008).

[74] Xinhua, 'China Vice Premier Urges Investment to Improve ' *People Daily Online* (08 November 2008) <http://english.people.com.cn/90001/90776/90785/6529733.html> accessed 25 January 2010.

[75] Ibid.

[76] X Qian and C Zhu, 'Risk Control of Pension Fund Management in China ' (2007) 15 China & World Economy 37, 40.

these enterprises after getting these shares. Therefore, while it is relatively small, compared with the assets of SIFs, the NSSF has the potential to become one of the largest investors worldwide. Moreover, the chairman of NCSSF, Dai xianglong has said that the pension fund industry is expected to become an active participant in its invested companies to promote the standards of corporate governance, fulfilling the role active pension funds like Calpers do in other markets.[77] It is therefore one of the research objectives of this thesis.

7.5 QFIIs

QFIIs are foreign institutions which meet certain conditions, and therefore may invest directly in the Chinese A-share market under the quota granted by the Government. This type of institution has existed in China only since December 2002, when the Government launched QFIIs program to open up its domestic market to large overseas investors. Before turning to examine the identity of QFIIs, it is helpful to gain a basic understanding of the QFIIs program.

Prior to the QFIIs program, foreign investors were not allowed to invest directly in the Chinese A-share market. As we have seen in Chapter 6, international investors interested in acquiring positions in the Chinese market were only permitted to buy B shares, or to buy stocks through H shares, red chips and N shares.[78] However, the non-A share market only accounted for a small amount of the Chinese securities market. Opening up the A-share market will bring many opportunities to foreign investors, and meanwhile, boost Chinese securities economy.

As Chinese securities market has only had a relatively short history, the Government did not intend to lose its control after opening-up the securities market. QFII program is a good choice. QFII system or similar programs have been widely carried out in

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[77] J Anderlini (n 63).

[78] See Chapter 6.1.3.

many countries, especially in the newly developing market economy countries, where the currency has not been freely converted, capital investment has not completely opened up and is still in a transitional system. For example, Taiwan, South Korea, India and Brazil have all successfully introduced programs similar to the QFIIs system.[79] Yeo notes that of those other systems, the experiences have been overwhelmingly positive in terms of the development of domestic securities markets, the improvement of risk management and 'encouragement of foreign investment'.[80] The positive results from these countries further encouraged China to conduct its own QFII program to liberalize its capital market.

Under China's system, before QFIIs start their investment activities in China, they have to meet certain conditions and get approval from the Government. The purpose of this program is to open the domestic market to foreign investors but to keep it under tight control prior to adopting a fully freely convertible currency. It gives authorities large powers to control the magnitude of capital flows and to relax or restrict them when necessary.

Following a two-year period of cautious research and consultation, on November 5, 2002, China launched the QFII system with some $ 10 billion being made available. There is no definite timetable for China to fully open its stock market and this is probably some time away, depending on the opening up of China's foreign exchange. For the moment, those international investors expecting to operate their business in one of the world's most rapidly developing countries will need to apply to participate in QFII program.

At present, a basic legal framework for QFIIs has already been established to govern their investment activities in China. In this structure, first, the primary legal regulation for QFIIs is the 'Provisional Measures on Administration of Domestic Securities

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[79] S YEO, 'The PRC Qualified Foreign Institutional Investors Market' (2003) 14 China Economic Review 443, 448.

[80] Ibid.

Investments of Qualified Foreign Institutional Investors' (Provisional Measures) which was jointly issued by the CSRC, People's Bank of China (PBOC) and State Administration of Foreign Exchange (SAFE) on 24 August 2006. A series of supplementing rules have been made to clarify the general principles set out by Provisional Measures and to provide guidance in detailed issues related to the QFIIs scheme. There are:

1. Notice on the Implementing of Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors ('Implementing Notice') , issued by the CSRC In September 2006.
2. A set of Question & Answers ('Q&A'), issued by CSRC in September 2006 and which highlighted the objects of the Provisional Measures.

The main regulators of the QFII program are the CSRC, responsible for supervising QFIIs' trading activities, and SAFE, in charge of foreign exchange operations. The following section describes the most important rules in respect of the operation of QFII program and its implication for Chinese corporate governance.

7.5.1 QFIIs Qualifying Criteria

The Chinese Government aims to attract top, sound and global international investors by setting up strict barriers. Foreign institutional investors who wish to access the China domestic securities market, according to the Provisional Measures, must meet strict financial conditions.[81] For example, they should have solid financial status, good credit standing record and certain assets size.[82] A summary of legal thresholds

[81] Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (hereinafter referred to as the Provisional Measures), Article 2. QFIIs includes oversees fund management institutions, insurance companies, securities companies, commercial banks, trust companies and government investment entities.

[82] Provisional Measures s 6 (1).

for each type of foreign institution is presented in the Table 7.2.[83]

Table 7.2 Legal threshold for each type of foreign institution

Applicant	**Operating experience**	**Revenue**	**Assets under management (Preceding Accounting Year)**	**Others**
Fund Management	>= 5 years	N/A	>=$ 5 billion	N/A
Insurance Companies	>= 5 years	N/A	>=$ 5 billion	N/A
Securities Companies	>= 30 years	>= $ 1 billion	>=$10 billion	N/A
Commercial Bank	N/A	N/A	>=$ 10 billion	Among the world's to 100 banks by total assets in the preceding accounting year
Other institutional investors (pension funds, trust funds, charity funds, etc)	>= 5 years	N/A	>=$ 5 billion	N/A

[83] Implementing Notes s 1.

In addition to the foregoing, the QFII applicant shall have a well-established governance structure and internal control system, conduct the standardized business and receive no major penalties by the regulatory institutions in its home country or region during the last three years.[84]

However, in order to encourage medium and long-term investment into China, the QFIIs Provisional Measures expressly state that the priority will be given to QFIIs applicants who manage closed-end China-focused funds, pension funds, insurance funds and mutual funds with good investment records in other markets.[85] QFIIs with long-term and stable investment strategies will yield multiple benefits to the Chinese security market. It is envisaged that their participation in the Chinese securities market will not only reduce the volatility of the stock market, but also accelerate the improvement of corporate governance standard in Chinese domestic companies. This point will be covered in detail in section 7.5.5.

The CSRC will issue each QFII with a Securities Investment License and each QFII should submit an application to SAFE through its custodian to request an investment quota in a year after it gets the license.[86] Upon approval, each QFII is allowed to trade A-shares in China's domestic securities market but only within their investment quotas. The QFII's investment in the securities market is subject to strict limitations, which will be discussed in Chapter 9.

7.5.2 Opening of Multiple Securities Account

To control foreign investors using other QFII's quota in order to access the Chinese market without meeting the strict qualification,[87] the Provisional Measures permit

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[84] Provisional Measures s 6 (3).

[85] Ibid, s 10.

[86] Provisional Measures s 9.

[87] S Leung and Y Zhang, 'Qualified Foreign Institutional Investors in China', An O' Melveny & Myers LLP research report. There have been media reports that a recent Citigroup investment into China domestic securities market was on behalf of other non QFII fund management entity.

each QFII to open multiple segregated security accounts that correspond to respective multiple cash accounts. Each QFII may open multiple security accounts as 'director accounts' or 'nominee accounts'.[88] The Implementing Notice further provides that when QFII provides asset management services to customers, a nominee account should be opened for customers.[89] Where a QFII opens a security account for public funds, insurance funds, charitable funds, donation funds, governments funds or other long-term investment fund under its management, the account can be in the joint name of "QFII+fund", independent from the assets of the QFII and belonging to the relevant funds.[90]

Permitting the opening of multiple accounts is a significant amendment by the Provisional Measures, done in response to representations made by interested parties who were concerned that the single account policy under the Interim Measures would lead to unclear assets structure. Under the Interim Measures, a QFII could only have one RMB special account and only appoint one custodian. Investment of a QFII through its QFII quota had to be put together in the same account with the assets of QFII's clients and other underlying investors investing through the QFII. The single account approach raised the risk that the underlying investors are beyond the supervision of Chinese government. In addition, under the Interim Measures, the QFII was recorded as the owner of assets, which result in some QFIIs being in breach of their home jurisdiction's laws.

The Provisional Measures made a great improvement to deal with these problems by adopting a multiple accounts policy. First, the ability to open sub-accounts will facilitate the fund manger of QFII to clearly identify the structure of assets in the accounts as belonging to their customers instead of to themselves and therefore, the investors' protection will be enhanced. It will also increase the ability of underlying

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[88] Provisional Measures s 16.

[89] Implementing Notice s 7.

[90] Implementing Notice s 8.

investors to use its vote meaningfully which may help in improving the corporate governance standard of Chinese listed companies.

Second, the QFIIs are required to report the name of actual holders and allocation to each actual investor to the CSRC and stock exchanges.[91] The investment activities of shadow investors will be under the supervision of the Chinese authority. Moreover, the changes in relation to the opening of securities accounts will satisfy both domestic and overseas regulations as stated in the CSRC's Q&A.

QFIIs are required to carry out the duty of information disclosure, and should comply with laws, regulations and other relevant rules.[92] To correspond with the shift from single account policy to multiple account policy, underlying investors are also obliged to disclose information. They are required to add up the foreign listed stocks and domestic listed stocks in the same listed company and report this aggregate holding to the stock exchanges through the QFIIs. QFIIs are under a duty to ensure that underlying investors for which the QFII opens nominee accounts comply with the relevant regulations.

7.5.3 Lock-in Period

Prior to the promulgation of Provisional Measures, the investments of QFIIs in China were subject to a lock-in period with a view to encourage long-term holdings and prevent short-term volatility. They had to keep their capital within the PRC for at least one year. For close-end funds, the minimum period was three years. During the lock-in period, the funds remitted into China by the QFIIs must be held by custodian in a special purpose RMB account. Concerning that these stringent lock-in requirements may deter fund managers from operating the investment funds efficiently, the revised Provisional Measures do not lay down specific lock-in period

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[91] Provisional Measures s 16.

[92] Ibid.

but instead provide that any lock-in period shall be as adjusted by the SAFE based on China's economic and financial situation, foreign exchange balance and according to arrangements set by the PBOC.[93] Until now, SAFE has not set out any supplemental rules with respect to the lock-in period.

Currently, requirements regarding lock-in period are provided in the CSRC's Q&A. The CSRC Q&A stipulates that the principle lock-in period for pension funds, insurance funds, mutual funds and other long-term foreign investors would be reduced to 3 months, and for other types of investor, the lock-in period would remain 1 year. Owing to lack of formal legal rules, the period regulation in the CSRC's Q&A has legal binding effect. Besides considering the safety of the Chinese financial market, such restrictions are made on the expectation that the long-term interests of QFIIs in the lock-in period would motivate them to participate in companies' affairs and contribute to better corporate governance standards.

7.5.4 Custodian Banks

According to the Provisional Measures, each QFII is required to entrust a domestic commercial bank as custodians for its QFII assets and a domestic securities company as brokers for its domestic investment activities. There is a separate set of strict qualifying criteria to become a QFII custodian, which is laid down in the administrative regulation – 'Review and Approval for the Qualification for Custodian banks of Qualified Foreign Institutional Investors'. There are currently 13 banks approved by the CSRC and PBOC as QFII custodians.[94]

A custodian bank provides QFIIs with significant financial services for their

[93] Provisional Measures s 28.

[94] They including 8 Domestic Qualified Custodians: Bank of China, China Construction Bank, Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of Communications, China Merchants Bank, China Everbright Bank, China citic Bank and 5 Foreign Qualified Custodians: Standard Chartered Bank Shanghai Branch, Hong Kong Shanghai Banking Corporation Shanghai Branch, Citibank Shanghai Branch, Deutsche Bank, DBS bank.

investment in the Chinese securities market. Where a QFII intends to gain a license and investment quota, it should submit the application documents through its custodian to the CSRC and SAFE. Under the approval of SAFE, the QFII shall open a RMB special account with its custodian. After it has qualified as foreign institutional investor, the QFII will be offered securities and cash clearing services from the custodian bank. The custodian bank is in charge of all the assets entrusted by QFII, and will service all QFII-related business such as the foreign exchange and other cash settlement needs of the QFII. The QFII is entitled to change its custodian provided it has adequate reasons to do so to be in line with its interests or if the custodian is deemed incompetent by the CSRC and SAFE.[95]

A custodian also acts as the primary communication channel between the QFII and the CSRC and SAFE. It is responsible for supervising the investment activities of QFII and reporting to the CSRC and SAFE in case QFII investments are found to have violated laws or regulations. A custodian also must report to the CSRC and the SAFE about the status of QFII's RMB special account and to compile the QFII's annual financial report. A custodian bank must keep records regarding its QFIIs' fund activities and foreign exchange operation for at least 20 years.[96]

7.5.5 Current QFIIs and their Role in Corporate Governance

The first QFIIs were UBS and Normura Securities, approved by May and June 2003, soon followed by other global foreign institutions. Previously, the Government was reluctant to raise the QFII quota, both for fear of sparking currency appreciation and bubble risk in the domestic stock market. However, official figures show that QFIIs have turned out to be less speculative than other institutional investors in China because their investment types are stable and tend to keep their investment, for

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[95] Implementing Note s 5.

[96] Provisional Measures s 13 (7).

example, blue chip stocks for a long time.[97] Reviewing the performance of QFIIs, SAFE considered that this system had facilitated a transformation in Chinese investors' sophistication, improved risk management, strengthened the global clout of Chinese capital markets and helped optimize corporate governance.[98] Thus, the Government has gradually eased the criteria and restriction on QFIIs. As of 2009, there were 91 institutions qualified as QFIIs with a foreign exchange quota of USD 30 billion.[99] 75.6% of granted quotas have been invested in stocks.

One of the most significant roles that the Government expects QFIIs to play is to improve corporate governance standards in Chinese listed companies. This is reflected in the select criteria for QFIIs, where priority is given to long-term and stable institutions having a well-established corporate governance structure. The positive impact of QFIIs on corporate governance can be achieved in two ways. Firstly, the intention to attract QFIIs' investment will drive Chinese companies to raise their corporate governance standards. Xia and Tomasic found that QFIIs would have more interest in a company's corporate governance than small investors who at most time were only concerned with the company' share performance.[100] Therefore, companies will stand a better chance of attracting QFIIs' investment if they exhibit the corporate governance characteristics that foreign investors recognize and prefer.

The second way to achieve better corporate governance is QFIIs' active engagement with the companies in which they invest. However, by investigating some QFIIs' activities in one Chinese listed company, Xia and Tomasic found that the present role

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[97] Xinhua News, 'China Triples QFII Quota Ahead of Key Meetings with U.S. Officials' (10 December 2007) <http://news.xinhuanet.com/english/2007-12/10/content_7226220.htm> Accessed 3 February 2008; China Securities Journal, 'China to relax regulation on foreign investment in Chinese securities market' (April 9, 2008)

[98] Ibid.

[99] Data from CSRC, available at < http://www.csrc.gov.cn/pub/newsite/sjtj/ > accessed 19 March 2010.

[100] X Jia and R Tomasic, *Corporate Governance and Resource Security in China : the Transformation of China's Global Resources Companies* (Routledge, London 2010) 67.

of QFIIs in improving corporate governance is rather limited.[101] As one will see in Chapter 9, QFIIs' activism is not observed in the sample companies. This largely results from the fact that their shareholdings are generally small, compared with the dominant controlling shareholders. Chapter 9 will discuss this issue in detail.

7.6 Conclusion

This chapter has examined the extent and nature of the institutional shareholder ownership in China. We have seen the rise of that ownership, as well as the different types of institutional shareholder, and the structure they employed to run their investments.

From a comparative perspective, some significant points can be recapitulated. First, some main participants in the UK market which can facilitate institutional shareholder engagement, including institutional shareholder representative organizations, proxy voting agencies, do not exist in Chinese market. Second, whereas UK's institutional ownership is mainly dominated by long-term investors, such as pension funds and insurance companies; relatively short-term mutual funds prevail in the Chinese institutional market. Despite considerable growth potential, pension funds, insurance companies and QFIIs are still in embryonic stage, subject to strict quantitative investment limits. These features predict that the level of institutional shareholder engagement will be lower than the UK part.

The following Chapter 8 takes a more empirical turn, to investigate the level of shareholder engagement in Chinese listed companies.

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[101] Ibid, 125.

Chapter 8 Chinese Shareholder Activism: Empirical Evidence

Given their large investment scale and huge potential for growth, there is no doubt that institutional investors have become increasingly important equity holders in the Chinese stock market. Do, however, Chinese institutional shareholders actually engage in the governance of portfolio companies? How do they interact with corporate management? What differences exist amongst different institutional shareholders in terms of their level or type of activism? And, crucially, how far do the answers to these questions confirm the validity of the model of activism developed in Chapter 1? These are questions this chapter answers.

In the UK, as one has seen, there is much evidence produced by a number of institutional representative organizations and academic scholars to understand how institutional shareholders shape the corporate governance of their portfolio companies. However, in the Chinese context, despite institutional investment in China having gained increased popularity over the last few years, empirical evidence investigating the role of institutional investors on corporate governance is rare.

So far, there are four studies concerning the exercise of shareholder rights in Chinese listed companies. There are:

(1) Yang's research on shareholders' meetings during 2002-2003;[1]
(2) Peng's study (2005) on the voting activities of shareholders at AGMs;[2]
(3) Institutional Shareholder Service's survey (2006) on ten Chinese institutional investors, investigating their views on Chinese corporate governance;[3] and

[1] J Z Yang, 'Shareholder Meetings and Voting Rights in China: Some Empirical Evidence' (2007) 18 International Company and Commercial Law Review 4.

[2] Wan Peng, 'Fenlei biaojue tedian xianzhu, zhuanjiahuyu touzizhe xinshi toupiaoquan'[Call for More Exercising of Voting Rights by Investors], Zhengquanshibao [Zhengquan Times],3 March 2005.

(4) Yuan *et al*'s study (2007) on the role of financial institutions in the corporate governance of Chinese listed companies;[4]

(5) Clarke and Howson' study on the use of derivative actions in Chinese companies.[5]

These studies make great contribution to investigating the role of shareholders in corporate governance. However, solely relying on this evidence cannot provide an adequate overview of institutional shareholders' participation in China. Therefore, it has been necessary for me to find empirical evidence to make the study feasible.

This chapter proceeds as follows. Section 8.1 sets forth the research method, followed by a discussion of the basic characteristics of the sample. Sections 8.2, 8.3 and 8.4 survey and discuss the results obtained from the sample by type of activism – private meetings, submitting proposals, proxy voting and derivative actions. Each section starts with an overview of findings of the sample as a whole and then investigates the evidence in more depth by focusing on the comparison of results among groups. Because of data availability, the analysis focuses on activism in the form of submitting proposals and voting. Less attention is paid to private meetings and derivative actions. Section 8.5 draws conclusion.

8.1 Research Design

8.1.1 Research Method

All the companies in the study were selected from the top 100 Chinese listed

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[3] Institutional Shareholder Service, '2006 Global Institutional Investor Study – Corporate Governance: From Compliance Obligation to Business Imperative', ISS.

[4] R Yuan, N Milonas and J Z Xiao, 'The Role of Financial Institutions in the Corporate Governance of Listed Chinese Companies' (2006) Cardiff Accounting and Finance Working Papers <http://www.cardiff.ac.uk/carbs/research/workingpapers/accounting_finance/A2006_3.pdf > accessed 3 June 2009.

[5] D Clarke and N Howson, 'Derivative Actions in the People's Republic of China' in *The Prospect of Structural Reform of Corporate Legal System* (The 21st Century Commercial Law Forum-Tenth International Symposium 2010) 190.

companies ranked by market value as of 2008. After evaluating the main sources of data and the institutional, technical and economic resources available, the focus was narrowed down to 30 companies on the basis of two selection criteria – institutional shareholding and corporate governance standard. The study selects the top 10 Chinese listed companies with largest investment funds' shareholding and categorize them into group A[6] (see Table 8.1), the top 10 companies which scored with highest corporate governance performance and categorizes them into group B[7] (see Table 8.2). Another 10 companies categorized into Group C were randomly selected from the top 100 listed companies which were excluded by Group A and Group B (see Table 8.3).

It is worth noting here that in the initial data, three companies fell into both Group A and Group B. For the purpose of comparison, these three companies were categorized into Group A and three other companies ranked top 11-13 were added into Group B as a matching sample. In order to present an accurate result, these three companies are discussed separately if data indicate their performances are distinctive from other companies in Group A.

The purpose of the study is two-fold. First, it intends to provide some empirical evidence on shareholder activism of Chinese listed companies. Since the Chinese shareholders activism is by far less well understood and studied compared with the UK part, the study offers an analysis of evidence obtained from the sample to present an overall picture of institutional shareholder activism in Chinese listed companies.

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[6] The largest institutional holding in Chinese listed companies by the end of 2009 is summarized by Hexun.com, a large financial securities website in China. The data only covers the proportion of investment funds' holdings and the actual holding of total institutions is estimated higher than this data. However, since SIF' investment accounts for about 80% of all institutional assets, this ranking could still roughly reflect the shareholding of institutions in Chinese listed companies.

[7] The assessment of corporate governance is conducted by Institute of world economic and political in Chinese Academy of social science in its 2009 nia Zhongguo Shangshi Gongsi 100 Qiang Gongsi Zhili Pinjia [Corporate Governance Assessment Report on the Top 100 Chinese Listed Companies For 2009],available at http://www.iwep.org.cn/, accessed 14 September 2009. Its evaluation criteria are based on six criteria: rights of shareholders, equitable treatment of shareholders, role of stakeholders, disclosure and transparency, board responsibility, and supervisory board responsibility.

Second, the study compares data in each group, with an interest in how and to what extent shareholder activism differs in each of these three groups of companies. We suggested in Chapter 1 that the greater the percentage of shares held by large institutions, the greater likelihood of shareholder activism. Also, the better the governance arrangement (meaning the lower the costs of activism), then again, the greater the level of shareholder activism we would expect.

To test the first assumption, the study chose the top 10 listed companies with largest institutional shareholdings, collectively. Meanwhile, as we will see in Tables 8.1, 8.2, 8.3, individual shareholding by the largest institution is higher than the rest of two groups. To test the second assumption, the study selected the top 10 listed companies identified as leaders in corporate governance. For comparison purpose, the study picked up third set of companies in the sample which are excluded from the previous two groups. In line with above assumptions, the analysis undertaken here finds that companies in the first two groups demonstrate more active shareholder participation than their peers.

Moreover, it is interesting to conduct a comparison between companies having larger institutional shareholding and companies having good corporate governance standards. Certainly, institutional shareholders are most likely to engage in their portfolio companies if their shareholdings are large and meanwhile, a facilitating corporate governance regime is provided. The idea here is to look at which factor is more decisive for institutional shareholder engagement: facilitating corporate governance arrangements as represented by the Group B or a large institutional shareholding, as represented in Group A. Could larger institutional shareholding lead to more activism in Chinese listed companies? Would better corporate governance systems attract more institutional investment and more shareholders' involvement? These are questions the study set out to answer.

All in all, the research design, as discussed above, could provide valuable evidence on the extent to which institutional shareholders monitor portfolio companies. However,

it is necessary to point out that this research is subject to a limit. The sample is relatively small and thus, hard to represent the overall institutional shareholders activism in China. However, it is not small relative to the total size of institutional holdings and the number of institutions in those listed companies. Nevertheless, when analyzing the results from these sample companies, the thesis also looks at other studies which covered larger sample companies randomly selected in the Chinese securities market. Thus, the evidence presented in the thesis can still give an objective assessment on institutional shareholder activism in China.

Table 8.1 Group A: Top 10 Chinese listed companies with largest investment funds' shareholding (At December 2009)

Ranking	**Name**	**Listing Code**	**Shareholding Distribution**			**Shareholding of the largest owner (% of total shares)**	**Shareholding of the largest fund (% of total shares)**
			Restricted Shareholding (%)	**Institutional shareholding(% of tradable shares)**	**Institutional shareholding (% of total shares)**		
1	Luzhou Laojiao	000568	48.69	41.50	21.29	53.52	1.56
2	Suning Appliance	002024	32.62	35.12	24	28.61	2.48
3	Shuanghui Fazhan	000895	51.48	34.58	17	30.27	2.2
4	Industrial Bank	601166	0	27.80	27.8	20.40	1.4
5	Xishan Meidian	000983	53.28	24.17	11.29	53.28	1.64
6	Shen Fazhan A	000001	5.84	23.58	22.2	16.76	4.54
7	Qinghai Salt Lake Potash	000792	49.40	21.48	15.48	30.60	3.41

8	Gree Electric Applicances	000651	1.46	20.83	20.53	21.30	2.67
9	Ping An Insurance	601318	0	20.41	20.41	8.43	1.51
10	Bank of Beijing	601169	36.48	19.82	12.79	16.06	0.74

Table 8.2 Group B Top 10 Chinese listed companies with highest scores on good corporate governance performance (At December 2009)

Ranking	Name	Listing Code	Shareholding Distribution			Shareholding of the largest shareholder(% of total shares)	Shareholding of the largest fund (% of total shares)
			Restricted Shareholding (%)	Institutional shareholding(% of tradable shares)	Institutional shareholding (% of total shares)		
1	China Merchants Bank	600036	0	18.37	18.37	17.63	0.64
2	Bank of China	601988	0	0.19	0.19	67.49	0.04
3	China Shenhua Energy	601088	73.86	19.72	5.15	73.86	0.22
4	Jiangsu Expressway	600377	67.2	0.72	0.23	54.44	0.29
5	ZTE	000063	3.77	17.58	16.91	36.21	1.80
6	Baoshan	600019	0	5.33	5.33	73.97	0.78

	Iron&Steel						
7	China Citic Bank	601998	71.42	3.28	0.94	62.33	0.08
8	Bank of Communications	601328	20.36	11.36	9.05	26.48	0.45
9	Shanghai Pudong Development Bank	600000	10.24	14.37	13	21.16	3.39
10	China Life Insurance	601628	0	NA(less than 1%)	NA	68.31	0.11

Table 8.3 Group C (At December 2009)

	Name	Listing Companies	Shareholding Distribution			Shareholding of largest shareholder(% of total shares)	Shareholding of the largest fund (% of total shares)
			Restricted Shareholding(%)	Institutional Shareholding (%of tradable shares)	Institutional shareholding (% of total shares)		
1	Shanghai International Airport	600009	43.25	3.23	2.16	53.25	2.24
2	Liaonin Chenda	600739	0	13.41	13.41	19.08	4.50
3	Shenergy	600642	0	1.55	1.55	50.56	0.32
4	China United Network Communications	600050	0	9.56	9.56	60.74	0.56
5	Sany Heavy Industry	600031	7.41	7.42	6.91	60.73	1.45

6	Yunnan Yuntianhua	600096	50.72	12.36	6.09	55.83	1.4
7	CITIC Securities	600030	0.90	10.69	10.59	23.69	3.22
8	Inner Mongolian Baotou Steel Union	600010	57.65	2.92	1.23	61.20	0.26
9	Shanxi Guoyang New Energy	600348	0	7.78	7.78	58.34	1.23
10	Youngor Group	600177	35.75	0.26	0.0016	44.70	0.93

8.1.2 Sources of Data

The data required for the present study were hand-collected from listed companies' websites, their annual reports and quarterly announcements from CSRC and stock exchanges.

One of the most important sources the study used is listed companies' self-assessment reports. In 2007, Chinese listed companies were required to conduct self-examinations on their corporate governance system by answering a list of questions provided by the CSRC. Three points in the reports are of critical importance to the study: influence of institutional shareholders, companies' relationship with investors and shareholder resolutions.

Another significant source of the data comes from the sample's shareholders' meetings announcement in the year 2007 and 2008. The announcements disclose information regarding the shareholders' attendance, resolutions, voting level and voting outcomes.

Subject to source limit, the sample periods for the below three types of activism are different. In the discussion of private meetings, the study relies on the information provided by self-examinations which covers the period over each company's IPO and 2007. In the section of submitting proposal, the study finds that the sample would be too small if it is only concerned with 2007 and 2008 and thus, it also collects relevant evidence from self-examinations. The sample period for submitting proposals, therefore, is each company's IPO to 2008. In terms of shareholder voting, the data consist of voting evidence at shareholders' meetings over the 2007-2008 sample period.

8.1.3 Basic Characteristics of the Sample Companies

The sample companies represent 10 industries, based on the industry classification proposed by CSRC. In relation to geographical distribution, listed companies located in Beijing, Shanghai, Guangdong and Shandong account for 62 percent of the total. In terms of listing locations, 22 companies are listed on the Shanghai Stock Exchange and the remaining are listed on the Shenzhen Stock Exchange.

In terms of share holding structure of the sample, two fundamental characteristics are apparent. The first is that shares in majority of companies are subject to tradability. In 75% of the companies, shares are not fully circulated in the stock market. Among those share-restricted companies, non-tradable shareholding in nearly 35% of them account for more than 50% of the total.

The second notable characteristic of the sample is that ownership in majority of them is relatively highly concentrated. In almost 63% of sample companies, the largest shareholders hold over 30% shares of the total, which is the threshold for being controlling shareholder. Although a majority of companies in the sample have a dominant share owner, disparity emerges when one analyzes the shareholding by group. Table 8.4 reports the average shareholding of the largest owner and distribution by group. Table 8.5 sets out the number of companies in each group according to the shareholding of the largest owner.

Table 8.4 Largest shareholding by Group

Group	**Large shareholding**			
	Mean%	**Median%**	**Min%**	**Max%**
A	27.92	24.96	8.43	53.52
B	50.19	58.34	21.16	73.97
C	48.81	54.54	19.08	60.74

Table 8.5 Number of companies in each group by the largest shareholders' holdings

Group	No of Company	1-30%	30-50%	50%-Above
A	10	6	2	2
B	10	3	1	6
C	10	2	1	7

As the above Tables shown, in Group A, the average shareholding by the largest shareholder is around 27.92% and the majority of companies in this group do not have a controlling shareholder. By contrast, in Groups B and C, as indicated by the average level of the largest shareholding and the number of companies having controlling shareholders, ownership is relatively high concentrated. This difference suggests that large institutional shareholding result in a relatively dispersed share structure.

As one will see later, these features of share ownership structure in the sample have significant bearings on the extent to and the way in which shareholders engage in corporate governance. Having obtained an overall image of the sample, the below sections set out evidence to analyze each type of shareholder activity in detail.

8.2 Private Meetings

The first form of shareholder activism that the study explores is private communication between the board/executives of portfolio companies and investors. When an institution has an issue it is concerned with, a typical engagement process is often that, first, to contact a portfolio company privately about the issue. Then, if the company management respond negatively, the institution will determine whether to file proposal or vote against management' proposals at the shareholders' meetings. Private meetings, therefore, are often used as the first mechanism for shareholder activism. As discussed earlier, this strategy has been widely adopted by UK institutional investors. In the Chinese context, research from Yuan, Milonas and Xiao also found that Chinese institutional shareholders demonstrate a preference for private

negotiation over other forms of activism as the first action.[8]

By interviewing 20 financial institutions and 10 directors from listed companies, they observed that institutions would go to talk to the management to explain why they might be dissatisfied and what action they desired from the portfolio companies. In the event of voting against a board proposal, they always informed the company in advance and explained the reasons for doing so.

Another significant purpose for institutional shareholders to conduct private communications is to collect information from corporate management. Institutions under ISS' global study describe private meetings as an investment necessity which enables them to gain information that is not disclosed in public statements.[9] A majority (12) of institutions under Yuan, *et al*'s study also rely on private meeting to obtain information about the company and the quality of the management team.[10]

The concerns of their meetings vary according to the different aims of meetings. Generally, the topics often focused in the area of corporate financial performance, corporate strategy, and corporate growth opportunities. The persons they get in touch with are often the secretary of the board, company chairman, general managers or managers from functional departments.

In short, there is no doubt, as the above evidence confirmed, that private meetings have been widely adopted by institutions in China as an important means to improve the shareholders-board communication as well as an important type of shareholder activism. However, despite the importance of private meetings, more detailed relevant information is not provided in Yuan *et al*'s research. Thus, my study extends their work to provide more evidence on the interaction between shareholders and corporate

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[8] R Yuan, N Milonas and J Z Xiao, 'The Role of Financial Institutions in the Corporate Governance of Listed Chinese Companies' (2006) Cardiff Accounting and Finance Working Papers .

[9] Institutional Shareholder Service, '2006 Global Institutional Investor survey', ISS, 61.

[10] Yuan, Milonas and Xiao (n 8).

management.

An inherent challenge in analyzing what happens once boards and shareholders do engage in private meetings, however, is that they are just that private. Therefore, the details of the negotiations are not shared with outsiders.

Despite these difficulties in measurement, some general aspects of such contact between the company and shareholders, such as the forms of meetings, the frequency of meetings, can still be captured. The source mainly comes from the self-assessment reports of sample companies, in which listed companies are required to disclose how they have communicated with investors.[11] Since companies are free to choose the information they intend to report, the contents and the extent of this disclosure vary among companies. Some companies had missing data.

Having analyzed information available in these reports, this section presents findings by three aspects of private meetings: meeting model, meeting participants and the frequency of meetings.

8.2.1 Form of Meetings

Companies in the sample report that their contacts with investors take the following forms: (1) phone call, emails; (2) investors' visiting; (3) corporate annual results investors' and analysts' briefing, press conference, and institutional investor meetings organized by companies; (4) conference or forum organized by institutional investors; and (5) road shows. Among those contact methods, investors' visiting in person, or phone call, emails are often the most commonly used methods for investors to get in touch with companies.

[11] In 2007, Chinese listed companies are required to issue reports on their corporate governance systems.

8.2.2 Meeting Participants

The majority of companies in the sample have established investor relations departments to deal with contacts with investors and thus, the persons with whom most investors talk to are staff or managers in these departments. In two companies, secretaries of board of directors and the CEO are in charge of these investor relations departments. In investors' conference or forum, persons from companies having dialogue with institutional shareholders were often directors and company senior managers.

8.2.3 Frequency of Meeting

Most companies in the sample reported that they met with fund managers and financial analysts each year. Some companies also provided detailed information regarding the frequency of meetings with investors. Table 8.6 summarizes the available data by Group.

Table 8.6 The frequency of board-shareholders contact during 2006

Group	Company	No of investors	No of Conference
B	601328	350	87
	601088	1000	NA
	600019	584	23
	600000	Around 100	NA
	600377	300	9
C	600642	39	6
	600030	150	4

Unfortunately, none of the companies in Group A has provided information with regard to the frequency of their contact with investors. However, it cannot simply draw the conclusion that there is more board-shareholder communication in Group B

companies since this difference might be produced by insufficient data. Nevertheless, available data that listed in the Table 8.6 suggest that both the number of shareholders that companies contacted and the number of meetings that companies attended in group B are higher than in Group C. It therefore can be said that at least for the companies listed in the Table 8.6, Group B has achieved more frequent board-shareholder contacts.

8.2.4 Conclusion

To recapitulate, the above analysis finds that there may be frequent investor-board contacts in the sample and the way in which they get in touch with each other. However, subject to limited data, the study is unable to explore more relevant information in detail.

8.3 Submitting Proposals

8.3.1 Legal Rules on Submitting Proposals

Submitting resolutions is another control mechanism for shareholders to make demands on management for changes in corporate practice. In China, under Company Law 2005 (CL 2005), shareholders who singly or collectively hold 3% or more of the voting rights of a company may propose a resolution for a shareholders' meeting by written submission to the board 10 days before a meeting.[12] The board must give the other shareholders notice of such a resolution within two days after receiving it and must present it for consideration at the meeting.

The study on the sample sought to determine the frequency of shareholders' resolutions submitted, types of shareholder proposals filed, the types of companies at which proposals were filed, the type of filer and the level of support for proposals.

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[12] CL 2005 s 103.

8.3.2 Frequency of Shareholders Proposals Filed

In the sample studied, there were 2 out of 30 selected companies in which shareholders submitted a total 6 resolutions at the shareholders' meetings during the 2007 to 2008 period. Table 8.7 shows the frequency of companies receiving these proposals across the sample period.

Table 8.7 Frequency Distribution of shareholder resolution proposed at the shareholders meetings

Shareholders resolution proposed at the shareholders' meeting (2007-2008)	**Frequency**	**Percentage**
No	28	93.33
Yes	2	6.67
Total	30	100.0

A study on these two resolutions is hardly to reveal the basic characteristics of shareholder resolutions in Chinese listed companies. In order to present a more complete picture of shareholder resolutions, the study also collected relevant information from self-assessment reports of the sample companies. Prior to 2007, data recorded in their self-assessment reports show 9 companies in the sample have been the recipients of shareholders' resolutions. To make it clear, it is necessary to note that this number does not include the two companies in which shareholders resolutions were proposed over the period 2007-2008.

In total, the data consist of 25 shareholder proposals submitted at shareholders' meetings in 11 companies over the period of 2002-2009. Table 8.8 reports summary statistics on the shareholders resolutions proposed.

Table 8.8 Shareholder resolution at the shareholders' meeting in China

Group	**Companies**	**Number of items proposed**	**Issues**	**Proposing shareholders**	**Proposing shareholder holdings (%)**	**Identities of the filer**
A	002024	1item	C4	The largest shareholder	34.01	Individual
	000001	4 items	C1	The largest shareholder	16.68	NSOE
	601318	2 items	C1 C3	The 3rd largest shareholder	7.4%	NSOE
	601169	3 items	C2(2) C4	Shareholders collectively holding over 3% of voting rights	3.20	NSOE
B	600063	3 items	C1 C2(2)	2 items by the largest shareholder and 1 by the shareholders collectively holding over 3% of voting rights	12.10 5.05	SOE
	601988	3 items	C2(2) C5	The largest shareholder	67.49	SOE

	000063	3 items	C3	The largest shareholder	36.21	NSOE
	600019	3items	C2(2) C4(1)	The largest shareholder	78	SOE
C	600030	1 item	C5	The largest shareholder	31.75	SOE
	600739	2 item	C4 C5	The largest shareholder	12.76	SOE

Note: (C1-Financial reporting/auditing/dividend; C2-Nominating/Electing, directors and supervisors;C3-Remuneration policies;C4-Amendment of articles of association; C5-Cash/bond offer issues, SOE-State-Owned Enterprises, NSOE-Non State-Owned Enterprises)

8.3.3 Who Were the Filers?

8.3.3.1 Aggregate Analysis

Filers of proposals were presented in Table 8.8. Of all 25 resolutions, 19 (76%) were proposed by the largest shareholders. The remaining 6 were dispersed among non-largest shareholders or individual shareholders collectively holding 3% or more shares.

Another notable fact revealed in Table 8.8, is that the shareholdings controlled by the largest shareholders are all significantly higher than the 3% legal threshold. This could explain the difference that shareholder resolutions are more frequently seen in Chinese listed companies than their UK counterparts. 3% might be a high threshold in companies with diversified ownership structure, while in China, in light of the concentrated ownership of Chinese listed companies, it is much easier for large shareholders to meet this requirement to exert their control over management.

Looking more carefully at the identities of those proposing shareholders summarized in Table 8.9, we can find that the most common group of shareholders that filed resolutions is NSOE, such as property investment enterprises (in 601169) and foreign investment institution (in 000001)[13]. None of the NSOE is institutional investor. 44% of resolutions were filed by SOEs, making it the second most common type of shareholder. The remainder was submitted by an individual investor who holds a controlling stake in the company (in 002024).

Table 8.9 The identities of proposing shareholders and the number of resolutions they proposed

Identities of proposing	No of resolution	Percentage

[13] I should note here that, it is likely that some of the NSOE are state-related. Unfortunately, data provided the Companies' reports do not give necessary and sufficient information about this issue.

shareholder		
SOE	11	44%
NSOE	13	52%
Individual	1	4%

8.3.3.2 Analysis by Group

Table 8.10 provides a breakdown of the number of proposals submitted by the identity of filers in each group. The result suggests a number of differences among groups.

Table 8.10 The identities of proposing shareholders and the number of resolutions they proposed by Group

Group	No of resolutions	Proposing shareholders		Identities of shareholders		
		Largest shareholders	Non-largest shareholders	SOE	NSOE	Individual
A	10	5	5	0	9	1
B	12	11	1	9	4	0
C	3	3	0	3	0	0

First, Group B received the largest number of resolutions over the entire sample period, closely followed by Group A. Group C received the fewest. It appears that, shareholders in companies that having good corporate governance systems (Group B), tend to be more active in submitting proposals. This point is further supported by the fact that half (5) of the resolutions proposed in the Group A were actually presented in the two companies which overlapped both Group A and Group B.

Second, a majority of shareholder resolutions in Group B, and all in group C, were proposed by the largest shareholders, while in Group A, only half of the total resolutions were filed by the largest shareholders. In terms of the identities of proposing shareholders, again, Group B and Group C share some parallels while

Group A is distinct. The predominant proposing shareholders in Group B and C were SOEs, while they were NSOEs in Group A, with none of the resolutions proposed by the SOE.

8.3.4 Topics of Proposals

8.3.4.1 Aggregate Analysis

Changes desired by proposing shareholders vary widely. The study collapses these topics into five broad categories: C1-Financial reporting/auditing/dividend; C2-Nominating/Electing directors and supervisors; C3-Remuneration policies; C4-Amendment of article of association; C5-Cash/bond offer issues.

Of the 25 proposal filed over the period of 2002 to 2008, as Table 8.11 indicates, by far the most popular category is the directors and supervisors election, followed by the category of corporate financial performance and planning. These two categories accounted for over half of proposals filed.

The third most popular targets of shareholder resolutions are issues of executive remuneration and amendment of article of association, followed closely by concerns about cash and bond offers.

Table 8.11 Frequency of each type of issues proposed by shareholders

	No of resolutions	**Percentage**
Nominating/Electing directors C2	8	32
Financial reporting/auditing/dividend C1	6	24
Remuneration policies C3	4	16

Amendment of article of associationC4	4	16
Cash/bond offer issuesC5	3	12
Total	25	100

8.3.4.2 Analysis by Group

To highlight the distinction among Group A, B and C companies, Table 8.12 reports a breakdown of the number of proposal submissions in each Group by the various categories of issues that resolutions were concerned with.

Table 8.12 Frequency of each type of issue proposed by Group

Group	**No of resolutions**	**C1**	**C2**	**C3**	**C4**	**C5**
A	10	5	2	1	2	0
B	12	1	6	3	1	1
C	3	0	0	0	1	2

As the above Table shows, topics addressed by shareholder resolutions vary greatly between Groups. Companies in Group A filed a total 10 proposals, with the majority of them focused on issues of financial reporting and strategic planning. The issue dealt with most frequently in Group B is election of directors and supervisors. Of three resolution filed in Group C, two dealt with cash and bond offer issues and the remaining one was concerned with amendment of article of association.

The discrepancy between Groups in regard to the concerns in resolutions may be explained by previous findings that the identities of filers in each Group vary and the issues that filers concerned with were therefore different. For the largest SOE shareholders, the direct way for them to exert their control over company is to appoint board personnel and thus, as seen in Group B, the resolutions proposed by them

would be more closely associated with director election or relevant issues.

8.3.5 Voting Outcomes

8.3.5.1 Aggregate Analysis

Another important measure of shareholder resolutions is the voting outcomes. By observation of voting data provided by the sample companies, a notable fact is that all resolutions proposed by shareholders were passed with significant majority votes. In majority cases, the voting levels in favor of shareholder resolutions were between 94%-99%. 8 resolutions even won 100% supports. One resolution was passed with the support of 83.45% of votes, representing the lowest supporting level among all resolutions.

In order to provide a more accurate result, the study also examines whether the voting outcomes are related to the identity of the proposing shareholders and the particular issue being proposed.

Table 8.13 shows the voting results by issue type. The issue that received the most support was the one related to amendment of articles of association, followed by those financial reporting and strategic issues (C1 and C5). The election of directors, supervisors-related and remuneration-related issues in terms of vote against are most controversial issues that received least support.

Table 8.13 Voting outcomes by issues

Issues	No of resolutions	Min%	Max%	Mean%
C1	6	97.27	100	99.47
C2	8	83.45	100	97.75
C3	4	95.44	98.91	97.71
C4	4	99.99	100	99.99

C5	3	98.59	100	99.43

8.3.5.2 Analysis by Group

Table 8.14 separates the voting data according to group.

Table 8.14 Voting outcome by Group

Group	No	Min%	Max%	Mean%
A	10	83.45	100	97.57
B	12	97.60	100	99.45
C	3	98.84	100	99.61

Proposals submitted in Group A received a remarkable lower level of support than proposals in the other Groups. However, as pointed out above, the majority of resolutions in Group A are concerned with C1, which is not the most controversial issue as shown in Table 8.13. This result is likely to suggest that shareholders involvement in Group A was more active in comparison with the rest two Groups. The section below will return to this point.

8.3.6 Conclusion from Data Analysis

Overall, the analysis above can lead to some tentative conclusions. Firstly, it appears that the mechanism of submitting resolutions in the sample companies is largely controlled by the large shareholders to demand changes from corporate management. By virtue of their dominant share holdings, resolutions sponsored by those large shareholders were passed with high levels of supports.

Second, in cases in which resolutions were filed by the non-largest shareholder, or coordinated shareholders, it is interesting to find that they also received widespread supports at shareholders' meetings. This fact provides an indication that there might be a great chance for institutional shareholders to win if they attempted to exercise

their rights to submit proposals. However, it could also be the case, where resolutions were only being proposed, even by non-SOEs, when the filers already know that the controlling shareholders would support, or at least not oppose, the resolution.

The third finding is that shareholders distinguish, on the basis of the subject of the proposals, how they vote. Those proposals relating to election of directors, supervisors and their remuneration receive relatively lower voting support than others. These issues were more controversial since appointment of managerial personnel has been widely seen as a method by the largest shareholder to control the company.

The examination of the data by Group also observed some differences among each group in regard to number of resolutions submitted, issue addressed, sponsor identity and voting outcome.

Group B received the largest number of resolutions in the sample, indicating that shareholders in this group have most actively engaged in the companies in which they invested. However, a more carefully evaluation of the data reveal that most of those resolutions in Group B were proposed by SOEs as the largest shareholders. Although Group A ranked the second, it topped in terms of number of resolutions submitted by non-largest and NSOE shareholders. It is an important finding, for it suggests that in fact, institutional shareholders or minority shareholders are provided with more opportunities to exercise their shareholder rights in the companies with high institutional shareholdings (Group A).

Of all groups, Group A is also distinct in terms of the voting outcomes. Even though the issues proposed in this Group were not most controversial, it received the remarkable lowest level of support per proposal. It might supports the assumption that shareholders are more actively engaged in voting activity in companies in which institutional shareholdings are higher.

Taken the above findings together, the study suggests that the type of company is an important determinant in the activism of submitting proposals. Shareholder

resolutions are more common in companies having better corporate governance standards. However, for institutional shareholders or other minority shareholders, the chances to have shareholder proposals are greater in companies with higher institutional shareholdings. It is least likely for this activism to occur in Group C.

Another important result from the study is that shareholder resolutions have not been initiated by institutional investors. Yang's research on 267 companies also does not report any case of institutional shareholders' resolution.[14] Chapter 9 will apply the activism model to explain institutional shareholder passivity in this regard,

Nevertheless, there has been one reported case in which institutional shareholders submitted a proposal to address the corporate governance issue of their concern. This case happened in Vanke (listing code: 000002) at the 2004 AGM.[15] The following part provides a snapshot of this company and explores how institutional shareholders exercised their rights to engage in the companies' affairs.

8.3.7 Vanke Case

Vanke is the largest listed real estate developer in the Chinese securities market. It also has high reputation for good corporate governance. Although under research conducted by the Chinese Academy of Social Science, Vanke is not ranked in the top ten Chinese listed companies with good corporate governance, it was awarded 'The best corporate governance' in China by Investors Relations Magazine, Aisamoney Magazine and The Asset Magazine.[16] It has attracted a large amount of institutional investment. According to the data provided in its self-assessment report, institutional holdings often accounted for more than 50% of its total tradable assets.[17] Another

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[14] Yang (n 1) 5.

[15] M Jin, 'Jijin Gaodiao Banyan 'Jiji Touzizhe' [Funds acted as 'Active investors] (9 May 2005) Zhongguo Zhengquan Bao [China Securities News].

[16] Information comes from Self-assessment report of Vanke on corporate governance.

[17] Ibid.

notable feature of this company is that in comparison with many other listed companies in China, the share ownership is much less concentrated. The largest shareholder-Huarun company – only controlled about 13% of total shares of Vanke company.

In this case, the issue in question was the provision of a guarantee by Vanke to a related-party. Guarantees for related-parties often dominate shareholders' concern on investee companies since as mentioned earlier, corporate guarantee is frequently used by the majority shareholder to exploit minority shareholders. At the shareholders' meeting, the board of China Vanke proposed to alter a provision of Vanke's articles of company's association as regards the proportion limits on guarantees for risk investment and asset mortgages. If the proposed amendment was passed, the thresholds for the amount of corporate guarantee would be calculated on the basis of the company's total assets. After the board's proposal was announced, 23 funds, managed by three fund management companies, Huaxia, Boshi and Nanfang, representing 12.83% of Vanke's tradable shares, voiced their dissatisfaction with the board's recommendation. They presented a proposal at the meeting that the thresholds should be calculated on the basis of company's net assets instead of total assets, which suggested a tighter threshold over the provision of guarantee. The funds' proposal was passed with the approval of majority shareholders.

8.4 Proxy Voting

8.4.1 Proxy Voting Rules

Prior to the shareholders' meeting, a notice of meeting shall be given to every shareholder 20 days in advance of an AGM, and 15 days in advance of an EGM. A shareholder can be physically present in the meeting or appoint a proxy voting on his

behalf.[18]

The default voting system is one-share, one-vote. A resolution can be passed with the approval of more than half of voting rights.[19] A two-thirds majority of the voting rights in the company is required to approve fundamental changes, such as the modification of the article of association, mergers and dissolution.[20]

In particular, a cumulative voting mechanism is allowed in Chinese listed companies for shareholders to elect directors or supervisors.[21] In cases where cumulative voting is applied, shareholders can multiply their votes by the number of directors and supervisors to be elected and can cast all their votes for a single nominee for the board of directors when the company has multiple candidates on its board.[22] For example, if an election is for five directors and a shareholder holds 100 votes, under a straight voting system, he has a maximum of 100 shares for any one nominee (500 vote total, 100 votes for each of the five nominees). With cumulative voting, he could cast all 500 for one candidate, 250 each to two candidates, or otherwise divided whichever way they choose. Cumulative voting has significant implications for institutional shareholder activism and Chapter 9 will return to this point.

In respect of the use of electronic voting, while not explicitly mentioned in the CL 2005, it was encouraged in the *Code of Corporate Governance for Listed Companies* (Chinese Code). The Chinese Code encourages listed companies to 'make every effort, including fully utilizing modern information technology means, to increase the number of shareholders attending the shareholders' meeting.'[23]

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[18] CL 2005 s 103.

[19] CL 2005 s 104.

[20] Ibid.

[21] CL 2005 s 106.

[22] CL 2005 s 106.

[23] Code of Corporate Governance for listed companies s 1 (2).

8.4.2 Voting Level

The study of shareholder voting covers 120 shareholders' meetings conducted at 30 companies over the 2007-2008 sample period.

8.4.2.1 Aggregate Analysis

On average, the study finds that the voting level at the shareholders' meetings in the sample was around 60.49%. This result is higher than that of prior work conducted by Yang, in which he observed the average voting level in the 2002-2003 financial year was around 56.79% in 267 Chinese listed companies.[24]

Table 8.15 Voting level and shareholder attendance in the sample

	No of meetings	**Mean**	**Median**	**Min**	**Max**
Voting Level	117	60.49%	60.55%	19.08%	86.49%
Number of shareholders attended	117	273	24	2	9,731

There are a number of likely contributory reasons for this difference. First, the increased level of voting is perhaps fueled by the use of electronic voting in some shareholders' meeting.[25] At the time when Yang conducted his study, electronic voting system was not introduced into Chinese shareholders' meetings. In my sample, some companies had adopted electronic means, providing shareholders with a cheap and convenient way to cast their shares, and thus promoted a higher level of

[18] J Z Yang, 'Shareholder meetings and voting rights in China: some empirical evidence' (2007) 18 International Company and Commercial Law Review 4, 10.

[25] Electronic voting will be introduced in the section below 8.4.3.

shareholder participation in voting. For example, in one company, the average voting level hit 73.88% when internet voting was provided, around 21% higher than meeting when shareholders or proxies had to be present in person. Second, the companies selected in the sample are companies evaluated as having good corporate governance practice or large institutional holdings, suggesting that they may have greater chance to encourage more shareholders' participation. The last possible reason is that the Government's increased efforts as mentioned above at improving corporate governance practice have raised the level of shareholders' engagement.

Generally, the voting levels in the sample appear to be quite close to that of UK listed companies. However, voting levels are positively connected to the share concentration level of a company. A high concentration ownership structure would result in high voting levels but represent few shareholders in number. For example, suppose in a company, 60% of the total shares are controlled in the hand of the largest shareholder, a single presence of this largest shareholder could hit the voting level of shareholders' meeting to 60%.

Indeed, looking more carefully at the data provided, the median attendance of the AGM is about 24 people, which means nearly half of the meetings conducted in the sample having less than 24 people voting in the meeting. This result reflects the fact that voting levels in the sample might be much lower if the votes from the controlling shareholders are excluded. Therefore, the institutional shareholder participation in the sample is typically far less than its counterpart in the UK, where voting levels largely depend on institutional shareholders' involvement.

The study could present a more desirable result if the votes cast by the largest shareholders can be separated from institutional investors and individual investors. However, subject to insufficient data, it is only possible to investigate the level of minority shareholders' participation in companies where the share concentration levels exceed 50%. In this type of company, any voting level above 50% is impossible to be achieved in the absence of the largest shareholder' participation. Therefore, if

the overall voting level deducts the largest shareholder's shares, the result is the minority shareholders' voting level. However, this method can not be applied in companies where the largest shareholder' holding is less than 50%. This is because one cannot exclude the chance that he might not have attended the meeting even if the voting level larger than 50%. In the absence of the largest shareholder's votes, even though the possibility is tiny, the voting level might be produced by the remaining minority investors.

Of all 30 companies, 14 companies have dominant ownership structures with the largest shareholders owning 50% or above of total equities. After excluding the largest shareholders' votes, the study finds that over the sample period, the average voting levels in those companies were around 7.02%, suggesting that *17%* of the remaining shareholders cast their votes. The voting levels in those companies turn out to be dramatically lower than previous data when large shareholders' votes were counted in.

The section below divides data obtained by Group, so as to explore whether institutional investors' passivity or retail investors' passivity attributed to low voting levels in companies.

8.4.2.2 Analysis by Group

As Table 8.16 shows, the voting level in Group B (70.96%) is nearly 15% higher than that of both Group A (55.96%) and Group C (54.55%). Group A also presents a higher voting level than the Group C, however, the different is not as significant as between Group B and the other two groups.

Table 8.16 Voting level by Group

Group	Mean%	Median%	Min%	Max%
A	55.96	55.42	33.53	70.45

B	70.96	74.79	44.46	86.49
C	54.55	54.97	19.08	67.28

Table 8.17 Attendance of shareholders by Group

Group	No of meetings	Mean	Median	Min	Max
A	43	509	25	5	9,731
B	31	215	33	5	1,845
C	43	77	13	2	961

However, as discussed earlier, since the voting level could be significantly associated with a company's concentration level, it is necessary to conduct a more in-depth analysis to distinguish shareholder attendances between companies with different share concentration level.

The study divides companies into three categories according to the size of the largest shareholder. There are (1) companies with the largest shareholding between 1-30%; (2) companies with the largest shareholding between 31-50%; and (3) companies with the largest shareholding above 50%. The number of each category in three groups and their average voting levels are presented in Table 8.18.

Table 8.18 Voting level by the concentration level

Group	1-30%		30-50%		50%-Above	
	No of companies	Voting level	No of companies	Voting Level	No of companies	Voting Level
A	6	55.44%	2	59.55%	2	55.42%
B	3	57.68%	1	56.17%	6	80.06%
C	2	35.74%	2	51.35%	6	62.01%

Two points are noteworthy. Firstly, the voting levels in each group increase as the concentration levels increase, although this trend is not followed in all cases. This trend is particularly obvious in Group B, in which the level in the third category is nearly 24% higher than the first and second categories. A similar sharp difference in voting levels have also been seen in the Group C: the voting level has risen by 27% to 62.01% when the concentration level in those companies exceeds 50%.

In contrast, the voting level in Group A remains steady when the holdings of the largest shareholder rise. We can even observe a slight drop in respect of voting levels when share concentration in Group A is over 50%.

Second, notably, the voting levels in both Group A and Group B are much higher than of Group C. This disparity is sharp in the first categories when companies have less dominant share owner structure.

Table 8.19 presents the average concentration level and voting levels after excluding the largest shareholders' votes in the sample companies in which the largest shareholdings exceed 50%.

Table 8.19 Voting by minority shareholders in companies with over 50% of largest shareholding

Group	Average largest shareholding	Voting level by minority shareholders
A	53.40%	4.02%
B	66.73%	13.39%
C	58.35%	3.66%

Another apparent point is that despite shareholdings in companies in Group B are much more concentrated, its voting level is still notably higher.

In addition to the above findings, a point worth noting here is the discrepancy with regard to voting levels between the three companies with high corporate governance

rankings and the rest companies in Group A. An average of 64.57% of the total votes in those three companies was cast, while a lower level – 52.25% – was found in the other companies.

8.4.3 Electronic Voting

8.4.3.1 Aggregate Analysis

As discussed earlier, electronic voting is key to a more efficient voting system. It provides shareholders with a cheap and convenient channel to cast their votes at the shareholders' meetings. The benefit of electronic voting has been well recognized by Chinese authorities, as reflected in the Chinese Code and the Provisions on Strengthening the Rights and Interests of Public Shareholders, where electronic voting are advocated for listed companies.[26]

Is this mechanism widely adopted in Chinese listed companies? The study analyzes relevant data and finds that the actual utilization of electronic voting system in the sample studies is quite low.

Only 14 out of 117 meetings in 9 companies were provided with internet voting to shareholders over the 2007 and 2008 sample period. There is an absence of data in the sample companies regarding which types of shareholder have voted their shares electronically. However, it has been reported in Securities News that since the introduction of electronic voting, in majority electronic voting events, institutional shareholders were found to be the main participants.[27]

Although electronic voting has only been adopted in a few cases, its positive influence on increasing shareholders' participation is obvious. Table 8.20 reports the voting level of meetings that applied electronic voting.

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[26] Code of Corporate Governance for listed companies s 8, The Provisions on Strengthening the Rights and Interests of Public Shareholders, issued by the CSRC in December 2004, s 5 (2).

[27] P Wan (n 2).

Table 8.20 Voting level at the meetings when electronic voting was provided

	Mean	Median	Min	Max
Voting Level	65.69%	69.11%	35.68%	84.70%
Attendance of shareholders	2036	746	196	9,737

Compared with Table 8.15, it is obvious that both the voting level and number of shareholders are higher when electronic voting system was adopted. Notably, the mean number of shareholders attending the meetings was nearly 10 times higher.

8.4.2.2 Analysis by Group

Table 8.20 separates the above aggregate result by Group. It shows that Group C appears to achieve the highest voting level of all Groups. However, interestingly, in terms of attendance of meetings, the number in Group C is about 5 times lower than that of Group A. The results therefore, seem inconsistent. The most likely contributory reason is the discrepant concentration level of share ownership between Group C and Group A.

Of the three companies in Group C, two of them have largest shareholders controlling around 60% of total equity, while in both Groups A and B, even the highest concentration level of share ownership is less than 40%. It is not surprising, therefore, in spite of less shareholders' participation, the voting level in companies with larger concentration ownership level is higher than that of others.

Table 8.21 Voting level at the meetings when electronic voting was provided by Group

Group	No of companies	Voting Level %				Attendance of shareholders			
		Mean	Median	Min	Max	Mean	Median	Min	Max
A	4	66.32	69.57	35.68	84.70	3427	743	196	9,737

B	2	61.47	59.48	51.05	73.88	643	740	277	911
C	3	68.65	70.95	61.73	73.28	648	751	231	961

8.4.4 Voting Substance

Among the three voting choices provided by Chinese listed companies: for, against or abstain, voting in favor of resolutions prevailed in most shareholders meetings. Of all 117 meetings, resolutions in 110 meetings received more than 90% support. As Table 8.22 suggests, on average, voting level against the resolutions at the AGM is around 1.5%. In Tang' research, in a sample of 267 companies, there were only eight cases in five companies , where the resolutions were rejected at the shareholders' meetings.[28]

Table 8.22 Voting level opposing resolution at the meetings

	No of companies	**Mean (%)**	**Median (%)**	**Min (%)**	**Max (%)**
Voting level against resolution at the meetings	30	2.31	1.5	0	68

Only in 3 cases in one company (Listing Code: 000792) were the board of directors' proposals defeated at the shareholders' meeting. These three resolutions, concerning related-party transactions, failed to pass at the 2008 EGM by 68.50% opposing votes. At that time when this meeting was held, relevant data suggested the amount of shareholding owned by investment funds accounted for nearly 67% of all tradable

[28] Yang (n 1) 11.

shares.[29] Among top ten tradable shareholders, which were all found to be institutional investors, 9 institutions voted against these three proposals. Despite the difficulty to trace how other institutions cast their votes, the high opposing level is unlikely to be achieved without institutional investors' effort given the large institutional shareholdings.

With regard to issues that are most likely to trigger opposition from shareholders in the meetings, related-party transactions top the list of meeting issues in the sample companies. Proposals concerning changing companies' audit firms, dividend policies and new share schemes also attracted opposing votes. In Tang's study, directors' remuneration and election of directors are also issues that are more likely to be disagreed by shareholders.[30]

8.4.5 Conclusion from Data Analysis

The analysis undertaken in this section finds that the average voting level in the sample is similar to the UK counterpart. However, the attendance and voting level are largely decided by the large shareholders, rather than institutional shareholders, as observed in the UK.

The study also finds that electronic voting system played a significant role in helping increase shareholders' engagement. Companies that adopted electronic voting have seen much higher voting levels and attendance at shareholders' meetings, particularly in Group A. This result implies that institutional shareholders were more willing to cast their votes if a convenient voting method was provided.

The comparative evidence shows that the Group of companies identified as leaders in

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[29] By the date meeting held, shareholdings by investment funds were 26227 and the total value of tradable shares are 39075. Data available at http://q.stock.sohu.com/cn/000792/jjcc.shtml, accessed 15 February 16, 2010.

[30] Yang (n 1) 11.

corporate governance have shown higher voting levels at the shareholder meetings than the other two Groups. However, interestingly, the average attendance of shareholders at the meetings in Group A is higher than the other two Groups. Different shareholding structures can partly explain the discrepancy. It is likely that more dispersed share structure in Group A results in higher attendance, while in Group B, relatively concentrated ownership structure is positively associated with the voting levels.

Compared with Group C, both Groups A and B demonstrate higher voting levels and shareholder attendance. This result is consistent with hypothesizes proposed in the beginning that large institutional shareholding and good corporate governance environment promote shareholder activism.

8.5 Derivative Action

8.5.1 Legal Rules

The shareholder derivative suit was introduced in China for the first time in 2005, in Chapter Six of the 2005 CL. It has significant implication for minority shareholder protection, for it provides small shareholders with a weapon against insider and controlling shareholders abuse in listed companies. According to Section 152, shareholders holding 1% singly or collectively may, depending on the circumstances, make a demand on the board of directors or the board of supervisors to sue under Section 150 of the Company Law, which imposes liability for compensation on any

> 'director, supervisor, or senior manager who causes losses to the company by violating laws, administrative regulations, or the articles of association during the course of performing his duties'.[31]

[31] CL 2005 s 150,152.

If shareholders request the board of directors to bring suit to remedy the alleged harm and the company does not bring suit within thirty days, they may bring suit in their own name.[32]

8.5.2 Empirical Evidence

Unfortunately, in the sample, there has no reported case of derivative action. The survey conducted by Clarke and Howson also found that derivative suits involving listed companies are completely absent by the end of 2009, despite the robust use of it in limited liability company.[33]

They suggested that this absence of listed companies-related cases is largely associated with potential high litigation and transaction costs incurred, which this thesis will turn to in Chapter 9.[34] Another likely reason is that courts do not accept derivative suits in relation to listed companies because of politically sensitivity or technically complexity involved. Clarke and Howson pointed out that the local Party and state officials have considerable influence over courts mainly through the power of appointment and power of budgets.[35] Courts will therefore refuse to permit the litigation to be proceeded if they confronted interference from local governments or related-institutions.

8.6 Conclusion

The study selected a total of 30 companies as the sample to explore shareholder activism in China. By examining a variety of factors and some extensive statistical data, the findings demonstrate that institutional shareholders' participation in listed

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[32] CL 2005 s 152.

[33] D Clarke and N Howson, 'Derivative Actions in the People's Republic of China' in *The Prospect of Structural Reform of Corporate Legal System* (The 21st Century Commercial Law Forum-Tenth International Symposium 2010) 190. See discussion in Chapter 9.2.2.1.2.

[34] Ibid, 205.

[35] Ibid, 195.

companies has not, in general, being active. Despite frequent shareholder resolutions and relatively high voting levels being seen in the sample, evidence suggests these activities were largely attributable to the large shareholders' involvement, rather than that of institutional shareholders. As a result, the shareholders' meeting, although legally it is the 'organ of the company', is often simply used by the large shareholders to advance their interests.

In regard to Group comparisons, the analysis undertaken here finds a sharp difference between companies having large institutional shareholdings, companies having good corporate governance standards and those peers having neither in terms of shareholder involvement. In line with the two assumptions put forward in the beginning of this chapter, the former two Groups demonstrate more active shareholders' involvement with reference to shareholder resolutions and voting levels in comparison to the last group. Therefore, it is reasonable to expect more active institutional shareholder engagement in the future in China when institutional shareholding increases and corporate governance practices improve in listed companies. Although some shareholders activism failed to make changes on corporate behaviors, it is likely that company boards will now at least think twice before determining on a course of action that may damage the interests of minority shareholders.

Moreover, the comparative evidence shows that the degree of involvement by institutional shareholders in the governance of their portfolio companies has *sometimes* been active and thus, distinguishes their investee companies from those with less institutional shareholdings. This finding is significant as it suggests that institutional shareholders have the potential to become the major player of corporate governance when institutional shareholding gained further popularity.

In some circumstances, more active shareholders engagement was also seen in companies having larger institutional shareholding than those having good corporate governance standards. It is important to note here that, large institutional shareholding and good corporate governance are not isolated. As indicated by the sample, majority

of companies identified as leaders of corporate governance also have attracted much institutional investment.

Overall, the theme that emerges from this analysis is that shareholders' participation in China relies heavily on the controlling shareholders and relatively little on institutional shareholders. The following Chapter 9 applies the model set out earlier to examine the factors influencing institutional shareholders' engagement in the governance of portfolio companies.

Chapter 9 Application of the Model in China

The core method of the thesis adopted to explain shareholder activism is the model of activism established in Chapter 1. The model provides a framework showing the factors that explain when *individual* institutional shareholders are likely to engage in activism. Recall, it suggests a two-step analysis. The first is to determine whether institutional shareholders can overcome the free-riding problem that faces any collective action. This thesis proposed four factors that will undermine the likelihood of free-riding: the decisiveness of large individual institutional holdings, the possibility of concerted action, 'in process' benefits and a normative obligation to act.

Once free-riding can be controlled, the second step proceeds to ask whether that shareholder's gains are greater than its costs. I suggested that the 'gains' include the shareholder's share of the total gains to the corporation from the activism, plus any individual benefits it secures through its activism. The costs are split up into direct costs and indirect costs.

In applying the model, given limited evidence, it is difficult to work out completely how these factors play out in the case of all types of activism. This chapter is structured so as to be divided up expressly around different types of activism, as Chapter 5 was. Most data available in this chapter relate to shareholder voting and I will therefore focus on that form of activism. However, as I proceed, where possible, I shall note differences in the way the model might apply to other types of activism.

9.1 Overcoming Free-riding

In determining whether free-riding can be overcome, the first two factors – the decisiveness of large individual institutional holdings and the possibility of concerted action – will apply *differently* depending on the voting systems adopted at shareholders' meeting. As discussed earlier, Chinese listed companies can adopt a usual one-share, one-vote system, or class voting system, or cumulative voting system,

determined by certain circumstances stipulated by legislation. The sections below will explain how these factors play out in different voting systems.

9.1.1 Usual Voting: The Decisiveness of Large Individual Institutional Holding

One of the factors which might overcome the free-riding problem is where a shareholder's stake in the company is sufficiently large that the shareholder calculates that stake will be decisive in changing corporate behaviors. Is the individual size of an institutional investor likely to be big enough to tip the balance? While there is not comprehensive data on all Chinese listed companies, Tables 9.1 and 9.2 summarize data from the sample. The answer is clear: most individual institutional shareholders are unlikely to have a decisive shareholding in their portfolio companies due to the presence of large state shareholdings.

In UK listed companies, with shares widely dispersed, there is some chance of a vote being fairly evenly 'split' and shareholders with 2 or 3% might sometimes be able to tip the balance. However, that is unlikely in Chinese listed companies, when 50% or above of the shares are controlled by the largest shareholder, as shown in Table 9.2, in half of the sample.

In the remaining 15 listed companies where the largest shareholding is less than 50%, an individual institutional shareholder might have tiny chance to be decisive. However, it is highly unlikely, given that the portion of shares held by the largest shareholders are still bigger than his.

Table 9.1 Number of company by the largest individual institutional investor

The largest individual institutional shareholding	**Number of Company**
3% - above	5

1-3%	12
0-1%	13

Table 9.2 Number of company by the largest shareholder

The largest shareholding	**Number of Company**
50% - above	15
30-50%	4
1-30%	11

The low level of individual institutional concentration in a single company is partly the product of strict investment restrictions. Institutional investors are often limited in how much stock they can own and the percentage of stake they can have in a single company. The part below gives a summary of equity portfolio regulations on each type of institution in China and then discusses the impact of these rules on shareholders activism.

9.1.1.1 Investment Restriction

Back in 2000, Caijing, a leading financial magazine in China, published an article entitled ‘Inside story of Fund Management Industry’, in which it revealed that many fund managers had manipulated the price of their holdings in order to gain unlawful short-term profits.[1] This report immediately drew public and regulatory attention on the booming funds industry. Regulators quickly stepped in to curb the malpractice. Since then, the Chinese Government has tightened the control of the securities investment funds (SIFs)’ investment in the securities market by laying down strict investment limits.

Under Fund Law, a SIF is not allowed to hold more than 10% of its net assets in the

[1] B Naughton, 'The Politics of the Stock Market' (2002) 3 Chinese Leadership Monitor ,4.

shares of a single issuer.[2] Neither is it permitted to hold more than a total of 10% of one company's share in the fund managed by the same fund manager.[3]

For insurance companies, it was not until 2004 that they were allowed to invest in equities, and they remain subject to strict regulations. The upper limit for directly investing in stock is 20% of total investment value.[4] In addition, insurance companies are permitted to access to securities market through investing in SIFs. Again, this investment channel is restricted. The aggregate investment in SIFs should not exceed 15%.[5]

The pension fund industry in China is still young, and perhaps not surprisingly, it faces tight restrictions on stock ownership. For corporate pension funds (CPF), when managed by an investment management company, investments in equities, investment-type insurance products, and equity funds shall be no more than 30% of the fund's net assets, while investments in equities alone shall be no more than 20% of net assets.[6] When a CPF managed by a single investment manager invests in a stock issued by a single company or in a mutual fund, the amount of that investment shall not exceed a total share of 5% of said stock or said mutual fund, nor shall exceed 10% of total pension fund assets managed by the investment manager.[7]

For the National Social Security Fund (NSSF), at least 50% of the NSSF assets must be invested in bank deposits and government bonds and among this, no less than 10 per cent should be invested in the bank deposits. For the remaining assets, no more

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[2] Fund Law, s 31(1); The same restriction applies in the UK mutual funds, see Chapter 4.1.1.1.

[3] Fund Law, s 31(2).

[4] Provisional Measures on Administration of Operation of Insurance Capital s 16(4). For detailed discussion, see Chapter 7.2.2.2.

[5] CIRC, Second Quarterly Press Conference in 2009, ChinaNews, <http://www.chinanews.com.cn/cj/cj-gncj/news/2009/07-31/1798879.shtml> accessed 20 December 2009.

[6] Interim Measures for the Management of Enterprise Annuities Fund s 47.

[7] Ibid, s 49.

than 40 per cent are allowed to be invested in equities.[8] Therefore, securities investment must be a minority portion of total assets.

A Qualified Foreign Institutional Investor (QFII) is subject to both the investment scope and ownership shareholdings. First, the investment scope of QFIIs is limited. A QFII can invest in shares(excluding B shares), treasuries, convertible bonds and enterprise bonds listed on China's stock exchanges.[9] Non-tradable shares and legal person shares of listed companies and derivative securities products are off-limits to QFIIs. Second, the total percentage of shares held by all QFIIs in a single listed company must not exceed 20% of the total shares of that listed company.[10] Moreover, investment by a single foreign investor through the QFII scheme in a single listed company must not exceed 10% of the total shares of that listed company.[11]

All in all, these strict investment restrictions mean that an institutional investor could only have a small portion of its assets in a single stock. As in the UK, the main purpose of these portfolio regulations is to help institutions maintain a diversified portfolio to limit the exposure of risks resulted from a large block in a single stock.[12] Another specific concern of Chinese policymakers is to prevent fund manager holding a large stake in a company from manipulating its share price. Prior to the split share structure reform, given that tradable shares only account for one-third of all outstanding shares, market abuse was threatening since a holding of 10% of a company's shares by a fund manager may actually hold one-third of tradable share, enabling the fund manager to engage in speculative trading to manipulate the stock market.

As we have already seen, portfolio regulation can also be found in the UK. What differentiates China's situation is that institutional shareholders are permitted to invest

[8] Interim Provisions on Administration of NSSF Investment s 28.

[9] Notice on the Implementing of Provisional measures on Administration of QFIIs s 9.

[10] Ibid, s 10.

[11] Ibid.

[12] See Chapter 4.1.1.1.

only a certain percentage of their total assets in the securities market. Under such restrictions, an institutional shareholder is not only limited in how much stock he can own in a single company as in the UK counterpart, but also the collective shareholdings of institutional shareholders are limited.

Admittedly, such regulations enabled the Government to curb market abuse and thus played an effective role in the nascent development of Chinese securities market. With the ongoing non-tradable reform, coupled with the robust development of institutional investment, the extent of the regulatory control is an issue of concern for future development. The hope for institutional shareholders to play a role in corporate governance relies heavily on their increasingly large shareholdings, and if their growth is limited, it is less likely for them to overcome the problems associated with concentrated state ownership as discussed in section 9.1.1.

9.1.2 Usual Voting: The Possibility of Concerted Action

Is, then, concerted action among institutional investors sufficient to 'tip the balance'? As said, in the Chinese context, this not only depends on the size of collective institutional share ownership, but also the size of the largest shareholder given the concentrated-share ownership.[13] The larger the institutional share ownership and the smaller the largest shareholding, the greater the chance they can collectively counterbalance the incumbent management.

The discussion of the likelihood of concerted action in the sample companies will be divided into two parts, depending on the size of the largest shareholders. First, for the 15 companies where 50% or above of shares are concentrated in the hand of the largest shareholder (see Table 9.2), even if it were feasible to form an alliance comprising all institutional shareholders in the company, still the concerted action would not make a difference to the voting outcomes. The cases of ZTE, and of China

[13] The shareholding disclosure rule, which will be discussed in section 9.2.2.2.2 as a source of indirect costs of activism, is also relevant to discussing the concerted action.

Merchants Bank, in the following section will illustrate well this point.

Second, we will turn to discuss the possibility of concerted action in the remaining 15 companies. Table 9.3 shows that in the majority of 15 companies, the institutional share ownership accounts for more than 10% of the total shareholding, with 5 companies having a collective institutional shareholding of more than 20%. However, none of these companies has an institutional ownership holding more than 30% of the total equity. These data indicate that, even if all institutional shareholders can explicitly agree with others that each will join in an action, together they do not have enough votes to tip the balance unless they can persuade a sufficient number of retail investors to do likewise.

Table 9.3 Number of Companies by the per cent of institutional shareholding

Institutional shareholding (% of total shares)	**Number of Companies**
20-30%	5
10-20%	8
0-10%	2

Comparatively, the possibility of concerted action is much higher in the UK than in China. Owing to the higher level of concentrated institutional ownership, fewer shareholders need to agree to act together in order to constitute a decisive block of shares in the UK.

9.1.2.1 Cases: ZTE and China Merchants Bank

The ZTE case has been widely seen as the example to demonstrate the weakness of institutional shareholders under a concentrated state ownership system. In July 2002, the board of ZTE Co., one of the largest listed telecoms manufacturers, announced a proposal to offer shares on the Hong Kong Stock Exchange (HKSE). It was believed that the H-shares' low price-earnings would drag down the price of the companies'

A-shares.[14] The potential negative impact on the A-share holders incurred widespread anger among institutional investors.

Private meetings and public rows between ZTE and funds failed to force the company to withdraw the plan. At the extraordinary shareholders' meeting, 113 shareholders were present, aggregately representing 66% of the total stakes. Eleven fund companies, holding 12.77% of the company's shares, voted against the proposal at the extraordinary shareholders' meeting, arguing that A-share holders' interests will be diluted by the dual listing on the HKSE. However, the proposal was easily passed with the support of the largest shareholder, Zhongxingxin Company, a state-controlled enterprise, holding 52.85% of the shares of ZTE. This case demonstrates clearly the powerless of institutional shareholder coalitions in Chinese listed companies with concentrated share ownership.

The plan was eventually aborted under market pressure despite having gained success in the meeting. Frustrated institutional investors dumped their shares after the failed battle and consequently prompted a sharp drop in the company's share price.

A second eye-catching case is that of China Merchants Bank and its issue of RMB 10 billion worth of convertible bonds.[15] China Merchant Bank is one of the biggest listed banks in China with a large institutional shareholding – more than 25% of the existing tradable shares were held by 53 funds. After the plan was released at the bank's 2003 interim performance report meeting, fund managers furiously opposed it arguing that it would dilute their interests. Some decided to exit, selling shares, prompting a sharp drop in the company's share price. Many publicly criticized the company' plan as a method to expropriate the interests of tradable shareholders, and some proposed alternative fund-raising schemes. However, the bank refused to compromise and

[14] J Zhao et al., 'Zhong JIjin Nanban Zhongxing Tongxun'[Funds Unable to Win in ZTE?] (16 August 2003) *Guoji Jinrong Bao [International Finance News]*.

[15] P Wang, 'Jijin Fandui Zhaohang Faxing Baiyi Kezhuanzai Rongzi'[Funds Disagreed China Merchant Bank's Bond Offer Plan]Zhongguo Zhengquan Bao [Chinese Securities Journal], September 29, 2003.

placed the plan before the votes. Eight funds, representing more than 20% of the tradable shareholder (or 5% of total shares) voted against the board.[16] However, it was virtually impossible for them to win despite forming an alliance due to 75% of the bank's shares being non-tradable shares and not surprisingly, the proposal survived with a majority supporting vote.

To sum up, although fund managers dissatisfied with corporate behaviour chose 'voice', rather than 'exit', they lost their cases and this is likely to continue to happen so long as large blocks of shares remain non-tradable or highly concentrated.

9.1.3 Unusual Voting System

The two factors – the decisiveness of individual votes and the possibility of concerted action – will become much more significant when the power of the large shareholder is restricted under a class voting system or cumulative voting system.

9.1.3.1 Class Voting System

One of the effective ways to mitigate the influence of the dominant non-tradable shareholders is to adopt a *class voting system.* It allows tradable shareholders to decide matters on shareholders' meetings by disenfranchising the non-tradable shareholders' votes.

9.1.3.1.1 Regulation of Class Voting System

The class voting rule has first been seen in a regulation concerning cash offers in Chinese listed companies. Cash offer is a method adopted by listed companies when they wish to raise further capital from the public after an IPO. It is, however, widely considered as a means of expropriation of minority shareholders by overreaching majorities since the new cash offer would restructure the interests of current tradable

[16] J Wang, 'Zhaohang yu Jijin: Gudong Dahui Shang Doufa'[Merchant Bank & Funds: Contest at the Shareholders' Meetings] (16 October 2003) *Zhengquan Shibao [Securities Times]*.

shareholders. Consequently, announcements of a cash offer by a company could often shake the confidence of investors in the company and cause a sharp drop in share price. To stabalise the financial market, the CSRC issued *Relevant Requirements for Listed Companies' Cash Offer of New Shares* (2002 Cash Offer Regulation) to regulate cash offer.[17] One of the key rules under the 2002 Cash Offer Regulation is that if the new shares issued exceed 20% of the company's existing total shares, the offering proposal must obtain approval from tradable shareholders at the shareholders' meetings.

Clearly, tradable shareholders' role in significant corporate decision-making will be enhanced under this separate voting system. However, it falls short of practical applicability. Again, here considers the ZTE and China Merchants Bank cases. The controversial issue in both cases was cash offers, however, neither applied the split voting system, although they both happened after the promulgation of 2002 Cash Offer Regulation. The CSRC denied the request from funds for the application of the regulation to the proposals, ruling on the grounds that (1) in ZTE case, the Regulation only applies to the cash offers in the domestic market, moreover, the amount of new shares (18% of the understanding shares) issued in the proposal has not reached the trigger point of 20%; (2) in China Merchant Bank case, the Regulation does not apply to convertible issue.

These two cases reflect two important problems with the 2002 Cash Offer Regulation. First, the application of the class voting system is limited to cash offer and therefore, denies its access to other significant corporate issues which are all critically important to the interests of tradable shareholders. Secondly, the board of listed companies could take advantage of the 20% minimum rule to deliberately set the amount of cash offer along the bottom line, where the rejection of the rule would be almost a certainty. In consequence, the 2002 Cash Offer Regulation did not work as expected to restrain the

[17] Relevant Requirements for Listed Companies' Cash Offer of New Shares] issued by the CSRD on July 24, 2002.

power of controlling shareholders in shareholders' meeting.

In recognition of these shortcomings, new rules regarding the application of class voting system eventually came in 2004 *Minority Shareholder Protection Provision* (MSP Provision) which was issued by the CSRC.[18] The MSP Provision has expanded the applicable scope of the class voting system, providing that major corporate matters such as cash offers, convertible bonds, significant assets restructuring, and overseas listing of subsidiaries should all win majority votes from holders of tradable-shares present in the general shareholders meeting.[19]

However, it does not come without problems. These problems may, if left unaddressed, have a significant impact on the efficacy of the separate voting system. First, the workability of these rules is in serious doubt due to the lack of detailed and functional provisions. For example, the MSP Provision provides no useful guidance as to what issues would fall into the category of 'major corporate matters' and how the conditions operate. The second problem lies in the unclear legal remedy. If tradable shareholders disagree with decisions made by the board, as to what remedy they would seek to protect their legitimate rights, the MSP Provision set no guidance. Thus, although the separate voting system will help institutional shareholders exert a greater say in governance, the applicability of this is in need of further explanations from regulators.

9.1.3.1.2 Applying the Decisiveness of Individual Shareholdings and the Possibility of Concerted Action under the Class Voting

A class voting system offers institutional shareholders a good opportunity to be decisive in companies where non-tradable shares are high. In the sample, as shown in Tables 8.1, 8.2 and 8.3, shares in 20 companies are not fully circulated in securities

[18] Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders, issued on December 7, 2004 by the CSRC.

[19] Ibid, s 1.

market.[20] Among them, 10 companies have a restricted shareholding accounting for nearly 50% or above of total equity, held by the state as the largest shareholder. When non-tradable votes are excluded in these companies, the ability of individual institutional shareholder is significantly enhanced. For example, if an institutional investor holds 3% of total equity in a company where 50% of equity is restricted to the public, a class voting system will enable him to control 6% of total shares at shareholders' meeting. Hence, the decisiveness of the individual shareholding is obviously stronger with a class voting system than a normal voting system.

Using a class voting system will also *increase* the possibility of concerted action. That is because, first, a coalition will make a difference on the outcome when the largest shareholder's votes are abstained at meetings, and secondly, the fewer institutional shareholders need to agree to act together in order to constitute a decisive block of shares. Take the Luzhou Laojiao (Listing Code: 000568) as an example. Under usual voting system, even if it is practical for all institutional shareholders to form a coalition, it is meaningless since the coalition cannot determine the voting outcome due to presence of large non-tradable shareholding. However, when non-tradable votes are excluded at AGMs under a class voting system, votes collectively controlled by institutions will increase from 21.29% to 41.50%, which makes the coalition decisive.

An important point to make here is that the facilitating role of the class voting system will be restrained when concentrated shares are not non-tradable (as the class voting only exclude non-tradable shareholders' votes not the largest shareholders' votes). This issue has to be addressed by gradually reducing state-owned shares and it will be discussed in Chapter 10.

9.1.3.2 Cumulative Voting

9.1.3.2.1 Introduction

[20] See Chapter 4.1.1.1.

Enabling listed companies to adopt cumulative voting is another method to increase the power of institutional shareholders in concentrated share ownership companies.[21] A cumulative voting system, as described by section 106 of Company Law (CL 2005), allows a shareholder to multiply his votes by the number of directors and supervisors to be elected and to cast all his votes in favor of one candidate for director or supervisor or distribute his votes among all candidates.[22] Before turning to discuss the implications of the cumulative voting system for institutional shareholder activism, it is illustrative to give a brief account of its development.

The cumulative voting system originated from Britain but in practice it was more widely adopted and attracted more attention in America. It has experienced a rise and fall history.[23] This system first spread rapidly in the late 19th century in many American States. At that time, the majority of these states adopted *mandatory* cumulative voting, only a small group of states added cumulative voting in a permissive form.[24] The benefits of such system, as suggested by Bhagat and Brickley is that it gives minority shareholders a chance to select their representation on the company board, to affect board and management and may reduce agency costs.[25] Gordon further argued that cumulative voting would probably increase the shareholders' welfare in large companies in cases when corporate control is active.[26]

However, a range of criticisms have been leveled against it. One is that a board elected under cumulative voting may be less effective than a board elected on 'a

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[21] For a good discussion of how cumulative voting can be beneficial in corporations, see generally, B Black and R Kraakman, 'A Self-enforcing Model of Corporate Law' (1994) 109 Harvard Law Review 1911.

[22] CL 2005 s 106. And also see the discussion in Chapter 8.4.1.

[23] D Sun, 'Cumulative Voting' (2008) 8 Knowledge Economy 32 (In Chinese), 35.

[24] J Gordon, 'Institutions as Relational Investors: A New Look at Cumulative Voting' (1994) 94 Columbia Law Review 124, 142-46.

[25] S Bhagat and J Brickley, 'Cumulative Voting: the Value of Minority Shareholder Voting Rights ' (1984) 27 Journal of Law and Economics 339.

[26] Gordon (n 24) 129.

winner-take-all basis'.[27] In addition, cumulative voting may reduce the large shareholders' willingness to participate in corporate governance.[28]

Due to these considerations, since the early 1970s, many US States began moving away from a mandatory to a permissive regime.[29] No important corporate law jurisdiction now continued to adopt mandatory cumulative voting. The legal practice of other countries, for example, Japan and South Korea also adopted a permissive cumulative voting system.[30]

The rise and fall of cumulative voting in the US cast doubt whether its benefits would outweigh the costs. The thesis argues that the impact of cumulative voting is dependent on, and varies with, the shareholding structure of a corporation. As discussed later, under some circumstances, the cumulative voting can be an effective instrument for institutional investors to enhance their ability to elect representatives on the board.

9.1.3.2.2 Legal Framework for Cumulative Voting

Provisions for cumulative voting existed prior to the revised company law. The *Code of Corporate Governance for Listed Companies* (Chinese Code) had first stipulated rule on the cumulative voting system as a means of fully reflecting the views of minority shareholders. Listed companies that have a controlling shareholder holding over 30% of the shares were required to adopt a cumulative voting system in shareholders' meeting for election of director, and companies that did not adopt the cumulative system should stipulate the implementing rules of this system in the articles of association.[31] The 2004 *Minority Shareholder Protection Provision* further encouraged companies to adopt cumulative voting for the selection of directors and

[27] See views summarised in Black and Kraakman Black and Kraakman, (n 21) 1949.

[28] Gordon (n 24) 126.

[29] But Professor Gordon attributes the decline of this system primarily to the political power of incumbent managers who wanted to make proxy contests more difficult, see Gordon (n 24) 153.

[30] Sun (n 23).

[31] Code of Corporate Governance for Listed Companies s 31.

supervisors.[32]

Cumulative voting has now been codified in the revised CL 2005, giving it a more formal legal background for better enforcement. Section 106 adopts a permissive regime to enable public companies to choose whether to adopt a cumulative voting method in the election of directors and supervisors. However, whereas the CL 2005 applies a permissive regime, the requirement laid down by the Chinese Code that listed company with controlling shareholders holding more than 30% of the shares should adopt cumulative voting systems is also mandatory in nature. In theory, as explained in Chapter 6 concerning legislation hierarchy, company law formulated by the State Council has higher authority than the Chinese Code issued by the CSRC. In practice, however, there are no public disputes raised in respect of the application of the cumulative voting system. In the sample, *17 of 30* listed companies have adopted in their articles of association or have used cumulative voting to elect directors at the shareholders' meeting, which roughly corresponds to the number of companies where the largest shareholding accounts for more than 30% of the total equity shares.

9.1.3.2.3 Applying the Decisiveness of Individual Shareholding and the Possibility of Concerted Action under the Cumulative Voting

The likelihood of overcoming free-riding via the decisiveness of individual shareholdings and through concerted action would be increased in cases where cumulative voting is adopted, in particular the latter factor. However, as one will see later, the impact of cumulative voting is dependent on, and varies with, the size of institutional shareholding and the number of directors to be elected.

Suppose a company which comprises of 10 shareholders is to elect 5 directors. The largest shareholder A owns 510 shares, which account for 51% of the total shares and the other 9 shareholders own 490 shares, which account for 49% of the total shares. If

[32] Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders s 1 (4).

it is estimated that the entire 1,000 shares will be voted, under the straight voting each shareholder is entitled to cast votes equal to the number of shares held. A controls 510 shares and can decide the composition of the board and the other 9 shareholders have no say. However, with cumulative voting, the number of votes given a shareholder equals the number of shares times the number of candidate directors. Thus, the total vote number becomes 5,000,[33] and among these shares, A owns 2,250 votes, the other 9 shareholders own 2,450 shares. The cumulative voting enables a shareholder to cast all his votes to one single candidate or votes for more than one candidate. If all the 9 minority shareholders could cumulate their shares together to vote for certain candidates, they can at least elect two directors even if A vote against them. Under this situation, A can only elect up to 3 directors.

The above example reveals that cumulative voting could strengthen the ability of minority shareholders to negotiate over the board composition by cumulating their shares together for one or more candidates. However, it will not benefit all shareholders to win a board seat for them, but only those that own a certain percentage of shares alone or together with others. Therefore, as suggested by Vittas and Gordon, it becomes the most powerful tool for allowing institutional shareholders to elect directors that are truly independent and to play an active role in protecting the interests of minority investors.[34]

Moreover, whether institutional shareholders' block of shares is decisive depends on the number of directors to be elected. The larger number of directors proposed in the shareholders' meeting, the larger chance for minority shareholders to win a board seat.

By law, the Chinese board of directors can consist of 5 to 19 directors elected by the

[33] 1000 shares multiple the number of directors to be elected, in this case, is five.

[34] D Vittas, 'Institutional Investors and Securities Markets: Which Comes First?' (1998) Paper presented at the Annual Bank Conference on Development Economics Latin American and Caribbean Conference, June 28–30, World Bank, Washington, D.C. 15; Gordon, Institutions as Relational Investors (n 24), 170-74 (describing the value of cumulative voting in overcoming the rational apathy of institutional investors).

shareholders' meeting.[35] Previous studies suggested that the average size of the board in top 100 Chinese listed companies is 11, which indicates that only shareholders individually or collectively hold *9.09%* or more of shares have the possibility to win a seat in the board.[36]

In the sample, as we have seen, *none* of the largest institutional shareholder can individually reach that threshold. The success to elect a director through cumulative voting therefore relies on whether a coalition could constitute 9.09% or above of the total shares. It is worth nothing here that the size of the individual shareholding is still clearly relevant to the practicality of such coalitions because it could determine the number of shareholders that have to get involved. In the sample, Tables 8.1, 8.2 and 8.3 show that there is a total of *14* companies where institutional shareholder ownership accounts for more than 11.44% of the total equity. As previously analyzed, only in these 14 companies can cumulative voting work as an effective tool to allow institutional shareholders to determine the position of a director.

Presumably, it will be more difficult for minority shareholders to elect supervisors of board by using cumulative voting, mainly because the size of supervisor's board is much smaller than board of directors – only 4.95 in top 100 Chinese listed companies.[37] Another reason is that nearly one-third of supervisor board must be elected by employees, and the rest are open for shareholders.[38] In 2007, about 36.97% of members of supervisor board are represented by employees in the top 100 Chinese listed companies.[39] Unfortunately, we *lack* good data on how institutional shareholders make use of the cumulative voting.

Two additional important points in regard to the cumulative voting system should be

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[35] CL 2005 s 107.

[36] Institute of world economic and political in Chinese Academy of social science, 2009 nia Zhongguo Shangshi Gongsi 100 qiang gongsi zhili pInjia [Corporate Governance Assessment Report on the Top 100 Chinese Listed Companies for 2008] < http://www.iwep.org.cn/> accessed 14 September 2009.

[37] Ibid.

[38] CL 2005 s 117.

[39] Ibid.

sounded here. First, one way for companies to reduce the likelihood that minority shareholders will elect a director is to decrease the size of the board.[40] By regulations, the number of board of directors in listed companies should be clearly stipulated in the articles of association, suggesting that the number of directors can be changed by the amending of articles.[41] In the companies where majority shareholders are able to control two thirds or more of shares, the number of directors can be determined by the controlling shareholders and through adjusting the articles of association, the election of directors will probably continue to be controlled by the large shareholders.

Second, the cumulative voting only ensures a minority of directors be elected by minority shareholders. This minority number certainly cannot guarantee any advantages for public investors in the board-decision process. However, at least, minority shareholders' voice gets the chance to be raised and it seems impossible or unreasonable in any country's listed companies that minority shareholders' representatives shall dominate the board.

9.1.4 'In-process' Benefits

To date, there is *no* institutional investor in China akin to Hermes that adopts engagement as its investment strategy. Moreover, as there is a lack of awareness among the public for the importance of shareholder engagement, the reputational benefit is minimal.

9.1.5 Normative Obligation

9.1.5.1 Regulatory demands

The role of institutional shareholder engagement in corporate governance appears to attract growing interests from Chinese regulators. In a public forum, for example, the

[40] Bhagat and Brickley (n 25) 342.

[41] CL 2005 s 44.

president of the CSRC, Shang Hulin stated that institutional shareholders shall continue to play a positive role in facilitating non-tradable share reforms, promoting corporate governance system of Chinese listed companies and enhancing capital market.[42]

The role of institutional shareholder in corporate governance has been specially emphasized in the Chinese Code by stating:

> 'Institutional shareholders shall play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes.'[43]

The normative obligation from regulatory demands worked stronger in non-tradable share reform, as one will see in section 9.2.2. However, a comparison analysis between the UK and China in terms of normative obligation on shareholder participation suggests that Chinese regulatory framework clearly falls short and thus, unlikely to provide institutional shareholders with strong incentives to take part in corporate governance.[44]

9.1.5.2 Culture

Chinese cultural beliefs which uphold a value of collectivism appear to be critical of the practice of free-riding. To understand the implications of a more collectivist society for overcoming free-riding, it will be useful first to consider some cultural beliefs in a collectivist society that govern a particular kind of individual behavior.

Collectivism and individualism are frequently used to describe how people interact

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[42] Jiandinbuyi fazhan zhuangda jigou touzizhe [To strongly promote the further development of institutional shareholders] CSRC cite Shanghai Securities <http://www.csrc.gov.cn/n575458/n575667/n641992/n2671194/3038836.html> accessed 12 March 2009.

[43] Code of Corporate Governance for Listed Companies, s 11.

[44] See Chapter 10.2.3.

with others in a society.[45] Societies are described by Hofstede as individualistic when ties between individuals are loose, and people are expected to look out for themselves and tend to ignore group interests if they conflict with personal interests.[46] The opposite cultural dimension of individualism is collectivism. This occurs when people are integrated into strong cohesive in-groups and the interests of the group take precedence over individual interests.[47] Owing to traditional Confucianism values, Chinese society has long been regarded as collectivist where family and social ties are strong, which distinguish it from British culture which is more individualistic.[48] Under Hofstede's model, the individualism index in China is scored only at 36, comparing to a much higher score of 89 in the UK.[49]

Within a collectivist culture, people look out for the well-being of the groups to which they belong, even if such actions sometimes require that personal interests be disregarded. [50] Accordingly, if institutional shareholder activism is collectively beneficial, every individual shall make his contribution to achieve 'group' interests even if his personal interest cannot be secured. The practice of free-riding on other's efforts is therefore culturally unacceptable and would lead to criticisms from other members.

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[45] There is a massive literature on this subject, for example, see C Triandis, C McCusker and H Hui, 'Multimethod Probes of Individualism and Collectivism' (1990) 59 Journal of Personality and Social Psychology 1006.

[46] G Hofstede, *Culture's Consequences, Comparing Values, Behaviors, Institutions, and Organizations Across Nations* (Second edn Sage Publications, California 2001) 20.

[47] Ibid.

[48] S Redding, *The Spirit of Chinese Capitalism* (de Gruyter, Berlin 1990) 62; D Williamson, 'A Management Control Assurance in the Different Cultures and Institutions of China and the UK in D H Brown and A MacBean. (eds), *Challenges for China's Development:an Enterprise Perspective* (Routledge, New York 2005) 121. Williamson compared the individual index under Hofstede' framework and showed that UK individualism scored at 89, while Chinese culture only has a 36.

[49] Hofstede (n 46) 87. Hofstede's survey did not include the China. However,Cragin has applied Hofstede's instrument to the China, see J.Cragin, 'Management technology absorption in China'in S Clegg, D Dunphy and S Redding (eds), *The Enterprise and Management in East Asia* (University of Hong Kong, Hong Kong 1986).

[50] John A Wagner III, 'Studies of Individualism-Collectivism: Effects on Cooperation in Groups' (1995) 38 The Academy of Management Journal 152, 153.

Chinese cultural beliefs for collectivism seem to provide a good driving force to overcome free-riding problem. If institutional shareholders are culturally obliged to take action, the level of shareholder activism in China would be much higher than the UK counterpart, where an individualistic culture is followed. However, as we have already seen, this is not the case. Section 9.2.2.2.3 will explain that some other aspects of Chinese traditional culture, such as the importance of relationships, and authoritarianism, will work more strongly to make shareholder opposition a less worthwhile activity.

9.2 A cost-benefit Analysis

Even if shareholders can be persuaded not to free-ride, recall that my model claims that we must still go on to ask whether the benefit of activism will outweigh the cost.

9.2.1 Benefits

Benefits from activism would be the share of total gains. In the UK part, the thesis noted that large institutional shareholders with longer-term investment horizons will receive more benefits from activism than smaller ones and this will also apply in the Chinese context.[51] However, this difference between institutions is less significant in China since the majority of institutional investors participating in activism are mutual funds. The potential long-term institutions, such as pension funds and insurance companies, are in an embryonic stage, and are subject to strict investment limits or have to indirectly invest through mutual funds.

Since the concept of shareholder activism is still relatively new in China, institutional shareholders are likely to receive lower reputational gains than in the UK as fewer beneficiaries would take institutional investors' engagement into account when they choose their asset managers.

[51] Chapter 4.2.1.1.

9.2.2 Costs

Costs of shareholder activism include indirect and direct costs. The part below provides an analysis on how regulatory or cultural elements reduce or increase the costs to shareholder when they engage in corporate governance.

9.2.2.1 Direct Costs

9.2. 2.1.1 Electronic Voting

Electronic voting is key to a more cost-effective voting system. Unfortunately, it is not explicitly mentioned in the CL 2005 (unlike UK corporate legislation).[52] It is a practice merely recommended in administrative regulations, such as the Chinese Code and the Provisions on Strengthening the Rights and Interests of Public Shareholders. The Chinese Code stipulates that a listed company shall 'make every effort, including fully utilizing modern information technology means, to increase the number of shareholders attending the shareholders' meeting.'[53]

The facilitating role played by the electronic voting is obvious, as explained by empirical data in Chapter 8.[54] For example, when electronic voting was available, the mean number of shareholders attended the meetings was nearly 10 times higher than when not.[55] This finding is clearly in line with the view proposed in Chapter 1 that lower costs for engagement can stimulate more institutional shareholder participation.

However, empirical evidence also shows actual utilization of electronic voting system in the sample studies is quite low, which could partly explain the low level of voting at the AGMs.

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[52] CA 2006 s 333.

[53] China Code of Corporate Governance for Listed Companies s 8.

[54] See Chapter 8.4.3 .

[55] Ibid.

9.2.2.1.2 The Costs of Litigation

This section is concerned with the cost incurred in bringing derivative action. The introduction of the shareholder derivative suit in CL 2005, as noted earlier, allows shareholders to pursue litigation when their interests are infringed by corporate managers. It certainly represents a major step towards stronger shareholder protection in corporate legislation, and could have significant implications for shareholder activism in the future.

However, even though derivative actions are allowed by statute, economic disincentives remain for institutional shareholders.[56] The cost of litigation, as that in the UK, has traditionally been a key determinant for whether to bring a derivative action. In China, filing a suit may bring huge financial costs, composed of at least two parts: the court's fees and the attorney's fees. The court's fees include the filing fees (*anjian shouli fei*) paid to the court before the suit and other expenses incurred during the hearing of the case such as fees for investigation and for preservation of assets. In addition, shareholders have to pay attorney's fees.

According to section 19 of the Supreme People Court's (SPC) Measures on the People's Courts' Acceptance of Litigation Fees 1989, the losing party should bear the filing fees and other litigation fees allocated by the court excluding attorney's fees.[57] Therefore, if the plaintiff shareholder loses the case, he has to pay a considerable amount in litigation costs.

When the derivative suit is successful, the recoveries accrue to the company as a whole, thereby, the plaintiff-shareholder – who will yet only a pro rata benefit – has little incentive to take litigation unless he can recover his costs off the top. That is, as

[56] D Clarke and N Howson, 'Derivative Actions in the People's Republic of China' in *The Prospect of Structural Reform of Corporate Legal System* (The 21st Century Commercial Law Forum-Tenth International Symposium 2010) 190, 205.

[57] Clarke and Howson reported that occasionally, the 'loser pays all' principle is not applied for some reasons undisclosed by courts. See ibid, 211.

discussed in Chapter 1, a classic 'collective action problem'. This disincentive is exacerbated by the fact that as a general rule in China, the plaintiff will have to bear some legal costs even if he wins the case. While Chinese law generally awards trial costs to the winner, such costs are usually defined only as funds paid to the court as filing and other fees, and do not include attorneys' fees.[58]

Comparatively, UK investors face similar economic burdens. As discussed above, a plaintiff-shareholder will benefit from the recovery only in proportion to his shareholding and unless a '*Wallersteiner*' order is obtained, a losing plaintiff shareholder will have to pay his fees and those of the defendant.[59] Partly by virtue of this economic disincentive, the level of derivative claims in the UK has been low.

In an attempt to prevent fees being obstacles to shareholders, some commentators have recommended the US approach to deal with the cost of litigation.[60] In the US, contingency fee arrangements apply, that is, the attorney's fees are contingent on the case being successfully settled. If the court grants monetary relief, the attorney will be paid at a fixed percentage of the recoveries, normally, in the range of 20-30%.[61] In cases where non-monetary relief is granted, the attorney' fee will be paid according to his or her work done, for example, on the basis of the hours he spent.[62] As this contingency fee system can be operated easily by the court, it is proposed as a reform to current Chinese derivative action rules.

Other commentators, as summarized in a study by Clarke, have suggested the

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[58] Yanfen Wu, *Lun Woguo Minshi Susong Feiyong Zhidu de Gaige yu Wanshan* [*On the Reform and Perfection of the System of Civil Litigation Costs in China*] (2004), Guangxi Xingzheng Guanli Ganbu Xueyuan Xuebao [Journal of The Guangxi Administrative Management] 82, 84.

[59] See Chapter 5.5.2.2.

[60] H Huang, ' The Statutory Derivative Action in China: Critical Analysis and Recommendations ' (2007) 4 Berkeley Business Law Journal 227, 249.

[61] M Loewenstein, 'Shareholder Derivative Litigation and Corporate Governance' (1999) 24 Delaware Journal of Corporate Law 1,14. *See, e.g.*, In re Oracle Secs. Litig., 852 F. Supp. 1437, 1452 (N.D. Cal. 1994); *Thomas v. Kempner*, 398 A.2d 320, 321 (Del. Ch. 1979).

[62] *See, e.g.*, Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 392 (1970); Sugarland Indus. Inc. v. Thomas, 420 A.2d 142, 149-50 (Del. 1980).

establishment of a foundation that would own shares in every listed company.[63] In South Korea, Taiwan, and Japan, litigation has been filed through similar non-profit organization and said to be reasonably successful.[64] It remains to be seen whether the model can be adopted in China.

9.2.2.2 Indirect Costs

9.2.2.2.1 Conflicts of Interest

The separation of ownership and control in a fund, just like that in listed companies, may give rise to divergence of interests between fund managers and fund investors. The conflicts are greatest starkly in publicly-visible activism, such as voting, derivative action, and to a lessen extent in private meetings. This conflicted interest if exercised without restraint would lead to fund managers acting for the purpose of obtaining private interests at the costs of shareholders' value. It has emerged as a serious governance issue, as admitted by a Chinese official.[65]

Acute conflicts of interests often arise from the fact that fund managers are affiliated with other financial institutions, mainly securities companies, trust and investment companies, who act as the major shareholders of most Chinese fund management companies. As Table 9.4 indicates, the largest shareholder of the top 10 fund

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[63] D Clarke, 'The Ecology of Corporate Governance in China' (2008) The George Washington University Law School Public Law and Legal Working Paper No.433 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1245803> accessed 20 November 2009, 55. Clarke *quoted* Liang Dingbang (Anthony Neoh), *Cong Zhengquan Jianguan Jiaodu Kan Gongsi Fa Xiugai* [Viewing the Amendment of the Company Law from the Angle of Securities Supervision], *in Feng Guo and Jian Wang, Gongsi Faxiugai Zongheng Tan [*An All Around Discussion of Reform of the Company Law*]* (Falü Chubanshe 2000) 29-34; Jiang Ping, *Gongsi Fa Cong 19 Shiji Dao 20 Shiji de Fazhan* [The Development of Company Law from the 19th to the 20th Century], also in Feng Guo and Jian Wang 21.

[64] See generally C Milhaupt, 'Nonprofit Organizations as Investor Protection: Economic Theory, and Evidence from East Asia ' (2004) 29 Yale Journal of International Law 1

[65] J Sun, 'Xu Jinyibu Yueshu Dagudong Ganrao Jijin Gongsi de Xingwei' [Need to Further Constrain the Majority Shareholder's Intervention in the Fund Management Company] *Shanghai Zhengquan Bao [Shanghai Securities News]* (9 September 2005).

management companies is either a security company or a trust company.

The conflicts stem from the affiliated financial institutions' business relationship with listed companies. Apart from fund management, securities and trust companies also conduct other business such as asset management or consultant services which could contribute a large portion of profits for them. For example, the CITIC Securities Co., which is the largest shareholder of China Asset Fund Management company, has carried out undertaking service for 54 listed companies in 2009, which generated a total profit of RMB 0.675 billion.[66] By virtue of the multiple business nets, when fund managers' activism would damage their business relationship with listed companies, they may pressure fund managers to be passive despite it conflicting with the interest of investors. A simple example could be helpful to illustrate that conflict. A listed company X is one of the companies in fund management company Y's portfolio. X also has business relationship with a securities company Z, which is a major shareholder of Y. If Y votes against X's proposal, X might terminate the business contract with Z and change asset management service to another securities company. Under this circumstance, Z may require Y to place its interests at a higher priority, voting pro manager to save its contract with X.

Another notable fact revealed in Table 9.4 is that the share ownership structure is highly concentrated in the top 10 fund management companies, with an average 47% of shares controlled in the hand of the largest shareholders. In Bosera Fund Company, the amount of stakes held by the largest shareholder reached as high as 73%. Thus, there is little doubt that those securities companies and trust companies have significant bearings on the operation and investment of the fund management companies if there is no mechanism to ensure the independence of funds from their major shareholders.

[66] Q Wu, '2009 Nian Juanshang Chengxiao IPO Jinzhang 48.5yi' [Securities Traders has Made Profits of 4.85 Billion by Undertaking IPO Service in 2009] *Zhengquan Shibao [Securities Times]* (5 January 2010).

Table 9.4 Shareholding of the top 10 fund management companies (At 30 December 2009)

Ranking	**Name**	**The largest shareholder**	**Percentage**
1	China Asset Management	CITIC securities Co.	60.73%
2	Bosera Fund	China Merchants securities Co.	73%
3	Harvest Fund	China Credit Trust Co.	40%
4	China Southern Fund	Huatai securities Co.	45%
5	E fund	GF securities Co.	20%
6	GF fund	GF securities Co.	48.33%
7	Da Cheng Fund	Zhongtai Trust Co.	48%
8	Hua An Fund	Shanghai International Trust Co.	20%
9	Bank of Communications Schroder Fund	Bank of Communications Co.	65%
10	China International Fund	Shanghai International Trust Co.	51%

Source: Data drawn from the CSRC.

Rules eventually came in 2004 to address these conflicts of interests, contained in the *Measures for the Administration of Securities Investment Fund Management*

Companies (2004 Measures). The 2004 Measures seek to avoid interference in the fund management company's business by securities companies, trust companies and investment banks

The 2004 Measures provide a set of relevant rules to require listed companies to establish systems for corporate governance and that (1) ensure the fund management business is not subject to interference by any particular shareholders. Shareholders of fund management company may exert their control only through shareholders' meeting;[67] and (2) protect against any particular shareholder seeking assistance with their own securities underwriting or investment in a way that damages the interests of fund investors.[68] In addition, a mandatory independent board system is imposed in the fund management company which requires at least one-third of the board of a fund management company must be composed of independent directors.

Moreover, in a recent provision issued by the CSRC in 2009: *Guidance Opinion on the Administration of Managerial Personnel in Fund Management Company*, it explicitly lays out that the fund manager should place investors' interest in priority when it is conflicted with the interest of the fund management company, its shareholders or other affiliated institutions.[69] These rules are expected to minimize the adverse impact of conflicts of interest on institutional shareholder activism. However, the effectiveness of this in resolving the problem remains to be seen.

Another potential solution to reduce this conflict is to align the interests of major shareholders of fund management companies with the fund unit holders. This effort was seen in a 2005 regulation from the CSRC which allows the fund management

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[67] Zhengquan Touzi Jijin Guanli Gongsi Guanli Banfa (issued by the CSRC on September 16, 2004, and became effective on October 1, 2004) (''2004 Fund Management Company Measures''). The Measures repealed the 1997 Provisional Measures s 36.

[68] Ibid, s 38.

[69] Guidance opinion on the Administration of managerial personnel in fund management company, issued by the CSRC in 2009 s 6.

company to invest in its own funds products.[70] Although this new investment channel should comply with a set of restrictions, when the affiliated institutions are also placed in the position of fund investors, they may be less likely to interfere with fund managers' engagement with portfolio companies.

In addition to business-relational conflict, fund managers are sometimes found to self-serve their private interests at the expense of that of fund unit holders. There is anecdotal evidence that during the share structure reform, some fund managers have taken advantage of their large tradable shareholding to blackmail management of investee companies for bribery in return for supporting votes on compensation.[71] Moreover, Zhang and Zeng found that in order to gain access to soft information in listed companies, some institutions acted against the interests of minority shareholders and voted for compensation schemes proposed by boards, making controlling shareholders obtain liquidity rights with rather low costs.[72]

9.2.2.2.2 Shareholding Disclosure Rule[73]

Given the dominance of state ownership in most listed companies, influencing a board's behavior is unlikely to be achieved by even a major fund manager alone and thus, the success of institutional shareholder activism lies in strengthening methods of collaboration among shareholders. Moreover, collaboration allows cost-sharing among shareholders, which further helps them to reduce the passive incentives created

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[70] Notice on Fund Management Company's Investment in Securities Investment Fund with its Own Assets, issued by the CSRC in 2005.

[71] 'Wuliang Jijin Jingli Suohui Zao Tousu, Zhengjianhui Yankong Gugai Heimu' [Villainous Fund Managers Seeking Bribery Subject to Complaints, CSRC Stepped up Scrutiny of Unlawful Activities in the Share Structure Reform], Zhengquan Shibao [Securities Times] (September 5, 2005); Also "Jijin Gongsi: Zapan Haishi 'Du Qianyan'" [Fund Management Companies: Dumping Shares or Self Sacrificing], Shangwu Zhoukan [Business Weekly] (July 20, 2005). 48, 50.

[72] Y Zeng and J Zhang, 'The Dark Side of Institutional Shareholders Activism in Emerging Markets: Evidence from China's Non-Tradable Share Reform' (2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1372428> accessed 5 May 2009.

[73] It is worth noting here again that shareholding disclosure rule is also relevant to the possibility of collective action.

by the collective action problem. Therefore, it is particularly important that there is no legal impediment to collective shareholder engagement. However, the collaboration among shareholders with similar concerns to influence a board has given rise to some concern that it would generally fall into the concert party situation. The shareholding disclosure regulation defines 'concert party' as

> 'two or more natural persons，legal persons or other organizations that，by way of any lawful means such as agreement，cooperation or relationship of affiliated parties so as to expand their controlling ratio of the shares in a listed company or consolidate their controlling status in a listed company，and make the same declaration of intention when exercising voting rights in respect of the listed company'.[74]

The collective action, as laid down in the regulation, could include submitting proposal, appointing directors or proxy voting without indication of voting purpose. One of the most significant consequences for institutions to form an alliance, apart from placing a mandatory bid as takeover is rare in China, is to comply with the troublesome disclosure requirement.

As in most jurisdictions, Chinese law requires an investor meeting certain thresholds to make an adequate and timely disclosure of his shareholdings. Section 86 of Securities Law 2005 (SL 2005) stipulates, when an investor comes to hold 5% of a listed company' stock, the investor must report his or her position. To do so, the investor must submit a report to the CSRC and the stock exchanges within three days from the date when such shareholding occurs, and must notify the company and the public.[75] During this period, the investor is prohibited from changing his position

[74] Shangshi Gongsi Gudong Chigu Biandong Xinxi Pilu Guanli Banfa [Administrative Measures for Information Disclosure of Shareholding Changes of Shareholders in Listed Companies] (issued by the CSRC on September 2002, and became effective on December 1, 2002), (''2002 Shareholding Information DisclosureMeasures''). section 9.

[75] SL 2005 s 86.

until the market is informed.[76] Moreover, he shall report and make announcement of each five per cent increase or decrease in the proportion of the issued shares he holds of the said company through securities trading on a stock exchange. During the reporting period, and for two days after the report and announcement are made, the investor may not continue to purchase or sell shares of the listed company.[77]

As regards the scope of the actual disclosure obligation, the information that the investor needs to disclose in the report includes facts about his identities and the amount of shares held.[78] He is also obliged to disclose his trading activities within the six months prior to the disclosure, including the amount of shares he traded monthly and the price range of the trading.[79] In addition, the investor must report his intention with respect to increasing or decreasing shareholding in a company and make announcements of his plan in the following 12 months.[80]

In addition to the above disclosure requirements, investors must abide by more stringent rules once a 'concert party' is formed. First, the members of the party are required to apply to the securities registration and clearing institution for temporary custody of all the shares held or controlled by each of them in the company for at least 6 months.[81] Second, the party must disclose its purpose, the time of forming the group, the contents of the agreement, and its plans regarding the exercise of voting rights.[82]

The above rules, while intended to safeguard the order of securities market, create legal impediments to shareholder collaboration action. *First*, given the dominant shareholding of the state, the threshold of 5% of a total share in a company is

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[76] SL 2005 s 86(1.)

[77] Ibid.

[78] SL 2005 s 87.

[79] Guideline on Contents and Format for Information Disclosure of Companies with Publicly Issued Securities No.15—Report on Shareholding Changes of Shareholders in Listed Companies, issued by the CSRC, s 36.

[80] Ibid, s 20.

[81] Shareholding Information Disclosure Measures, s 10.

[82] Ibid, s 19(2)

stringent and could be conflicted with good corporate governance practice. Institutions collectively holding even 5% do not have enough power to bargain with the largest shareholder.

Second, a 'concert-party' faces a burdensome disclosure requirement, followed by compliance costs. If a proponent seeks supports from other shareholders before launching a campaign, he must be aware of the disclosure requirement. Not only his information, the filing documents also have to identify all other group members. There is an absence of reliable evidence on how burdensome the strict disclosure requirements are to institutional shareholders. However, a costly compliance aggravates the effect of the collective action problem, reducing institutional shareholders' incentive for taking collective action.

Thirdly, concert parties confront a legal risk for non-complying even if the members did not break the rules on purpose. Any legal sanctions, ranging from corrective to the CSRC investigation, would bring a negative impact, such as reputational damage, on the institutional shareholders.

Lastly, a direct result from temporary custodian requirement is that the liquidity of stocks holding by parties is affected. As noted, members of a group have to place their securities in the listed company into temporary custodian for at least 6 months. Thus, possible restriction on liquidity would discourage institutions to engage in collective action.

In sum, institutional shareholders face a dilemma: if they do not launch activism jointly, they are unlikely to succeed; if they form a group, they have to incur costs to fulfill burdensome obligations surrounding the concerted action. Therefore, a trade-off must be made between the facilitation of collective shareholder activism and the shareholding disclosure regime by choosing the appropriate threshold and disclosure time.

This balance can be determined on the basis of the *local situation*. Thus, there should

be some flexibility over the threshold and disclosure time according to different cases. For example, if 5% of the outstanding shares do not account for a significant holding in a company with a concentrated ownership, in order to encourage shareholder activism, the regulator could consider raising the threshold. Or an alternative way would be for the regulator, as in the UK, to provide *clarification* on the distinction between shareholder activism and corporate controlling.

9.2.2.2.3 Cultural Factors

The traditional *Confucian* culture embedded in Chinese society, which does not encourage people to solve a dispute in public, impose additional indirect cost on institutional shareholders who wish to take action.

As observed by Redding, Confucian values penetrate Chinese people's belief via a combination of school and family teachings at their early ages.[83] It governs people' s expectation of how others will behave in a particular situation and guides them to make choices on their own behaviors based on these expectations.

One of the central Confucian values is the high degree of collectivism, that I have already explained in section 9.1.4.2. In a collectivist society, the interests of groups take precedence over the needs of individuals. This seems to have two, but *contradictory*, implications for the likelihood of shareholder activism. On the one hand, as already noted above, this absorption of collectivist values may make *free-riding* less likely. The likelihood of free-riding on others' efforts is reduced as individuals feel obliged to make their contribution for the interests of the group. On the other hand, however, when it comes to balancing the costs and benefits of activism, at that point activism may still be less likely since people in a collectivist society may perceive a higher cost in the sort of confrontation that activism involves. Rather, they may rely more on informal norms within the relationship rules to interact

[83] Redding (n 48) 47.

with others.[84] Although UK and other countries see relationships as important, the nature of British and Chinese relationships tend to be different. The terms of relationships are often viewed, as Li *et al* note, as 'personal connection', 'networks' and 'networking' or similar alternative in Western countries.[85] In China, however, it has a wider meaning, including all these elements of the relationship in the UK and more. It is commonly referred to in Chinese word as'*Guanxi*'. Yang describes *guanxi* as:

> 'dyadic relationships that are based implicitly (rather than explicitly) on mutual interests and benefit. Once *guanxi* is established between two people, each can ask a favour of the other with the expectation that the debt incurred will be repaid sometime in the future.'[86]

Guanxi is an important characteristic of the Chinese cultural collectivism. It forms the basis of personal and social networks, and the formation and maintenance of which are important task for Chinese people. To do so, people have to establish trust in such networks. The bounded trust in the network of relationships, as argued by Redding, works on the basis of 'personal obligations, the maintenance of reputation and *face*…'[87]

In consequence, people are very concerned with their 'face'. Public confrontation is seen as improper as it would result in *loss of face* – a feeling of shame. Although face or reputation is widely considered important in most societies, the importance of it for the Chinese is much greater. It was seen as the primary sanction in a society under traditional Confucian values.[88] In such an environment, shareholders are not comfortable questioning directors and criticizing directors through public actions.

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[84] Redding (n 48) 62.

[85] Yunyan Li, Martin Parnell and Nick Hawkins, 'Guanxi, Relationship, Marketing and Business Strategy' in Brown and Macbean (n 48) 102, 103-4.

[86] M M-H Yang, *Gifts, Favors, and Banquets: The Art of Social Relationships in China* (Wilder House Series in Politics, History, and Culture, Cornell University Press, New York 1994)1.

[87] Redding (n 48) 67.

[88] Redding (n 48) 48.

Hence, at this stage, it is not surprising that many aspects of China's business culture is largely relationship-driven and built on a desire to avoid conflict.

The second characteristic of Chinese culture that appears to have an impact on shareholder activism is its respect for status and power. The culture can be supportive of paternalism and tends to uphold authoritarianism.[89] These features are termed a 'high power distance' culture under Hofstede's framework, that is, the interpersonal power of influence between two people as perceived by the less powerful.[90] Under Hofstede''s framework, China was scored with 56, while UK has score of 35.[91] Compared with other countries, such as Malaysia which has a score of 104, the high power distance culture in China is not as strong. It could, however, be one reason for lower shareholder activism in China than in the UK and therefore, worth a brief discussion here.

As explained by Redding, people within a high power distance culture tend to express, in their behavior and attitudes, a strong sense of 'vertical order' of their surrounding world.[92] The orders include 'family order, itself inside a powerfully maintained state order, itself seen as part of a natural cosmic order…' and all these are 'dedicated to the maintenance of the status quo.'[93]

Public confrontation in shareholder activism thus does not fit with the cultural belief that 'an individual must fit into and conform to the basic social order of his surrounding world.'[94] As a result, shareholder activities opposing directors who are often appointed by the Government or related institutions are against the culture within the high power distance society.

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[89] See generally J Pan, 'The Dual Structure of Chinese Culture and its Influence on Modern Chinese Society' (1990) 5 International Sociology 75.

[90] See (n 49), and the accompanying text.

[91] It is cited in Williamson (n 48) 121.

[92] Redding (n 48) 61.

[93] Redding (n 48) 51-52.

[94] Redding (n 48) 58.

To sum up, relationship rules and high power distance embedded in society help to explain the low level of institutional shareholder activism in China. Even if the first step of overcoming collective action is met, the second step fails since the costs could be likely higher than the received benefits owing to these culture hurdles.

9.2.3 Case study: Institutional Shareholder Activism in the Process of Non-tradable Share Reform

Institutional shareholder activism in the non-tradable share reform offers a good opportunity to show how the activism model is applied. As I discussed in detail in Chapter 6, all mainland listed companies were required to propose a reform scheme to operate the transfer of non-tradable shares to tradable shares. As this may affect the value of existing tradable shares, the reform scheme must include a compensation package for those existing holders of tradable shares.[95] In the reform, institutional shareholders show a higher level of engagement in listed companies than usual. There are many high-profile cases where institutional investors strongly opposed the board sand forced them to re-plan the proposal for the benefit of tradable shareholders. The part below will apply the activism model to explain why institutional investors were more willing to participate in non-tradable share transfers in their investee companies.

Step 1: Overcoming Free-riding

1. Decisiveness; and 2. The possibility of concerted action

The reform requires a class voting system at shareholders' meetings to let tradable-shareholders decide whether or not to accept reform schemes. As I have discussed in section 9.1.3.1, when large non-tradable shareholders' votes are abstained, the likelihood of individual shareholding being decisive and the possibility of the concerted action would increase to an extent where institutional shareholders may, individually or collectively, be sufficiently large to surmount the collective action

[95] See Chapter 6.1.

problem. For example in Shanghai 3F New Materials Co.(3F), the top five tradable shareholders, which all are institutional investors, collectively accounted for more than two-thirds of the total tradable shares.[96] A coalition consisting of those top five shareholders is therefore sufficient enough to determine the voting outcome. Given their power, it is not surprising to see that institutional investors in 3F, as well as other companies which have similar shareholding structure, such as Shenzhen Yantian Port Co., Hailuo Cement Co, strongly opposed the board's reform schemes.

3. 'In-process' benefits

Institutional shareholders' participation would help them get a more favourable or profitable plan from non-tradable shareholders. Moreover, due to the regulatory demands, institutions would put their reputation at risk if they do not engage in the reform. In turn, those who show a certain level of involvement would potentially attract more clients.

4. Normative obligation

Due to the large institutional shareholding in the group of tradable shares, the regulatory demands for institutional shareholder engagements are strong in the non-tradable share reform. Under the Guidance Notes on the Split Share Structure Reform of Listed Companies, institutional shareholders are encouraged to:

> 'take active part in the share reform, and defend the rights of investors, especially public investors, as well as sustained development of the market. *Disciplinary* actions will be taken against those *institutional investors for such misconducts* as in interfering into the decision-making on the part of other investor, manipulating the voting results of the Share Reform meeting of interested A-shareholders, or abusing

[96] San'aifu Gugai Liuchan, Farengu Jiezheng Renu Jijin' [3FShare Structure Reform Miscarried, Legal Person Share Problem Annoyed the Funds], *21 Shiji Jingji Baodao [21st Century Economic News]* (19 December 2005).

the dominant shareholding position to seek interest exchange.'[97]

Driven by regulatory pressure, institutional investors are more actively to devote their resources and time to vote their shares on reform schemes.

Step 2: A cost-benefit Analysis

Benefits

Benefits come from a more profitable reform scheme. The 'in process' benefits are those discussed above.

Costs

In many cases, institutional shareholder involvement is conducted through *private meetings* with corporate managers and non-tradable shareholders. As analyzed in Chapter 5, the form of private meeting is a relatively cost-saving activism. Private negotiation over the reform plan is a way preferred by both the board and institutional investors. For the company, after it announced its plan for transferring non-tradable shares to the public, the non-tradable shareholders must consult with the tradable shareholders to form a consensus on the scheme. The failure to win two-thirds approval from tradable shareholders would force listed companies to go through the time-consuming and costly process again after initial compensation scheme was denied.

For institutional investors, private meetings help them to avoid potential negative market impact associated with public confrontation, such as the fall of share price. Under this circumstance, the dissenting fund manager may have to sell down his shares at a lower price, indicating that '*exit*' is also *no longer* a favourable option. Meanwhile, the *indirect costs* resulted from the *conflicts of interest* can be reduced through the behind-the-scene negotiation.

[97] Guidance Notes on the Split Share Structure Reform of Listed Companies s 14.

To sum up, through applying the model, we have seen now that institutional shareholder activism was more frequently seen in non-tradable share reform because, firstly, it is easier for them to overcome free-riding, and secondly, the benefits from activism more likely outweigh the costs.

9.3 Conclusion

This chapter has applied the activism model to explain how these factors contained in the model play out in the case of Chinese institutional shareholder engagement.

In doing the first step of determining whether free-riding can be overcome, we found that the first two factors – the decisiveness of large individual institutional holding, the possibility of concerted action – have applied differently between usual and unusual voting systems. Under a usual one-vote one-share scheme, owing to small institutional shareholdings and the presence of a dominant state shareholder, institutional shareholders rarely have the ability to challenge corporate managers in their investee companies. We have seen that the likelihood increases in some listed companies when a class voting or a cumulative voting system was adopted at shareholders' meeting. However, the impact of unusual voting systems still depends on the size of institutional share ownership. The third factor of 'in-process' benefit does not work in the Chinese context since currently no or few institutions adopt engagement as their investment strategy. In respect of the normative obligation, whereas regulatory demands for shareholder activism are relatively weak, it is culturally strong because Chinese traditional collectivism beliefs are critical of free-riding.

In doing the second step of cost-benefit analysis, we found similar as the UK, the benefits mainly come from the share of the total gain. However, since the concept of shareholder activism is still relatively new in China, the 'in-process' benefits to institutional shareholders are likely to be lower than in the UK. Costs of shareholder activism include indirect and direct costs. This chapter has analyzed how regulatory

or cultural elements reduce or increase the costs to shareholder when they engage in corporate governance. We have seen that electronic voting system encourages shareholder participation by reducing the cost of voting and we also seen an overwhelming financial disincentives for shareholders to bring legal action against company director for breach of their duties. When moving on to consider indirect costs, we found some of the costs, such as conflicts of interest and shareholding disclosure rules, are similar to the UK. A high indirect cost which serves to distinguish China from the UK is the traditional Confucian value. It governs people to rely on relationship rules and encourages high power distance, which together make shareholder activism a costly activity.

In an effort to work out more clearly how the model is applied in China, this chapter employed a case study to discover the contributory reasons for a higher level of shareholder engagement in non-tradable share reform.

To sum up, this chapter applied the model to explain the current level of institutional shareholder activism found in Chapter 8. It suggests that efforts to promote shareholder activism are not likely to be sufficiently successful so long as listed companies remained under the control of majority shareholders, as almost all are today. It is expected that non-tradable share reform would change the balance of share ownership, with a decline in state ownership and a corresponding increase in the ownership of public investors, especially among institutional investors. When shares in Chinese listed companies become fully tradable, institutional shareholdings will be more likely to replace the state or local government to become the large shareholders in many enterprises. Chapter 10 will make a comparative turn to explore what China might learn from UK’s approaches to promote a more active institutional shareholder engagement.

Part IV Comparisons and (Modest) Prescriptions for Reform

Chapter 10 The Way Forward in China: Some Implications from UK Experience

In Parts II and III, we have explored and compared the nature and the extent of institutional shareholder activism in both countries. Generally, UK institutional shareholders present a more active involvement in corporate governance than their Chinese counterparts. UK institutional shareholders are more aware of the importance of corporate governance and shareholder engagement, have more frequent contact with the board of their investee companies and have more often exercised their voting rights in relation to their shares to discipline management.

Based on the above findings, this chapter will comparatively apply the activism model and examine factors that contributed to the different levels of activism in the UK and China. It will then make some valuable recommendations about how China could draw lessons from the UK to deal with the issue of promoting institutional shareholder engagement.

Before delving deeply into these inquiries, it is necessary to deal with a preliminary issue that is relevant to any comparative study. This concerns whether borrowing experience or rules from other countries is desirable and workable. Having done so, the analysis will then move up to the essential questions of what China can learn from the UK's approaches and how these proposals could be implemented in the Chinese governance system.

10.1 The Possibility of Applying UK Approach to China

This section deals with the issue of whether aspects of the UK approach can be

transferred to the Chinese system, or whether different systems are so influenced by so-called 'path-dependency' as to be unable to adapt to new rules.

10.1.1 Is Convergence Taking Place relating to Shareholder Activism?

The practice of transferring legal rules or experience from one country to another is commonly observed around the world, in different periods of history and in a variety of conditions. Watson terms such practice as '*legal transplantation*' and considers it as the most fertile source of legal development since 'most changes in most systems are the result of borrowing.'[1] As a result of such transplantations,[2] it is sometimes said that in many respects a convergence[3] is occurring in many part of the world in the field of corporate governance. This convergence is often attributed to the effects of the globalization of financial and product markets.[4] As argued by the OECD,

> 'as regulatory barriers between national economies fall and global competition for capital increases, investment capital will follow the path to those corporations that have adopted efficient governance standards.'[5]

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[1] A Watson, *Legal Transplants: An Approach to Comparative Law* (Scottish Academic Press, Edinburgh 1974) 94.

[2] Legal borrowing may occur voluntarily by, for example, adoption or imitation, or involuntarily as when a country is colonized. Chinese corporate legislation is a good example of voluntary legal transplantation. Some countries, for example, Malaysia and Singapore, received British commercial legislation and common law during the period of British colonial rule as involuntarily transplants. See generally, P De Cruz, *Comparative Law in A Changing World* (Cavendish, Londoon 2006) 511. A point should made here is that *convergence is more likely to occur* voluntarily under the pressure of globalization.

[3] Gilson provides a helpful model and categories the convergence occurred into three types: functional, formality and contractual. *Functional convergence* occurs when existing regulatory institutions are sufficiently responsive to change without a change in the rules. This type of convergence is suggested to be the first response to competitive pressured because it is less costly method. *Formal convergence* involves changes occurred in the legislative level when the regulatory framework is adapted. *Contractual convergence* occurs when existing governance institutions have to adapt contractually as national institutions are not flexible enough to adapt to accommodate changes and political obstacles constraint formal convergence. See, R J.Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function' (2001) 49 American Journal of Comparative Law 329.

[4] S Nestor and k Thompson (eds), *Corporate Governance in OECD Economics:Is Covergence Under Way?* (Directorate for Financial, Fiscal and Enterprise Affairs, OECD, Paris 2000).

[5] OECD，*Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets* (Paris: OECD 1998) 83.

Owing to the convergence trend, commentators have argued that the governance structure and good corporate governance practice of large corporations all over the world will come to resemble each other.[6]

Transposing this background to the context of corporate governance in Chinese listed companies, *is there already a convergence under way relating to shareholder activism*? If we compare institutional shareholder activism in both countries, we will find that there are clearly many resemblances between two countries at the *legislative level*.

Under corporate legislation of both countries, shareholders are granted a variety of similar rights over companies to ensure managerial accountability, such as, proxy voting, calling for shareholders' meetings, submitting proposals and bringing litigation in the form of derivative actions, as already discussed in Parts II and III. The technical rules for exercising these rights also exhibit a certain level of similarity.

For example, for proxy voting, apart from class voting and cumulative voting systems which apply in Chinese listed companies under certain circumstances, the default position of voting under corporate law in both countries is one-vote, one-share.

For submitting proposals, although the thresholds differ, (3% and 5% of the total votes in the UK and China, respectively,) both allow shareholders to require a resolution to be proposed at the AGM.[7] The shareholder resolutions if passed at the AGMs are binding on companies under both company laws. In terms of legal procedures, shareholders in both the UK and China have the statutory ability to bring legal actions against directors in the form of a derivative suit.

At the *less formal regulatory* level, we can also observe some similarities between

[6] See e.g. H Hansmann and R Kraakman, 'The End of History for Corporate law' (2002) 89 Georgia Law Journal 439; J Coffee, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' (1999) 93 Northwestern University Law Review 641; B Cheffins, 'Current Trends in Corporate Governance: Going from London to Milan via Toronto ' (1999) 10 Duke Journal of Comparative and International Law 5; L A Cunningham, 'Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance' (1999) 84 Cornell Law Review 1133.

[7] UK CA 2006 s 338; Chinese CL 2005 s 103.

two countries with regard to the way they consider shareholder engagement. Corporate governance guidelines in both countries, such as UK Stewardship Code and Chinese Code of Corporate Governance, have placed considerable emphasis on the role of institutional shareholders in promoting good practice in listed companies. They encourage institutional shareholders to make constructive use of their ownership rights and we have seen that regulatory demands have increased the level of institutional shareholders' engagement in both countries.

Overall, there is evidence of some degree of *formal convergence*, as Gilson terms it, even if actual practice is often different behind the rules.[8] However, whilst the rules on which institutional shareholder activism is built look similar, it should not be concluded uncritically that the UK's approach can necessarily be borrowed into China without problems.

This is because laws must not be separated from their *purpose* or from the *circumstances* in which they are made.[9] Differing cultural and ideological and economic traditions beneath the law have sowed considerable divergence into national systems and they are likely to limit the ability of national systems to adapt or evolve elements of governance from other systems with fundamentally different cultures and ideology.[10] Sometimes this is referred to as the phenomenon of '*path-dependence*' whereby the dynamics of history and the design of politics can set national system down a particular path, which will create and maintain differences in corporate governance systems around the world.[11]

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[8] Gilson (n 3).

[9] O Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37 The Modern Law Review 1; P Legrand, 'What 'Legal Transplants'? 'in D Nelson and J Feest (eds), *Adapting Legal Cultures* (Hart Publishing Oxford 2001) 55, 57.

[10] D M Branson, 'The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance ' (2001) 34 Cornell International Law Journal 321; Also see A N Licht, 'The Mother of All Path Dependencies, Towards a Cross-Cultural Theory of Corporate Governance Systems' (2001) 26 Delaware Journal of Corporate Law 147; Mauro F. Guillen, 'Corporate Governance ad Globalization: Is there Convergence across Countries' in T Clarke. (ed), *Theories of Corporate Governance: the Philosophical Foundations of Corporate Governance* (Routledge, London 2004) 225.

[11] L Bebchuk and M Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance ' (1999) 52 Stanford Law Review 127, 137.

Empirical analysis also reports some rather unsuccessful transplant examples from the past, where the borrowed rules or systems failed to fit with existing institutions or conditions in the receiving countries.[12] An often mentioned case is the transplant of corporate law in Russia. While Russia has established a more refined corporate law in the region thanks to American advisors, it failed to induce as much corporate accountability and other benefits as its proponents expected.[13]

Bearing these risks in mind, in doing a comparative study, we shall take a cautious approach towards convergence, recognizing that ownership and control mechanisms are part of a society's unique characteristics. However, we shall *not* be over-threatened by these risks. The problems involved in transplantation can sometimes be alleviated or even avoided if one could carefully examine the conditions and needs of each case. For millennia, legal systems around the world have developed through legal borrowing. And until now, when a legal problem is confronted in countries, 'the overwhelming trend' is still 'to turn to a more developed legal system.'[14]

10.1.2 The Need for Sensitivity in Legal Transplantation

So legal borrowing must always be *sensitive* to, *firstly,* whether imported rules can fit into the broad corporate governance system of the receiving country, and *secondly,* whether any 'path-dependency' might prevent the imported rules from achieving the same results as in the original country. Convergence will be more constrained in a country which has more unique institutional, political and social traditions as they are

[12] One well-known example is Columbia, which voluntarily transplanted the Spanish Commercial Code of 1829 and enacted a liberal corporate law in 1853. Unfortunately, it did not work as expected mostly because economic systems were unprepared for the changes it brought so that the private corporation did not take hold in the country. Again, the Uniform Law on Negotiable Instruments, which was widely applied in the U.S, failed in Colombia. D Berkowitz, K Pistor and J-F Richard, 'The Transplant Effect' (2003) 51 The American Journal of Comparative Law 163,179; De Cruz (n 2) 511. Moreover, see problems occurred in legal transplantation in China, see D C Clarke, 'Lost in Translation? Corporate Legal Transplants in China ' (2006) GWU Law School Public Law Research Paper No. 213 .

[13] B Black, R Kraakman and A Tarassova, 'Russian Privatisation and Corporate Governance: What Went Wrong?' (2000) 52 Stanford Law Review 1731, 1752-57.

[14] Watson (n 1) 116.

more likely to defeat attempts of legal transfer. These are issues this section addresses.

First, there needs to be sensitivity to the fact that all the rules must *work as a coherent* whole. There should not be a 'pick and mix' approach. It requires us to ask whether the adoption of new rules is able to work in conjunction with fundamental principles in corporate legal systems. Thus, we have to look at broad corporate governance systems of two countries and explore whether fundamental mechanisms that the potential imported rules build upon are available in the receiving country.

If one looks at the corporate governance mechanisms in the Chinese system, a wide range of institutions are all instantly recognizable to anyone familiar with western corporate governance. That is because the development of corporate legislation and corporate governance system in China is itself a borrowing process. When China's first Company Law was being formulated in the early 1990s, the policymakers looked to more developed Western models and finally adopted a system fairly closely to the continental model in terms of the types of company that it contemplates and in some of its rules regarding corporate structure. The Chinese company law is now more like a hybrid-model, combining features from both continental model, such as the board of supervisors, and civil model, such as independent directors. There are many parallels between the UK and China in the way that they deal with various aspects of corporate governance, in particular when Chinese company law introduced an independent director system in light of the UK experience. Whilst it is not possible to compare every similarity of two countries' corporate systems, a discussion of a few key areas will suffice our purposes. Both the UK and China adopt similar corporate structure.[15] The core functional features of that structure are: (1) limited liability for share owners and managers; (2) shared ownership by many investors; and (3) management and organization structure of the company, such as shareholders' meeting and board of directors. Meanwhile, the division of private company and public company in the UK bear resemblance to the division of Limited Liability Company and Joint Stock

[15] See Chapter 2 and Chapter 6.

Company. Hence, there seems a trend to converge corporate forms, as suggested by Hansmann and Kraakman.[16]

There are also many identical terms or requirements designing corporate governance mechanisms in both countries' framework. For example, both countries have specific statutory provisions aimed at ensuring accountability of the company and enhancing investor protection. Chinese company law imposes duties, such as the duty of diligence, the duty of loyalty, which have similar meanings as fiduciary duty in the UK, on company directors. Directors in both countries are liable for breach of duty if they violate law or the company's articles of association, and consequently cause damage to the company.[17]

While at first glance the UK adopts a different board structure without a separate board of supervision as in China, the role of non-executive directors, as previously compared, is very similar to that of supervisory directors in Chinese listed companies.[18] In light of UK experience, independent director system has also formally endorsed in Chinese company law as a way of strengthening supervision over corporate malfeasance.

At the field of *securities regulations*, the trend towards convergence with a western model becomes more *evident*, as analyzed by Macneil.[19] There is considerable evidence that structure and content of Chinese securities and listing regulations are very similar to those operating in developed markets.[20] For example, as said in Chapter 6, the listing requirements set out in Chinese laws follow very closely the pattern of UK model.[21] Macneil explains the reason given for those convergences, is the source of path-dependency – the state control – as one will see later, less likely to

[16] Hansmann and Kraakman (n 6).
[17] See Chapter 2.3 and Chapter 6.3.2.
[18] Ibid.
[19] I Macneil, 'Adaptation and Convergence in Corporate Governance: the Case of Chinese Listed Companies' (2002) 2 Journal of Corporate Law Studies 289, 306.
[20] For a more detailed discussion of how Chinese securities regulation differ and follow western model, see Macneil, Ibid.
[21] For a full account of Chinese listing requirement, see A Lau, 'The New Shanghai Stock Exchange Listing Rules: An Egg Hatched or An Egg within An Egg' (1999) 20 Company Lawyer 243.

work as a barrier because the process of raising capitals and secondatory trading of securities less affect the interests of the State as the dominant holder in listed companies.[22]

Taking the above discussion together, the Chinese corporate governance framework has already exhibited considerable evidence of formal convergence with the UK model, or broadly, western pattern. Therefore, it seems that introducing rules relating to shareholder activism at a 'low level' will not produce difficulty in fitting in 'higher level' systems that the ultimate values or purposes the rules are intended to serve.

However, we must ask whether there are any 'higher level' differences which restrain the ability to adapt. *Thus, secondly, there needs to* be sensitivity to hurdles that would prevent new rules *from achieving the same purposes in receiving countries as the original country.* The question follows what and how do those sources of path-dependency make Chinese institutional shareholder activism differ from UK counterpart? In the main, the *State,* playing dual role as the regulator and controlling shareholder, constrains China's ability to adapt itself to resemble a UK model.

The State can make use of its role as regulator to facilitate its control over listed companies as a dominant shareholder. *As a regulator,* the State make rules in favor of itself. Many aspects of Chinese corporate governance system are served for the purpose of preserving the State's control. For example, to retain governmental control over listed companies, it applied a restrictive concessionary approach to make corporate legislation rely heavily on administrative control and mandatory regulations, compared with a 'permissive regime' adopted in UK company law.[23] Moreover, Chinese company law differs sharply from the UK in its requirement for a role of political party in a listed company. For example, it requires an organization to be

[22] Macneil (n 19) 306.
[23] A Seidman and R B Seidman, 'Drafting Legislation for Development: Lessons From a Chinese Project' (1996) 44 The American Journal of Comparative Law 1, 13; K T W Ong and C R Baxter, 'A Comparative Study of the Fundamental Elements of Chinese and English Company Law' (1999) 48 The International and Comparative Law Quarterly 88, 94.

established in the company to carry out activities of the Chinese Communist Party.[24] In contrast, UK company law advocates freedom of contract and is hostile towards the government's interference on business affairs.[25]

As a dominant shareholder, the State can determine the outcome of corporate affairs even sometimes without the participation of the remaining non-state shareholders. Their control as shareholders over listed companies is further enhanced in company law where the shareholders' meeting in Chinese listed companies is allocated large decision powers, among which some of them are placed within the scope of the directors' authority under UK company law.[26]

It has been noted that Chinese institutional shareholders present a much lower level of involvement in corporate governance than the UK counterpart and this thesis believes that the continuing large shareholding by the State is perhaps the *biggest contributory* reason for that gap. For example, the State can control voting outcomes under a one-vote, one-share system, which will certainly reduce institutional shareholders' incentive for engagement when they know they cannot make any difference. It limits the growth of institutional investment, which makes the factors contained in the model, such as the decisiveness of individual shareholding, the possibility of concerted action, the cost-benefit analysis, considerable weaker in Chinese landscape.

To sum up, we have seen there are similarities in the corporate legislations of both countries as regards institutional shareholder activism and also various aspects of corporate governance system, which show a tendency towards convergence. Yet we have also noted that these two systems are clearly differentiated and the system of corporate governance still operates in a manner which is fundamentally different to the UK as a result of the state control.

The point, perhaps, is that, for the moment, although convergence of legal rules at

[24] CL 2005 s 19.
[25] Ong and Baxter (n 23) 94.
[26] See Chapter 6.3.2.

‘low level’ in relation to shareholder activism is occurring, fundamental, deep-seated differences in ideology, political attitude, and economic policies would first have to be reconciled with each other. Chinese corporate governance remains in a considerable degree idiosyncratic and therefore a wholesale process of convergence towards the UK model is unlikely to occur. Therefore, it is not possible to adopt every aspect of UK rules and systems in relation to shareholder activism into China.

After carefully evaluating the needs of the receiving country, its potential for exportation, and its capacity for importing foreign experiences, the recommendations in the sections below can be split up into three types. *First*, when the UK’s approach is valuable but not workable, I explicitly points out the impossibility of direct transplant and turns to other solutions, such as the UK’s prudent person model. *Second*, there are cases where the UK approach is both valuable and workable but China shall adopt a different means to achieving it, such as the shareholder engagement guidance. *Third*, some proposals which do not require institutional change are highly adaptable, such as calling for more academic support.

10.2 What can China Learn from UK Experience?

Yet we have seen that institutional investment has gained an impressive growth in both countries and accompanying these increases, calls for more active institutional shareholder engagement in portfolio companies are widely seen in both countries. We have also seen that, despite both countries clearly devoting much effort to promoting shareholder involvement, UK institutional shareholders have more incentives to engage in corporate governance and thus present a higher level of activism. The question is now turning to the last one remaining unaddressed in the thesis: What can China learn from the UK approach?

There could be various relevant factors contributing to the greater institutional shareholder activism in the UK. However, as explained, not all can be applied in the Chinese context. Based on its needs and conditions, the thesis suggests that China

could still embrace certain features of corporate governance mechanisms employed in the UK. They include:

1. To create a stronger institutional investor base through removing unnecessary investment limits, enhancing institutional internal corporate governance and increasing foreign participation
2. To establish industry trade associations, representing institutional shareholders, to encourage the emergence of active and informed owners and support concerted shareholder action.
3. To establish institutional shareholder engagement guidance, which sets out good practice on engagement with portfolio companies which the government believes institutional investors should adopt, and backed up by a rigorous and effective legal system.
4. To encourage institutional shareholders to adopt clear policies regarding their standards for corporate governance of portfolio companies and the way in which they exercise their voting rights.
5. To encourage institutional investors to establish a well-organized and efficient internal corporate governance.
6. To nurture a good culture of corporate governance by means of more academic support and governmental advocacy.

10.2.1 The Decisiveness of Individual Shareholding: Promoting (Long-term) Institutional Investment

We have seen that institutional shareholders with large institutional shareholdings and long-term investment horizons, have more incentives to avoid free-riding and thus to take action in their portfolio companies. Institutional shareholder engagement is therefore more active in a country having higher level of institutional shareholding concentration in listed companies.

The comparison of the institutional landscape between the UK and China, as already shown in Part IIs and III, reveals two evident disparate features. First, although institutional investment has grown impressively in both countries, we have seen that the UK still differs from China in the greater presence of institutional investors. Ownership of UK equities by institutional shareholders soared from 18% in 1963 to 40% in 2008.[27] In China, due to the presence of large state shareholder, institutional ownership only accounts for a relatively small portion of the total equity of listed companies (an average of 10% in the sample).[28] Secondly, whereas UK's institutional market is dominated by long-term investors, such as pension funds and insurance companies, relatively short-term mutual funds prevail in the Chinese institutional investment industry.

By virtue of those differences, it is not surprising to find that UK institutions investee companies are more willing to take part in corporate governance than their Chinese counterparts. As such, in pursuit of a higher level of institutional shareholder participation, the Chinese government should further promote the development of its institutional investment industry, in particular pension funds and insurance companies.

Apart from promoting good corporate governance, China has other strong reasons to develop an institutional investor base. Greater participation of institutional investors in the securities market would promote market integrity, stability and increase financial innovation.[29] Moreover, the development of institutional share ownership has evident synergies with other reforms currently occurring in China, such as reforming SOEs, transferring non-tradable share to tradable shares and establishing a social security system.

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[27] See Chapter 3.1.
[28] See Chapter 8, Tables 8.1, 8.2, 8.3.
[29] D Vittas, 'Institutional Investors and Securities Markets: Which Comes First?' (1998) Paper presented at the Annual Bank Conference on Development Economics Latin American and Caribbean Conference, June 28–30, World Bank, Washington, D.C. and Y Kim, I S M Ho and M S Giles, 'Developing Institutional Investors in People's Republic of China' (2003) World Bank Country Study Paper , 2-4.

Accordingly, over the near term as well as over the long term, the Chinese government should put effort into promoting the emergence of competent institutional investors. Based on the Chinese situation, the thesis considers the following reforms as vital to strengthen the institutional industry:

1. Gradually reducing state-owned shares or constraining the State's ability to interfere with corporate affairs;[30]
2. Relaxing investment limitations mainly through reducing allocation in fixed income assets and increasing equity investment; Combining investment restrictions with a move to a prudent person rule where possible;[31]
3. Relieving tax policy on pension funds;[32]
4. Encouraging foreign institutional investors' participation.[33]

10.2.1.1 Reducing State Ownership in a Gradual Way

As we have seen, the greatest obstacle to institutional shareholder activism is the dominance of the State as shareholder in listed companies. To reduce state ownership is therefore the first and foremost reform that I propose to promote institutional shareholder activism in the future.

Currently, China is undergoing a non-tradable share reform which brings state-owned non-circulated shares on to the securities market. This reform would obviously present a promising opportunity for expansion of institutional industry. Institutional investors, including foreign institutions, can provide the liquidity and sophistication to absorb these transferred shares without disrupting market stability. However, such growth *cannot* be achieved if the State retains control of those shares after they float in the market. A fundamental change in ownership pattern demands the Chinese government to reduce the number of state-owned shares.

[30] See section 10.2.1.1.
[31] See section 10.2.1.2.
[32] See section 10.2.1.3.
[33] See section 10.2.1.4.

There are a number of ways to gradually dilute state ownership or constrain the Government' control in listed companies. China has been considering mechanisms to reduce state shares through transferring state shares to pension funds. As we have seen, some state-owned enterprises conducting domestic IPOs were required to transfer 10% of their shares to the National Social Security Fund (NSSF).[34] In the future, based on market needs and conditions, the Government could continue this approach to support and strengthen its pension fund system.

Transforming the state equity into non-voting shares or restrained voting shares is another approach that the Chinese government could employ.[35] This would separate control rights from the Government's income right in its investee companies, so as to empower public investors by enabling them to have a proportionately greater say in corporate affairs and therefore to allow market forces to shape corporate governance standards. Currently, as we have seen, China implements a class voting system to refrain the largest shareholder from voting when deciding on some significant corporate matters. Both these measures – restricting the State's voting power while remaining a beneficial owner – could be useful mechanisms at a transitional stage, as they could signal that the Government would not interfere with corporate management through its political power.

In the meantime, given the limitations imposed by dominant state ownership on the effectiveness of direct regulatory control, the Government shall shift its role within companies by relying more on indirect control including delegated monitoring or self-regulatory organizations. The thesis will return to this point in section 10.2.2.

10.2.1.2 Relaxing Institutional Investment Restriction

The second significant factor explaining the higher level of institutional concentration in the UK is its more liberal investment ownership limits. Institutional investors in

[34] See Chapter 7.4.2.
[35] S Tenev, C Zhang and L Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (World Bank Publications Washington 2002), 144.

both countries are subject to some restrictions to ensure that they diversify their investment risks. However, different regulation models apply in these two countries. In the UK, pension fund investment portfolio management and part of insurance industry are operated under a 'prudent person' model, in which the investment of pension assets is undertaken with care, the skill of an expert, prudence and due diligence.[36] Trustees and/or asset mangers invest fund assets fiduciary as someone would do in the conduct of his or her own affairs, i.e. there is generally no any specific restriction on particular assets investment.[37]

In contrast, Chinese institutional investment industry is managed under a 'quantitative portfolio regulation' approach, where limit holdings of certain types of assets within the portfolio.[38] For example, no more than 40% of the NSSF assets shall be invested in equities. Consequently, the concentration level institutional investment, both individually and collectively, is constrained.

Although a much less restricted ownership limit is imposed on securities investment funds, it is suggested that the growth of investment fund will be slower if pension funds and investments funds are compelled to invest in non-marketable products, which limit their investment into SIFs.[39]

These tough restrictions partly deter institutional shareholders from exerting a greater voice in the governance of portfolio companies. Moreover, much empirical analysis, for example that by Calatan, found that the development of China's capital market is less likely to be achieved if institutions were restricted in their holdings of marketable equities.[40] Therefore, although the total size of institutional investment in China can be considered enormous, its beneficial impact on capital market development is

[36] See Chapter 3.2.1.
[37] P E Davis, 'Prudent Person Rules or Quantitative Restrictions? The Regulation of Long Term Institutional Investors' portfolios' (2002) 1 Journal of Pension Economics and Finance 157, 167.
[38] See Chapter 7 and Chapter 9.1.1.1.
[39] D Fernando and others, 'The Global Growth of Mutual Funds' (2003) World Bank Policy Research Paper 3055 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=636417> accessed 23 March 2009, 7.
[40] M Calatan, G Impavido and M R Alberto, 'Contractual Savings and Stock Market Development: Which Leads?' (2000) World Bank Social Protection Discussion Paper Series <http://ideas.repec.org/p/wbk/wbrwps/2421.html> accessed 12 August 2008.

constrained by stringent investment limits.[41]

Accordingly, to promote greater shareholder activism, the Chinese government should adopt appropriate strategies of deregulation to relax the current strict investment limits for institutional investments. The UK's experience in developing its financial institutions is clearly inspiring. In the UK, a 'Prudent Person' approach has the advantage of ensuring investment flexibility by avoiding constantly regulatory adjustment and it will yield better results in the long term.[42]

However, importing a similar approach into Chinese system is *not* the most desirable solution, at least not in the near future. The precondition to apply a 'Prudent Person' approach is that conflicts of interest are clearly defined in regulations and understood by market participants from legal cases. Moreover, it requires highly experienced fund managers and strict supervisory bodies on investor malpractice as well as self-regulatory bodies.[43]

These conditions are currently not sufficiently available in China. In comparison with the UK's more developed market, the Chinese market is nascent, with shorter trading histories, less liquidity and a smaller institutional investor base. As suggested by Davis, there could be rational for a country to impose regulatory restrictions on institutions if they are not sufficiently experienced and the market is more volatile.[44] International experience also suggests that it is common that in an initial stage of institutional investment, a country may well start by adopting a strict regulatory regime and then proceed to relax it as the needs of institutional institutions and the securities market evolve.[45] Moreover, the implementation of 'Prudent Person' approach involves legal difficulties since both regulators and asset managers in China are unfamiliar with the concept of fiduciary responsibilities in a civil law jurisdiction.

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[41] Tenev, Zhang and Brefort, (n 35) 4.
[42] P E Davis, *Private Pensions in OECD Countries* (OECD, Paris 1997).
[43] Davis (n 37).
[44] Ibid.
[45] Fernando and other (n 39) 16. For example, Chile and some countries in Eastern Europe have engaged in long-term upgrading of their regulatory systems since the pension reforms in 1980s.

Thus, it is more appropriate for the Government to follow a gradualist approach to ease slowly institutional investment restrictions. In the long run, institutional investors should be encouraged to apply a 'prudent person' principle over investment management activities where possible.

The reform to liberate investment restrictions should concentrate mainly on two areas. The first is the lower limits on certain assets classes, e.g. government bonds and bank deposits.[46] At present, the investment of both corporate pension funds and NSSF must comply with minimum investment limits, e.g. at least 20% of net assets of corporate pension funds shall be invested in government bonds, and minimum 50% of NSSF assets must be allocated in bank deposits and government bonds.[47]

This practice is not recommended in the OECD's *Guidelines on Pension Fund Asset Management* (Guidance) issued in 2005 to address the issue of using quantitative limits for controlling pension fund investment risks. Although the Guidelines do allow for the use of investment limits to control the risk of assets investment, nevertheless, the Guidelines warn that quantitative limits shall be applied with care. For example, they do not recommend minimum investment limits because these could constrain fund managers' ability to make proper decisions, reduce investment profitability and may 'artificially inflate asset prices'.[48] Given that, the current minimum limits imposed by the Chinese regulatory framework might well be counter-productive to achieving a return which is capable of dealing with China's serious ageing problem. In the future, institutional investments should be made less in conservative, low risk, low return assets classes and increasingly in more innovative securities for a higher return where possible.

The second target for reform is the tough upper limits on equity investment. There is

[46] Y-W Hu, 'China's Pension Reform: A Precondition Approach' (2006) 35 Global Economic Review 413, 16; Also Y-W Hu, F Stewart and J Yermo, 'Pension Fund Investment and Regulation: An International Perspective and Implications for China's Pension System' (2007) OECD <http://www.oecd.org/dataoecd/9/30/39604854.pdf> accessed 18 June 2009, 2.
[47] See earlier discussion in Chapter 9.1.1.1.
[48] Y-W Hu, 'The Impact of Pension Funds on Financial Markets' (2006) *OECD Financial Market Trend* 174, 186.

much evidence on the benefits of a less restricted approach on diversification and performance. Hu, for example, looked at the quantitative effects if corporate pension funds were operated in more or less liberalized regulatory regimes. He found that returns are consistently higher for more diversified portfolios. As such, he concluded that the existing pension investment regulation has forced assets to be invested in an *overly conservative* manner, which led to a lower return for the portfolio and thus a lower benefit for retirees.[49] Hence, Chinese regulators should relax existing restrictions and encourage institutions to invest in more sophisticated, innovative securities products in the search for higher risk-adjusted rewards. (In the long run, China should move towards a prudent person rule where possible.) And this change in portfolio investment might be achieved by a move towards a regulatory regime based not on fixed quantitative limit, but rather on a model more like the UK's 'Prudent Person' approach.

10.2.1.3 Tax Relief

An important contributory factor for rapid growth of institutional investment in the UK is its beneficial tax treatment.[50] In light of the UK experience, the Chinese government should grant greater tax relief to both employers and employees to facilitate the growth of institutional investment. Currently, under China's tax practice, employer contributions of 4% (or more) of the payroll are tax deductible, while employees' contributions are not tax deductible.[51] Contributions used to buy insurance contracts are not entitled to tax concessions: the employee should pay tax on the contribution the employer makes for his benefit.[52] Meanwhile, tax benefits vary in practice from province to province. In the future, the Chinese government should make efforts to standardize and harmonize tax relief policy and increase tax

[49] Hu, 'Pension Fund Investment and Regulation: An International Perspective and Implications for China's Pension System' (n 46) 15.
[50] See Chapter 3, footnote 7, 8 and the accompanying texts.
[51] BBVA, 'Pension Trends:Latest Development of China's Pension Market' (2008) <http://www.bbvaresearch.com/KETD/ketd/ing/nav/tematicas/pensiones/historico/afondo/index.jsp> accessed 12 March 2009.
[52] OECD Country profile <http://www.oecd.org/dataoecd/53/46/38766497.pdf> accessed 12 March 2010.

benefits on corporate pension funds.

10.2.1.4 Encouraging Foreign Institutional Investors' Participation

A further factor in creating a strong institutional investment is to increase foreign participation. China faces the opportunity to import regulatory and corporate governance capability by opening its market to foreign institutional investors.

It is believed that massive international funds will flow into China in the next few years, according to a recent survey conducted by Fidelity International and the Economist Intelligence Unit.[53] The survey covered 109 large global institutional investors. 58% of institutional investors surveyed planned to increase their investment allocation to China in 2010 in the hope of better returns and improved diversification.[54] 57% of Western institutional investors and 62% of Asian institutional investors named China as their top choice for fund investment.[55]

Despite the promising market expansion of foreign funds' assets in China, the current investment legislation, as we have previously seen, might be counter-productive to facilitating an attractive investment regime. Under existing policies, foreign institutional investors are allowed to access the Chinese domestic stock market through the QFIIs program. However, their investment scope and amount in Chinese listed companies are restricted. China has been taking a cautious step in opening up its domestic market to QFIIs. Capital inflows and outflows are strictly controlled to avoid the potential financial risk that would be imposed by any dramatic changes from foreign capital. JINGU notes that similar stringent approach was also taken by Taiwan to regulate its QFIIs program and thanks to this way, Taiwan suffered comparatively little turmoil during the Asia financial crisis.[56] Therefore, there is little

[53] Economist Intelligence Unit, '*From West to East: Gauging Institutional Investor Attitudes to Asia*', February 2010 <http://graphics.eiu.com/upload/eiu_fidelity_fromwesttoeast.pdf> accessed 24 June 2010.
[54] Ibid, 4.
[55] Ibid, 5.
[56] T JINGU, 'Moving Forward in Reforming China's Capital Market ' (2002) Nomura Research Institute Paper No.40 <http://www.nri.co.jp/english/opinion/papers/2002/pdf/np200240.pdf> accessed

doubt that a strict policy on foreign capital entrance can help the Governance to maintain the stability of the domestic securities market. However, Chinese qualification requirements for foreign institutional investors to access the domestic markets are still much higher than that of in Taiwan. For example, in Taiwan, when it first introduced the QFII scheme in 1991, the ranking requirement for banks was the top 500 in the world, and in 1993, the regulation was further relaxed to the world's top 1000.[57] However, under the QFII regulation in China, for commercial banks wishing to invest in Chinese securities markets, they are required to be ranked among the world' top 100. A great deal of foreign long-term assets institutions such as pension funds, securities companies who are interested in investing in China failed to access China's A-share market, to a large extent because of these strict qualification requirements on assets size, operational experience and world rank. It is fair to say that, while these rigid requirements help to take precautions and reduce the financial risks, the fact that foreign investors cannot invest in the securities market has denied China a further source of capital and a further source of institutional investors.

Hence, the restrictions imposed on the scope and structure of the investment regime need to be considered and slowly relaxed when the financial institutions and capital market become more mature and better regulated by effective supervisory authorities. Along with more foreign investors, the Chinese government should encourage them to increase their engagement level with companies whose shares they hold.

It is crucial to note here, in addition to the above four ways (reducing state shares, relaxing investment limits, tax reliefs and liberation of foreign participation), a more rigorous accounting system, increased level of transparency and disclosure, a competent regulatory framework and improved standard of corporate governance systems in listed companies are all critical importance to the future develop of Chinese institutional industry. There are concerns from investors that current poor

11 August 2008, 4.

[57] A Lin and C-Y Chen, 'The Impact of Qualified Foreign Institutional Investors on Taiwan's Stock Market' (2006) Vol. 9 Chinese Management Review, 7.

financial sectors deter them from increasing their investment. For example, despite seeing significant opportunities, international portfolio investors surveyed also expressed some worries about their investment in China's A-share market. Concerns about transparency and the quality of the regulatory infrastructure are commonly cited as main barriers to investment in China among institutional investors surveyed.[58] Furthermore, as pointed out by Kim, Ho and Giles, the poor financial health and inadequate corporate governance mechanism in China, deter foreign investment in China.[59]

Moreover, the growth of institutional investment will require the managers and staffs of institutions to own adequate profession skills to become involved in investment analysis and portfolio management. Therefore, action would be taken to strengthen the professional capability of institutional analysis and managers to manage equity portfolio in the clients'' best interest. For example, relevant associations or regulators to financial institutions can provide institutions with training or continuing educations on prudent behavior and investment techniques. The Government should promote more cooperation and communication between foreign and domestic institutional investors. The advanced technology and skills transplanted from foreign institutions will likely rapidly and markedly upgrade the capacity of domestic institutional investors in China.

10.2.2 Concerted Action: Industry Trade Association

In order to strengthen the power of institutional shareholder in listed companies, China could learn from the UK to establish industry trade associations to co-ordinate institutional shareholder engagement. As shown in previous chapters, the facilitation of trade associations in the UK has undermined the free-riding problem by making it easier for institutions to form a coalition. In addition, these organizations give voting advice, develop opinion papers on governance issues, sponsor research, and raise the

[58] Economist Intelligence Unit, (n 53) 12.
[59] Tenev, Zhang and Brefort (n 35) 49.

salience of particular issues. Their efforts have ultimately contributed to the increase of shareholder activism in the UK.

In the Chinese context, apart from promoting shareholder engagement, establishing self-regulatory organizations will yield some unique benefits. Firstly, trade associations can facilitate the Government to *reduce* its political and administrative control over companies – a widely-recognized barrier that deters a well-run financial market and restrains corporate autonomy. Strong state control hampers the ability of the managers to respond efficiently to market forces, aggravates the expropriation of minority shareholders by majority shareholders, and leads to weak governance of many listed companies.

To gradually reduce its regulatory role, the Government should rely more on indirect regulatory methods, including 'delegated monitoring, self-regulation of professional organizations, and mobilizing public in the enforcement processes'.[60] Tenev, Zhang and Brefort further point out that, empowering the 'right' party to build a strong regulatory capacity would increase the Government's confidence that it is able to run the economy effectively without direct ownership control.[61] Hence, it offers some reasons to vest rules writing in a quasi-public or non-profit organization rather than in a government agency.

Furthermore, establishing industry associations could enhance the Government's regulatory efficiency by mitigating resource constraints. As the economic and enterprise reform continues to broaden and deepen, the complexity of the issues and the magnitude of the task pose significant challenges to the Government's regulatory capacity. If the State decides to do its job entirely on its own resources and direct methods of regulation, it will have difficulty meeting these challenges. Co-operating with self-regulatory bodies and allowing those institutions, which own professional staff and capacity, to prepare for regulatory rules will release the Government's

[60] Tenev, Zhang and Brefort (n 35) 136.
[61] Ibid.

burden. The UK's approach to develop its corporate governance framework has illustrated how government can rely on self-regulatory guidelines and on extending right parties to enforce good practice. Moreover, as already seen in the UK case, some provisions in Codes or guidelines may also assist to prepare the ground for changes in company and securities law, where such changes are deemed necessary.

In the Chinese context, all the above benefits – promoting shareholder engagement, reducing government's political control and enhancing government's regulatory capacity – ultimately rest on the *independence* of trade associations. The Government should realize that preserving their independence is crucial to the effectiveness of trade organizations. As such, it is important to ensure that associations are formed as non-governmental, independent organizations acting on the behalf of institutional shareholders. However, at the initial stage, when trade associations are new to China, the Government could assist them to become established, for example, training professional staffs, providing opportunity to learn experience from other countries and granting funds where necessary. Meanwhile, various means could be adopted to strengthen the independence of trade associations. A minimalist approach could include, for example, an effective election mechanism to ensure the independence of associations' staffs and internal regulations to define the responsibility and power of the associations.

In the light of the UK experience as well as Chinese conditions, the thesis believes industry associations should achieve three basic objectives: (1) promoting good corporate governance practice and encouraging shareholder engagement; (2) Facilitating concerted action among institutions; and (3) promoting the development of institutional investment.

10.2.2.1 Promoting Good Corporate Governance and Shareholder Engagement

An important role that UK trade associations have played is to promote the importance of good corporate governance and to encourage more active shareholder activism. In China, trade associations can pursue the same objective by issuing a series of guidance to raise the awareness of the importance of good corporate governance, help members to understand their responsibilities and rights, and make suggestions on possible shareholder actions.

In the initial stage of development, Chinese associations can learn from international experience through an active exchange with organizations in other countries. A large body of guidelines or good practice as regards UK institutional investors' responsibility is seen in the UK prepared by trade associations, such as NAPF, ABI and ISC. The ISC's earlier guidelines,[62] have now adopted by the FRC as the UK Stewardship Code. Another good example of institutional investor self-regulation is the ICGN's *Statement of Principles on Institutional Shareholder Responsibilities.* These guidelines could complement China' input to further develop and refine the recommendations by associations. It is crucial to note here that these would need to be developed in a way that sensitive to China's situation.

10.2.2.2 Establishing Voting Policy

In the UK, the engagement policies set out by trade associations are often among the most important factors determining institutions' approach to corporate governance. For example, ISC's *Statement of Principles* have been widely adopted by many institutions as a part of their voting policies.[63] This role played by trade associations is potentially of particular importance in the Chinese context. Currently, having policies to clarify how institutions would cast their votes in the governance of portfolio companies is rare. Institutions' representative bodies can produce statement of, and guidance on best practice in respect of voting to facilitate inexperienced institutions to set up their voting polices. The thesis will return to this point later in section 10.2.4.

[62] See Chapter 3.3. and Chapter 4.1.4.1.2.
[63] See Chapter 5.3.1.3.

10.2.2.3 Facilitating Concerted Action

With a more developed and larger institutional investor industry, the power of institutional shareholders as a group will be strengthened in Chinese listed companies, providing strong possibilities for collective action. To co-ordinate corporate governance initiatives among institutional shareholders to form effective coalitions against incumbent management and powerful controlling shareholders should be placed as a priority on the agenda of trade associations.

In China, collaboration among institutions is perhaps among the most significant factors determining the outcome of their activism, given the dominant shareholding of the large shareholder. Regrettably, as we have seen, communication and cooperation among institutional shareholders to initiate shareholder activism are currently rare in China. This is mainly the result of the perceived lack of awareness of corporate governance as well as lack of institutions to organize collective action. To establish professional, self-regulatory association would help to fill these gaps.

Aggregating the power of institutions is relatively easily achieved through the facilitation of these associations, as already proved in the UK case. For example, the case committees formed by NAPF and ABI have been reported to be an effective tool to assist institutions to meet with boards and negotiate changes in corporate behaviors.[64]

Moreover, as representatives of their institutional members, trade associations could speak out for the benefits of their members if a company's behavior is identified as being in breach of good corporate governance standards. Their collective voice could send a powerful dissenting signal and will be more threatening than individual action. Meanwhile, where collective action is organized by associations, the likelihood of retaliatory action by management against activist shareholders, and the conflicts of interest for institutional shareholder that the fear of such retaliatory action can

[64] See Chapter 3.3.

produce, are both likely to be reduced.

10.2.2.4 Promoting Institutional Investment

Besides encouraging shareholder engagement, trade associations should achieve the objective of promoting the development of institutional investment. In the future, as we have seen in section 10.2.1.2, China has to gradually move towards a more liberalized investment regulatory regime for institutional investors. The continued liberalization, along with increasing sophistication of China's capital markets would, overtime, create demand for professional expertise and high industry standards. The support provided by trade associations to strengthen the professional capability of institutional analysis and managers will be much needed and particularly beneficial.

To meet these challenges, trade associations should set up their own code of ethics and conduct in areas, such as institutional investment, share schemes, and provide training services, such as asset management, risk control, to their members. These services have been widely undertaken by UK trade associations. Take the NAPF as an example, it offers training courses to different levels of pension fund trustees in varying programs. It also issues a range of publications, including an Annual survey of the industry, asset pooling, and Indices and Bench marketing to guide its members. Accordingly, Chinese industry associations can offer similar services to facilitate the development of institutional investment industry.

Moreover, with their professional judgment, trade associations would facilitate the Government to evaluate regulatory limits on investment and determine whether and how further relaxation can be achieved. They can also liaise with and/or lobby the Government to propose reforms that are beneficial for the development of institutional industry.

10.2.3 Normative Obligation: Institutional Shareholder Engagement Guidance

The third significant reason for a higher level of institutional shareholder activism in the UK is, I believe, its more sophisticated regulatory framework as regards the role of institutional shareholder in corporate governance. Institutional shareholder engagement has long been ascribed a vital role in the UK' system of corporate governance. In contrast, China lacks a sufficient recognition of the role that institutional shareholder can play to promote corporate governance.

In the UK, the CA 2006 gives the Government the power to require institutional investors to disclose how they have voted their shares.[65] While it is stated that the Government will use this power only if a voluntary regime fails to improve disclosure, the threat forces institutional investors to consider their responsibilities to be responsible owners of investee companies for the interests of their beneficiaries. In response to the reserve power, as noted, more UK institutional investors have set up the level of engagement with their investee companies.[66] In contrast to the UK, Chinese company law has not recognized the potential influence of institutional shareholders and their role in corporate governance.

Moreover, in the UK, successive corporate governance guidance, from the Cadbury Report in 1992, through the Greenbury, Hampell, Turnbull, Higgs reviews in the mid 1990s to early 2000s to the current UK Corporate Governance Code (UK Code), has placed significant emphasis on institutional shareholder monitoring as a discipline on corporate management. The newly-issued Stewardship Code well demonstrates the Government's consistently willingness to promote shareholder engagement in the UK. The Stewardship Code sets out good practice on engagement with portfolio companies to which the government believes institutional investors should aspire.

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[65] CA 2006 s 1277-1280.
[66] See discussion in Chapter 4.1.4.

By contrast, the role of institutional shareholders has not attracted sufficient attention from regulators, which can be reflected in China's *Code of Corporate Governance for Listed Companies* (Chinese Code). While the role of institutional shareholders is indeed mentioned in the Chinese Code, it is very vague. Section 11 of Chinese Code states that 'institutional shareholders shall play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes.'[67]

Such a broad provision can be hardly implemented in practice. It does not make the case for why institutional shareholders should consider active engagement to be in their interests and be consistent with their duty to their beneficial owners. Nor does it give sufficient guidance to those institutions that are seeking to play a role in corporate governance. These shortcomings give rise to the lack of awareness among institutional shareholders about why and how they can make constructive use of the ownership influence that they undoubtedly have. It is perhaps not surprising then, that although some institutional shareholders in China have made commendable efforts to influence companies in the right directions, cases in this area have been regrettably few.

Given this, I believe that a Guidance for institutional shareholder engagement, incorporated into the current Chinese Code, would present a chance to build a critical mass of institutional shareholders to the high quality of engagement with companies needed to underpin good governance. Based on China's conditions, a set of benchmarks and principles relating to, for example, the responsibilities of institutional shareholders, should be prepared by relevant institutions for the contents of guidance. The guidance shall be regularly reviewed, updated and changed to adapt to the varying market situations.

If this approach is to work, it would bring large potential benefits to China. The emphasis of the role of institutional shareholders will provide them with more

[67] China Code of Corporate Governance for Listed Companies s 11.

incentives to act responsibly in relation to the companies whose share they hold. More active institutional shareholder voice should enhance minority shareholder protection, curb majority shareholders and managerial malfeasance, and assist the efficient operation of capital market. Greater clarity in the responsibilities of institutional shareholders will also enhance their accountability to clients, which will ultimately contribute to the increase of confident in business.

These benefits can not be achieved if the guidance is not designed and implemented properly. The UK Stewardship Code provides a good example of how similar guidance can be addressed in the Chinese context. However, given that UK has a stronger shareholder engagement culture, some aspects of UK Stewardship Code can not be adopted in Chinese case where its shareholder activism is still in infant stage. Details of the Guidance shall be carefully evaluated and well-prepared by relevant institutions. In general, the thesis considers that *three* points are particular important and should be prepared in the Guidance.

Firstly, the effectiveness of this approach depends on institutional shareholders being willing, directly or indirectly, to put resources into engaging actively with the companies whose shares they hold. As such, the *overriding emphasis* in the Guidance should be on recognizing the role institutional shareholders can play to promote better corporate governance in listed companies. The Guidance should be explicit about the responsibilities of institutional shareholder towards the companies they invest in, including the need for informed shareholder engagement. A good-awareness of the multiple benefits of active institutional shareholder ownership, as already repeatedly noted in the thesis, will provide institutions with the right incentives to act responsibly. However, it is best to keep in mind that merely adopting provisions declaring the benefits of active engagement is *unlikely* to achieve desirable change. Accompanying

the guidance should come supporting institutional arrangements, further development of institutional investment, more academic research and governmental advocacy.[68]

Secondly, Chinese guidance should provide some instructions on the way in which institutional shareholders are expected to engage with their investee companies. The UK Stewardship Code gives some good guidance on what institutional shareholders can do to monitor their investee companies. When institutions have a concern over corporate management, the first step recommended by the Stewardship Code is to have an initial discussion taken place on a confidential basis. If the board does not respond to institutional shareholders' concerns, institutional shareholder can consider escalate their action to approaches that the thesis has introduced in Chapter 2.2.3.2.[69]

Moreover, the guidance shall encourage institutional shareholders to establish clear *voting policies* and disclose their voting activities when appropriate – this will be covered in detail in section 10.2.4.

10.2.3.1 Implementation

Having said that, implementing a Guidance of institutional shareholder engagement in China would bring multiple benefits to Chinese corporate governance framework, however, the success of the guidance is contingent on effective implementation and enforcement. As with the UK Code, the Stewardship Code is implemented on a 'comply or explain' basis.[70] Institutional investors are encouraged to disclose in their reports or websites if and how they have applied the Code. The Financial Reporting Council will retain a list of those investors who have published a statement on their compliance or otherwise with the Code.

Whether this implementation method is effective on promoting corporate governance still remains to see. However, as the Stewardship Code is developed from the best practice guidance issued by the ISC in 2002, surveys reported by the NAPF and IMA

[68] Academic and governmental support will be discussed in section 10.2.5.
[69] UK Stewardship Code, Principle 4.
[70] UK Stewardship Code, Preface.

showed that there is an increase in the level of institutional shareholder engagement as a response to the ISC guidance.[71]

Will this 'comply-or-explain' approach work effectively to enforce shareholder engagement in the Chinese context? This thesis believes China should give it rather greater *legal* force than this approach.[72] The 'comply or explain' approach functions on the basis that the market and shareholders are capable of enforcing good standards and thus requires investors to actually pay a premium on those companies and institutions implementing the recommendation. However, as discussed, the Chinese corporate governance system has long been relying heavily on tight government control. It is therefore natural to doubt whether the market and shareholders have incentives and capacities to perform their checks and balances.

It is essential that compliance and disclosure against the Guidance is monitored effectively, and the thesis suggests that this role would fall most appropriately to the Chinese Securities Regulatory Committee (CSRC) at the first stage. Compared with the UK approach, Chinese implementation method can be more threatening. However, for the future, the thesis suggests that the Chinese government could work along a gradualist approach, to considerably and slowly ease government' intervention and at the meanwhile, increase the sanction of the market. During the process, companies and organizations that specialize in evaluating and informing on corporate governance practice such as compliance advisors, rating agencies, proxy voting services, industry trade associations, or even academic institutions should be encourage to be established. They can help educate the general public and investors about governance-related legal requirements and common corporate governance practices.

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[71] See discussion in Chapter 5.3.1.

[72] A point is worthy sounded here. It is suggested that the light-touched regulatory approach in the UK should also be backed with more rigorous legal provisions. For example, see R Tomasic, 'Beyond 'Light Touch' Regulation of British Banks after the Financial Crisis' in I Macneil and Justin O'Brien (eds) The Future of Financial Regulation (Richard Hart, Oxford 2010) 111 and R Tomasic, 'Towards A New Corporate Governance After the Global Financial Crisis' in *The Prospect of Structural Reform of Corporate Legal System* (The 21st Century Commercial Law Forum-Tenth International Symposium 2010) 213.

Based on China's situation, in order to ensure institutional shareholder engagement taking place, the Chinese regulatory framework should further enhance minority shareholders' protection and increase their ability to discipline companies. There are some points to be emphasized here. First, currently, the Chinese Code has imposed a fiduciary duty on controlling shareholders towards minority shareholders for not abusing their power. Since the concept of fiduciary duty is not well established in China, it is proper for relevant rules to stipulate the full range of fiduciary obligations.

Second, a transparent disclosure regime of large shareholders' activities relevant to the interests of the listed companies is of critical importance to effective shareholder activism. The corporate governance regulatory framework must secure sufficient disclosure, both from listed companies and large shareholders, to enable institutional shareholder to effectively evaluate the performance of them, and exercise their rights when necessary. Such disclosure duties can be imposed on listed companies, if not in all cases, at least, when certain activities relevant to the controlling shareholders occur, such as related part transactions, corporate guarantees occurs.

The above suggestions are still rather preliminary and might well change as Chinese markets become more sensitive to corporate governance mechanisms as a factor affecting the long term value of a corporation.

10.2.4 Voting Policies

The voting policy of institutional investors is an important factor in affecting the level of shareholder activism and their role in corporate governance, as evidenced by the UK experience. It guides institutional shareholders to cast their votes, enhances the transparency of how institutions make use of their shareholder rights and informs beneficiaries whether managers are consistent with their fiduciary duties. Notwithstanding its importance, the practice of establishing voting policies is now rare in China. To promote active and informed shareholder participation by institutional investors, Chinese government, regulators and institutional organizations

should encourage institutions to establish voting policies to make clear the way in which they exercise voting rights in investee companies.

The contents of policies should be decided by each individual institution catering for its individual situation. However, as it is new to many Chinese institutions, trade associations and proxy voting service could provide guidelines to help institutions to establish their voting policies. The voting policies should clarify, for instance, issues such as the circumstances in which they will vote for, against or abstain in the meeting, how they measure the effect of the voting on the clients' benefits and how the voting they use will influence the company management, detailing the process by which such decisions are made. Moreover, voting policies shall be regularly reviewed and to determine whether any change is needed based on market circumstances.

Meanwhile, Chinese institutions could also look at UK's approach to deal with voting activities. The UK Stewardship Code, for instance, states that 'institutional investors should seek to vote all shares held. They shall not automatically support the board.'[73] If not, the policies should identify what specific types of general meeting agenda items it would ordinarily its vote.

Apart from establishing voting policies, the Government should encourage institutional shareholders to *disclose* their voting policies. Rules can be applied similar as that in the UK Stewardship Code: 'Institutional investors should disclose publicly voting records and if they do not explain why'[74]

Or similarly as rules in the OECD Principles of Corporate Governance:

> 'Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights'[75]

[73] UK Stewardship Code, Principle 6, Guidance.
[74] Ibid.
[75] OECD, *OECD Principles of Corporate Governance* (OECD, Paris 2004), II F.

The purpose of disclosure is to increase the transparency of institutional shareholders' use of their shareholders rights through public scrutiny and enhance the confidence of beneficial owners in management. More importantly, it could protect investors against the potential for *conflicts of interest* that may affect the exercise of shareholder rights regarding institutions' investment. This purpose seems particularly relevant in the Chinese context, as the conflicts are often acute when the funds are a subsidiary or an affiliate of another financial institution, which is a common occurrence.[76]

It is important to note here that the thesis is not suggesting a mandatory approach to require institutions to establish voting policies because of the risk of 'box-ticking' compliance involved. It will be more proper and workable to implement this proposal in the voluntary-based codes and guidance, and backed by the major business associations and authorities.

10.2.4.1 Proxy Voting Service

Another area that needs to be discussed is the development of proxy voting services. Chinese business industry can consider establishing its own proxy voting services, comprised of professional corporate staff, targeting corporate governance practice in Chinese listed companies. Or, it can invite existing foreign proxy voting services to develop their business on Chinese listed companies. Chinese investors and companies will become more familiar with the idea of proxy voting services as the development of QFIIs program in corporate governance evolves. Although there is lack of good evidence on whether QFIIs employ proxy voting agencies to vote their Chinese shares, the growth of Chinese investment by foreign owners will ultimately attract proxy voting agencies' attention to Chinese corporate governance.

The potential benefits are large. First, the use of proxy voting service can mitigate institutional investors' resources restraints on exercising their governance rights. Most institutions do not have the resources to make voting judgments on every resolution at

[76] See Chapter 9.2.2.2.1.

every company in which they invest, nor to be present in person. As shown in the UK part, delegating third-party proxy advisory agencies can supply institutional investors with professional research, explicit voting guidance and other services on a range of corporate governance issues.

Second, the development and application of proxy voting advisors would add to general awareness and understanding of governance issues in China. Third, voting opinions from independent third-party agencies are likely to be less prone to conflicts of interest from affiliated financial institutions. Also, they would be relatively free from major shareholders' interferences.

10.2.5 Improving Internal Corporate Governance

Further liberalization of investment restrictions should accompany improved internal corporate governance of all financial institutions. Government and regulators should insist that institutional investors have the governance structure and incentives that encourage them to exercise their ownership rights in a more active way. Greater activism does suppose that the institutions are themselves subject to proper corporate governance structure and that there are no conflicts of interest with other members of the companies. As suggested in Part 2 and Part 3, the levels of shareholder activism by institutional investors are affected by their own corporate governance system.

A well-organized and efficient internal corporate governance of financial institutions would include ensuring that appropriate internal controls and internal audit functions and risk management systems are all in place and work properly. In particular, given the magnitude of conflicts of interests within Chinese financial institutions, the focus of the internal system should be on the independence of institutional investors from their affiliated institutions. A minimalist approach would, for instance, include establishing policies on how they deal with conflicts of interest. They can set up a disclosure system to publicize conflict when occurs.

Moreover, the rapid evolution of China's economic environment and complexity of

corporate governance issues will demand institutional investors to establish specialists in dealing with engagement with their portfolio companies. Institutional investors operating in a global environment should be able to recognize, demand and suggest good corporate governance in the form of proper audit systems, timely information disclosure, quality of board and shareholders' right protection.

10.2.6 Fostering a Culture of Good Governance

Apart from establishing a more effective legislative framework and a more sophisticated institutional investor base, another critical element in ensuring further development of corporate governance in China is the cultivation a corporate culture of good governance. Ultimately, China must develop a culture where institutional investors are aware of their power to exercise shareholder right as owners to discipline managers in ways that are aligned with the interests of ultimate beneficiaries. An encouraging culture will make 'exit' more costly.

To build a culture can not be achieved overnight and neither is it simply a matter of laws and theory. It is far more a practical issue and demands long-term efforts. Through a study of UK institutional shareholders activism, the thesis suggests two points are critical to nurturing a good culture: academic supports and the Government's advocacy.

10.2.6.1 More Academic Support

Academic work taken by scholars will undoubtedly be one of the *most important* factors to build a stronger engagement culture in China. At present, while there are considerable studies to explore avenues for the development of Chinese corporate governance, few of them have paid attention to the role of institutional shareholders in corporate governance. As we have seen, it is difficult to find any evidence regarding the level of institutional shareholder activism in Chinese listed companies.

By contrast, in the UK, the topic of institutional shareholder activism has preoccupied

much debate in UK over the past few years. There has been a great amount of commentary in the academic research. In Part II, we have seen extensive studies conducted by many scholars to investigate UK institutional shareholders and their role in improving corporate governance. They helped to identify problems in current landscape, raise public awareness of the importance of shareholder engagement and offer feasible solutions to future development. It is fair to say that today's more active shareholder engagement is partly the product of academic support in the UK.

In the light of the UK approach, institutional shareholder engagement should become one of the central research interests of Chinese academic scholars in the corporate governance arena. Extensive efforts should be devoted to explore the institutional shareholder participation, identify obstacles that activism faces and make suggestions for further improvement.

Moreover, similar to UK trade associations, Chinese counterparts can conduct annual reviews and surveys on their members in regard to their corporate governance and shareholders activities. In addition, studies from institutional investors themselves can also make considerable contribution to the subject of corporate governance. A good example of it is the work done by Hermes.[77] Through its engagement approach, it found that there might be a positive link between corporate governance and corporate performance.

The valuable information provided by scholars, associations and institutional investors will promote a better understanding of shareholder engagement among the public and accordingly, encourage a greater institutional shareholder participation in corporate governance.

10.2.6.2 Government's Advocacy

The objective of nurturing good culture can not be achieved without the support of the

[77] See Chapter 3.2.4.

Government. The UK case well supports the view that if the Chinese government puts more effort to emphasise shareholders' responsibilities, it is likely to see an increase in institutional shareholder engagement in the future.

As already evidenced by some studies, today more active shareholder engagement in the UK could be seen very naturally as a response to the Government calls for 'responsible ownership'.[78] After the Labour Government came into power in 1997, that Government consistently argued that shareholder oversight of corporate governance should be considered as a moral rather than merely an economic duty. The publication of Myners' reports and Walker's review, coupled with many Ministerial speeches and papers, transmitted the idea that responsible ownership, manifested through institutional shareholder activism, was the best way to achieve long-term value of investments and corporate development.[79] The Government's support raised the public's awareness of the importance of shareholder engagement and promoted a more active shareholder voting level. Moreover, much effort from trade associations, as shown above, is largely attributable to the Government's advocacy.

China can learn from the UK's approach to consistently emphasize the importance of institutional shareholder engagement in Governmental reports, media or speech, so as to promote the culture of active institutional ownership in listed companies. The Government should make every effort to encourage communications between institutional investors and corporate managers, and advocate institutional investors to make use of their governance rights in relation to their shares.

In sum, extensive academic support, together with consistent advocacy by the Government, will promote a sense of ownership amongst institutional shareholders, and thus contribute to a significant improvement in shareholder participation in Chinese listed companies.

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[78] P Montagnon, 'The Role of the Shareholder' in K Rushton, *The Business Case for Corporate Governance* (Law practitioner series, Cambridge University Press, Cambridge: New York 2008) 89.

[79] For discussions on the Myners' report and the Walkers Review, see Chapter 2.2.3.

Chapter 11 Conclusion

The central aim of the thesis is to understand and compare the role of institutional shareholders in corporate governance in the UK and China. In pursuit of that aim, the thesis seeks to provide answers for four research questions specified in Introduction. By way of conclusion, it is necessary to review how and what the thesis has responded to these questions.

11.1 Research Summary

11.1.1 Question 1

Is activism by shareholder rational? What factors determine the extent of institutional shareholder activism? Can these factors be ordered so they form a coherent model of shareholder activism?

Chapter 1 developed a ‘model’ to explain *when* and *why* activism by shareholder is rational, collectively and individually. It called for a two-stage analysis. The first stage entailed asking whether *collective* action by shareholders would be *collectively* beneficial. The second stage was to explore whether activism is *individually* rational for an individual institutional investor.

At the *collective* stage, this thesis found no solid basis for the theory that shareholder activism is detrimental to corporate governance. By contrast, this thesis argued that shareholder activism is collectively valuable as a means of reducing agency costs in listed companies. This was justified primarily by *theoretical* arguments, whilst noting that the empirical data are, at best, rather mixed and unclear about the consequences of institutional shareholder activism. Moreover, Chapter 1 showed that institutional monitoring fits within a broad tapestry of devices and market forces which operate to ensure managerial accountability. However, crucially, these other devices and market

forces are *not* an *alternative* to shareholder activism. Rather, they in part also *depend* on shareholder activism for their own effectiveness. The thesis therefore confirmed that shareholder activism should be encouraged as a means of improving corporate governance.

Turning to the second, *individual*, stage, it was argued that individual action is likely to happen when two conditions are satisfied. First, the free-rider problem must be overcome, and second, the institutional shareholder's own individual benefits must be calculated as likely to outweigh its own individual costs. In determining whether free-riding is likely to be avoided, fours factors were submitted as being of critical relevance:

(a) whether the individual institutional shareholding will be decisive
(b) whether concerted action is manageable and likely to be decisive
(c) whether 'in process' benefits are likely to arise for the institutional shareholder
(d) whether there is a strong moral/normative obligation to participate

In respect of the benefits and costs involved in activism, the thesis broke these down into the following categories:

(a) Benefits: (i) share of total gains; plus (ii) personal in process benefits

(b) Costs: (i) direct costs; plus (ii) indirect costs

Taken together, the model established in Chapter 1 addressed the first of my four research questions. The thesis then moved on to the second question: to 'prove' this model by 'applying it' to empirical evidence concerning shareholder activism in both the UK and China.

11.1.2 Question 2

What empirical evidence is there about the strength of these factors in the UK and China?

The thesis first dealt with empirical realities in respect of corporate governance systems in the UK and China. Any comparative study of institutional shareholder activism in these two countries must take into account the fact that the systems of corporate ownership and governance in these two countries are in many ways different from each other, as Chapter 2 and Chapter 6 have shown, respectively. The UK is characterized by a relatively large number of listed companies, a liquid capital market where corporate ownership and control rights are frequently traded among dispersed investors, and the absence of a core shareholder capable of exercising, alone, 'internal' control rights. The corporate sector of China is, in contrast, characterized by a relatively small number of listed companies, a less liquid capital market where ownership and control rights are often concentrated in the State as the 'blockholder' which can, and does, exercise control rights over management.

As a reflection of the above differences, the regulatory frameworks employed to govern the internal structure of listed companies therefore present some quite different features in the two countries. First, whereas many matters concerning the governance system of companies are left to 'private ordering' in the UK, Chinese corporate legislation relies heavily on a mandatory approach to prescribe a clear allocation of decision-making powers between shareholder meetings and the board of directors. Second, much of the governance in the UK goes beyond the legislative framework, using instead other less formal bodies of rules such as governance codes with a 'comply or explain' enforcement approach. By contrast, most regulations and rules concerning corporate governance in China, including stock listing rules, standards, compliance manuals and codes of conduct, are largely compulsory in nature, issued

by organs of the State, and backed by formal sanctions. Building on the foregoing analysis, along with enhancing managerial accountability, the distinctive systems of corporate ownership and governance in China created an additional demand for institutional shareholder engagement – to hold majority shareholders accountable to minority shareholders by means of activating the use of various corporate governance mechanisms already established in the Chinese regulatory framework, and enforcing good corporate governance as a way of replacing direct regulatory control from the State.

Apart from corporate governance settings, the composition, the nature and the extent of institutional investment in each country were found to have important implications for the nature and level of a country's institutional shareholder activism. Firstly, this thesis observed that both countries have seen sizeable increases in the proportion of equities held beneficially by institutions in the past few decades. However, comparatively, the portion of institutional ownership in China is considerably less than UK institutions' holdings. Although institutional investors are large equity holders in China, and collectively represent nearly half of the *tradable* share market, owing to the presence of large state shareholder in China, their holdings only account for a relatively small portion of the *total* equity of Chinese listed companies. The second finding was concerned with the composition of institutional investors in the market. Whereas UK's institutional ownership is mainly dominated by long-term investors, such as pension funds and insurance companies, (comparatively) short-term mutual funds prevail in the Chinese institutional market. The third conclusion manifests the fact that institutional shareholders in the UK are supported, in turn by a range of collective, representative bodies, such as associational organizations (ABI, NAPF, ISC *etc*) and proxy voting services. They serve to distinguish the UK institutional investment from its Chinese counterpart where similar organizations currently do not exist.

These findings regarding institutional ownership are clearly critically relevant in the context of shareholder activism as Chapter 4 found wide differentials in the behaviours of different types of institutional investors. We observed that the institutional investor most likely to intervene with a portfolio firm would be those *large* institutional shareholders with *long-term* investment horizon because (1) it is easier for them to overcome free-riding; and (2) they will receive a greater payback from activism and incur fewer financial costs for engagement. We also found that some institutional shareholders – and Hermes was the best example – have additional incentives for activism as they will receive some 'in process' benefits through engagement. We have also seen that trade associations played facilitating roles in organizing collective action among institutions as well as building good practice for institution shareholders concerning their engagement. All these factors, in conjunction with observations concerning different features of institutional landscape in the UK and China, were shown to be relevant in explaining the divergent levels of shareholder activism in these two countries.

Chapters 5 and 8, were devoted mainly to an examination of the different forms of activism in the UK and China, respectively. Institutional shareholder engagement in the UK was found to consist of (a) routine meetings with company management, individually and collectively, or through trade associations; (b) an increasing level of voting at AGMs, and most large institutions all cast their votes; (c) infrequent intervention to change the management through the approach of submitting proposals; and (d) virtually no use of litigation.

By contrast, shareholder monitoring in China was found to possess the following comparative features, namely (a) probably frequent private contact with company management; (b) an average voting level of 61.2% at AGMs, but only around 7.02% when the largest state shareholders' votes were excluded, which suggests 17% of the remaining shareholders (mainly institutional investors) cast their votes; (c) infrequent

activism by submitting proposals, with most such proposals having been filed by the largest controlling shareholders. None of the proposals investigated in the sample were proposed by institutional shareholders; and (d) no use of derivative action.

Building upon that empirical evidence, Chapters 5 and Chapter 9 then applied the activism model to show how the various factors that constituted the model of activism set out in Chapter 1 operated in practice. In Chapter 5, we found that private meetings have been the most commonly-used approach adopted by institutional shareholders because they enabled shareholders relatively easily to overcome free-riding, and also gave a positive trade-off between costs and benefits. The private meeting provides a good opportunity for institutional shareholders to be decisive, and to act in concert. Moreover, it can secure 'in process' benefits and was *culturally* preferred. Regulatory demands from regulators to require regular contact between the board and shareholders also forces both sides to take action. We also saw that the increasing voting level in UK listed companies was largely driven by strong normative obligations laid down by regulatory instruments, including the 'soft law' of voluntary codes of practice. The associated reputational 'in-process' benefits further push institutions to show the public that they do exercise rights as responsible owners. However, a note of caution must be sounded. Regulatory forces, including making voting compulsory for institutional shareholders may ensure a high voting level, but ultimately would be achieved at the expense of a properly considered use of shareholder rights. It might, in other words, produce 'tick box' responses. The rights to submit proposals and bring legal suits are infrequently exercised owing to the potential high costs involved.

The application of the model to Chinese shareholder activism in Chapter 9 has been a more complex process on account of the multiplicity of voting systems that might be employed, depending on whether a usual or unusual voting system was adopted at AGMs. However, the message conveyed by the model was simply clear. The two

factors – decisiveness of individual shareholding and the possibility of a concerted action – depended, significantly, upon just whether the largest shareholders' votes were cast. Minimal 'in-process' benefits and weak regulatory demands all worked together to give Chinese institutional shareholders fewer incentives to engage in activism. As we moved on to the second step of the model – namely the cost-benefit test – we found the pay-off from activism is a modest benefit arising from an increase in the value of their shares, with few personal benefits. We observed that some financial disincentives to activism were more or less similar to those in the UK, such as the litigation fee, shareholding disclosure rules and conflicts of interest, although their strength in deterring activism may vary between the two countries. Moreover, the traditional Confucian culture embedded in Chinese society, which impels people to rely on relationship rules and encourages high 'power distance', is undoubtedly a significant contributory reason for the passivity of institutional shareholders in engaging in corporate governance when activities were publicly-seen.

11.1.3 Question 3

What can be done to overcome factors that weigh against institutional shareholder activism, or to strengthen factors that encourage more shareholder activism?

Besides offering a description of, and an explanation for, differing levels of institutional shareholder activism in the UK and China, the thesis also provided a number of normative prescriptions for achieving greater institutional monitoring. These were, of course (given the comparative focus of the thesis) predominately recommendations for improvement for China, based on the UK model. But the UK's experience is by no means perfect. And I therefore included, in Chapter 5, a number of prescriptions for its future development in respect of shareholder activism too. These included, in particular, five measures that should be considered as possible means of increasing an active institutional shareholder involvement in an effective

way in the UK, namely, (1) to require the disclosure of securities lending when necessary; (2) to remove procedural barriers to voting; (3) to clarify regulations on insider dealing and acting in concert; (4) to require disclosure of voting policies and records and; and (5) to monitor the voting behavior of proxy agencies.

In China, it was submitted that, the greatest obstacle to institutional investor activism is the dominance of the State as a shareholder in listed companies and the first and foremost reform I suggested was therefore to reduce state ownership, albeit in a gradual way. In the meantime, the Government should develop a stronger institutional investor base, not solely for the purpose of an increase of shareholder activism, but also for the long-term development of the Chinese securities market. This thesis proposed three approaches, including relaxing institutional investment restrictions, tax relief for institutional investors and a liberalization of investment opportunities for foreign institutional investors, to achieve the aim of enhancing institutional investment industry. Secondly, in light of the facilitating role played by trade industry associations in the UK, this thesis recommended establishing similar organizations in China, as they have the potential to make a significant contribution to increase the level of institutional shareholder engagement. In this regard, this aim could be achieved through the following four approaches: (1) promoting good practice concerning corporate governance and shareholder engagement; (2) establishing voting policies; (4) facilitating concerted action and; (4) encouraging institutional investment. In addition, trade associations may prove to be of regulatory importance since they can shift some of the less formal rule-making burden from the Government to relieve current resource constraints.

The third approach that would be vital to create greater institutional shareholder monitoring is to enhance normative obligations via shareholder engagement guidance. China can learn from the newly-issued UK Stewardship Code with a full account of its specific conditions and needs, to build a set of benchmarks and principles relating

to the responsibilities of institutional shareholders in corporate governance. However, unlike a ‘comply-or-explain’ approach adopted by the UK Stewardship Code and the UK Corporate Governance Code, Chinese guidance should be subject to more mandatory enforcement given that the Chinese securities market still lacks the capabilities to generate sufficient sanctions. In the short term, it may prove to be the most effective way towards promoting good practice. It is also straightforward and easy to implement. But, in the long-run, the thesis suggested the Chinese government can gradually ease administrative intervention while relying more on market discipline, as the market itself becomes more sophisticated.

Fourthly, public scrutiny will be an effective means to mitigate the risks resulting from conflicts of interest, which will accordingly require Chinese institutional shareholders to establish and disclose their voting policies. Meanwhile, various mechanisms, including internal control and disclosure systems and specialist teams on engagement, should be established to build a well-organized and efficient internal corporate governance structure for financial institutions. The last critical element in ensuring further institutional shareholder activism is the cultivation of a corporate culture of good governance to strengthen the normative obligation on institutional investors. This is admittedly, a long-term task, which cannot be fulfilled without consistent academic support from scholars and the Government’s advocacy.

11.1.4 Question 4

Comparatively, I am answering questions 1, 2 and 3 in respect of both the UK and China.

As the summary above shows, the thesis has answered the first 3 questions for both countries. It did, however, in Chapter 10, note that that there are potential difficulties in a comparative study. Differing cultural, ideological and economic traditions beneath the law can set national system down a particular path, which would limit the

ability of a country to adapt elements of governance from other systems. This chapter proposed that a legal borrowing should be sensitive to, *firstly*, whether imported rules can fit into the broad corporate governance system of the receiving country, and *secondly,* whether there are any hurdles that would prevent new rules from achieving the same purposes in the receiving country as in the original country. The thesis therefore carefully evaluated the needs of Chinese corporate governance system, its potential for exportation, and its capacity for importing foreign experiences, so as to determine whether the UK's approaches are desirable and workable. By doing so, the problems involved in legal borrowing can be largely alleviated.

11.2 Issues for Future Research

Indeed, the model developed in the thesis is hoped to provide a theoretical framework for the future study of institutional shareholder activism. A number of further avenues of research relevant to the subject study of this thesis can be envisaged.

First, the conclusions on the Chinese part could be yet more compelling if still greater empirical evidence and data regarding the current level of institutional shareholder participation were available to determine how the activism model holds in the Chinese case. To be sure, some evidence of this nature was included in Chapter 8, drawn from the empirical evidence study conducted on the sample of Chinese listed companies. However, a much more extensive empirical evidence survey could be envisaged, which could in the future provide more robust Chinese data.

The second avenue of research relates to the influence of foreign institutional investors in the corporate governance of domestic listed companies. In the UK, as was pointed out in Chapter 3, institutional ownership by foreign investors increased to roughly 40% of the total UK equity shares. The decisions that foreign institutional investor makes – whether on their own behalf or on behalf of their beneficiaries – will have a profound effect on the governance and performance of the UK companies. In China, whilst the

current QFIIs' holdings seem to account for only a small portion of institutional investment, their implications for future development of the corporate governance practice of Chinese companies is potentially far-reaching as the Chinese market liberalizes, and given increasing investment demand from foreigner institutions. Their influence over Chinese listed companies through activism will be of considerable practical and legal significance. Therefore, it also constitutes an interesting topic for the future research to explore the role of foreign institutional investors in domestic corporate governance practice.

Last but not least, a more general avenue of research is to examine how, and to what extent, institutional shareholder activism is linked with other variables if possible, such as political views, fund managers' personality traits and the characteristic of portfolio companies. They all offer fertile ground for future work.

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