Shareholder Power

Jennifer G. Hill

Shareholder power, rights and activism are topics of enormous current interest around the world. Different images of the shareholder underpin regulatory choices in terms of whether to constrain or expand shareholder power.

The paper argues that at least three shareholder images can be discerned since the time of the global financial crisis: (i) the shareholder as “predator”; (ii) the shareholder as “unfaithful servant”; and (iii) the shareholder as “governance steward”. The tension between these contrasting perceptions of shareholders, and shareholder power, is apparent in a range of contemporary international corporate governance developments. These include the shareholder empowerment and proxy access debates in the United States; recent efforts to enhance shareholder participation in corporate governance through Stewardship Codes in the United Kingdom and Japan; and evolving regulatory attempts to differentiate “bad” predatory activism from “good” governance stewardship by shareholders.

The paper is structured as follows. Part 2 examines the close connection between shareholder image, power and choice of regulatory technique. It contrasts “regulatory strategies” that protect shareholders, with “governance strategies” that empower them. Part 3 considers the change in profile of shareholders over the last century, culminating in “agency capitalism” (Gilson & Gordon 2015), and how this development has created new, and inconsistent, images of the shareholder from a regulatory perspective. Part 4 discusses the trajectory of the US shareholder empowerment debate through the lens of different shareholder images. Part 5
considers whether recent US corporate governance developments constitute a fundamental paradigm shift regarding the balance of power between shareholders and directors. Part 6 seeks to explain the strong resistance in the United States to granting shareholders increased participation rights, by reference to comparative corporate law and history. Part 7 focuses on shareholder Stewardship Codes in the United Kingdom and Japan, as illustrative of recent international regulatory developments that view shareholder power as a positive corporate governance attribute and cast shareholders in a quasi-regulatory role. Finally, the paper examines the regulatory challenge posed by conflicting attitudes to shareholder power. It discusses a recent Australian regulatory guide (Regulatory Guide 128), which, in seeking to establish a dividing line between proper and improper use of shareholder power, demonstrates considerable ambivalence towards increased institutional investor activism and co-ordination.

2. Shareholder Image, Power and Corporate Regulation

Shareholder image has significant regulatory consequences in corporate law. Various images have existed across time and jurisdictions. These include the shareholder as owner/principal; beneficiary under a trust; bystander; participant in a political entity; investor; or gatekeeper (Hill 2015; Schön 2000). Differences in shareholder image also inevitably affect the role and responsibilities of the board of directors and reflect competing paradigms of the corporation itself (Hill 2000).

Power is deeply implicated in how we view shareholders and their role in the corporation. Yet, the concept of power generally, and shareholder power in particular, is elusive and by no means easy to define (Moore 2013, 17-18; Wells 2015, 13). Power can be held individually or collectively; can be used to influence both corporate controllers and lawmakers (Wells 2015; Davies 2015); and is often most effective, when invisible (Becht, Franks and Grant 2015). Although economic power and legal power are theoretically distinct, they are interrelated, since economic power can be used to leverage stronger legal rights, and to legitimize certain corporate actors. Finally, although shareholder empowerment via strong legal rights is closely connected to investor activism, the two are not coterminous. Japan, provides a good example of this paradox. In Japan, for example, although shareholders possess strong legal rights, shareholder activism has traditionally been rare. (Goto 2014).
Shareholder power, together with image, plays an important role in regulation. It has been said that regulation “occurs in many rooms” (Galanter, 1981, 1), and corporate regulation encompasses an array of techniques to control conflicts of interest, and ensure accountability, within the corporation (Hansmann and Kraakman, 2009, 38). These techniques lie across a regulatory spectrum, which is closely connected to shareholder power. At one end of the spectrum are “regulatory strategies”, which are designed to protect shareholder interests, and control agency problems, by means of prescriptive legal regulation, including fiduciary duties (Hansmann and Kraakman, 2009, 39-41). These regulatory strategies are protection-focused, and based on a traditional image of shareholders as vulnerable and unable to safeguard their own interests.

At the other end of this spectrum lie “governance strategies”, which, by way of contrast, are generally empowerment-focused. Governance strategies seek to address the inherent power disparity between shareholders and the board of directors (Eisenberg 1989, 1472), by enhancing shareholders’ participation rights in governance (Hansmann and Kraakman, 2009, 42-43). This form of strategy grants shareholders specific legal rights, such as “appointment rights” (allowing shareholders to control the composition of the board of directors) and “decision rights” (enabling them to intervene in certain firm decisions). It promotes shareholder participation in corporate governance, as a form of self-help or self-protection, and as an accountability mechanism in its own right.

Use of shareholder empowerment as a regulatory technique is context-specific and dependent upon corporate ownership structure. Where ownership is dispersed, shareholder empowerment represents a counterweight to centralized board power, and may constrain the board’s discretion and autonomy. However, in a concentrated ownership setting, including state-owned enterprises, ultimate control will rest with the majority shareholder/s (Bebchuk and Hamdani 2009; Hopt 2009). In this scenario, shareholder empowerment is irrelevant, or even counterproductive, as an accountability mechanism (Lan & Varottil 2015; Kim 2015).

3. **Regulatory Implications of the Shift in Shareholder Profile and Image**

[A segment of Part 3 dealing with the change in shareholder profile and rise of agency capitalism in the US and UK has been deleted].
As the profile of shareholders has changed, so too has their image. In the post-crisis era, this image has become increasingly ambiguous. At least three images of the shareholder can be discerned in contemporary corporate governance developments – (i) the shareholder as “predator”; (ii) the shareholder as “unfaithful servant”; and (iii) the shareholder as “governance steward”.

According to some commentators, shareholders were an intrinsic part of the problem and culpable for reckless and predatory conduct during the global financial crisis (Mitchell 2009). This image of the shareholder as “predator” treats shareholder power as an inherently pernicious and dangerous aspect of contemporary corporate law. Negative depictions of shareholders, and shareholder power, are common in the United States, and in a number of civil law jurisdictions, where contemporary institutional investor pressure has provoked hostility (Hill 2015, 56-57).

From the perspective of regulatory diagnosis and prescription, the “predator” image provides policy justifications for limiting governance strategies and shareholder rights. The paradigm also potentially suggests a radical shift in corporate law, from its traditional focus of protecting shareholders to a new goal of protecting the corporation from its shareholders, and shareholders from each other (Hill 2015, 57). This shift is encapsulated in Martin Lipon’s recent recommendation that any new legislation/regulation should include protection for companies against shareholder pressure (Lipton 2015b, 7).

Closely associated with a predatory shareholder image, though in subtler form, is that of the shareholder as “unfaithful servant”.\(^1\) This depiction builds on the contemporary reality of “agency capitalism” (Gilson & Gordon, 2015), under which capital markets in jurisdictions, such as the United States, are dominated by institutional investors that invest, not on their own behalf, but on behalf of their ultimate beneficiaries. The image focuses on agency problems and divergence of interests as a result of this split in the ownership atom. The scholarship of the Chief Justice of the Delaware Supreme Court, Leo E. Strine Jr exemplifies this approach. While supporting an interpretation of Delaware corporate law that provides strong fiduciary protection to shareholders, Chief Justice Strine adopts a different attitude to shareholder empowerment. Emphasizing the “separation between ownership and ownership” (Strine 2014), he argues that there is a divergence between the incentives of activist

\(^1\) With apologies to The Band.
institutional investors with short-term goals, and their ultimate beneficiaries - “human beings who have a strong interest in durable wealth creation” (Strine 2015, 38). The vulnerable parties in this picture are not only these beneficiaries at the end of the investment chain, but also directors (id, 40).

There is an alternative story told about the global financial crisis, which does not involve active shareholder complicity. It is essentially a story of dereliction, under which shareholders were blameworthy for paying insufficient attention prior to the crisis. This approach is epitomized by John Plender’s lament in relation to crisis - “where were the shareholders?”. Plender’s complaint was, not that institutional investors in the United Kingdom possessed inadequate legal rights, but rather that they failed to use them effectively and responsibly. A similar interpretation is evident in the 2009 UK Walker Review report, which stated that institutional investors must pay attention to the long-term performance of investee companies in order to gain social legitimacy (Walker Review 2009, [5.7]). This approach parallels the views of Brandeis J. exactly a century ago, when he stated that it is the shareholder’s “business and his obligation to see that those who represent him carry out a policy which is consistent with the public welfare” (Fraenkel 1965, 75).

Several post-crisis regulatory initiatives treat shareholder power as a positive, but under-utilized, regulatory attribute. They cast shareholders in a quasi-regulatory role, as “governance stewards”. One manifestation of this trend is the widespread adoption of “say on pay” (Barontini et al 2013; Thomas & Van der Elst 2013). Another is the introduction in the United Kingdom, and transplantation to Japan, of a Stewardship Code, which represents a regulatory response to Plender’s question, “where were the shareholders?”. A stewardship shareholder image alos accords with Gilson and Gordon’s theory of agency capitalism, under which “sophisticated but reticent institutional investors” can be prompted into supporting activism by other market players under appropriate circumstances (Gilson & Gordon 2015). It is, however, in direct conflict with both the “predator” and “unfaithful servant” images of the shareholder.

These contradictory shareholder images have led to fundamental recent policy and reform questions concerning shareholder power. These include the issue of what legal rights and powers should shareholders possess; whether shareholder power should be subject to legal
constraints and, if so, which; and how to differentiate positive from negative use of shareholder power.

4. The Shareholder as “Predator” and “Unfaithful Servant”: The US Shareholder Empowerment Debate

[Section 4, which deals with competing shareholder images under the US shareholder empowerment debate, has been deleted].

5. Recent US Developments Regarding Shareholder Power

5.1 Post-Crisis Developments re Proxy Access Reform

[Section 5.1 has been deleted. It deals with the trajectory of the proxy access debate in the US under the Shareholder Bill of Rights (2009); the Dodd-Frank Act (2010) and the failed SEC efforts to implement a mandatory federal proxy access rules, as a result of the decision in Business Roundtable v SEC (2011), which invalidated SEC Rule 14a-11, granting limited proxy access to shareholders.].

5.2 Current US Developments - Use of Private Ordering to Acquire Governance Rights

In the wake of the failed SEC efforts to implement a mandatory federal proxy access rules, institutional investors adopted a self-help/private ordering strategy to acquire proxy access rights. The Business Roundtable v SEC decision, although invalidating Rule 14a-11, left intact SEC amendments to Rule 14a-8, permitting shareholders to bring their own resolutions relating to director nominations (Kess 2015). Adopting a stepping stone approach, US shareholders have used existing powers, such as the power to propose precatory Rule 14a-8 resolutions, to place pressure on boards to grant them new election-related rights. Their
recent success in adopting this strategy is reshaping the corporate governance environment in
the United States.

Overall, the number of US shareholder proposals relating to corporate governance has
increased dramatically, and proxy access is the stand-out issue in the 2015 proxy season.
Admittedly, there has been a recent decline in proposals relating to other corporate
governance issues, such as majority voting and declassification of staggered boards, but even
this decline seems a testament to shareholder success. Majority voting and declassification of
staggered boards are no longer burning governance issues because, to a large extent, these
battles have been won. More than 80% of S&P 500 companies, now have majority voting
requirements and around 60% permit shareholders to call special meetings (Sullivan &
Cromwell LLP 2015, 1, 3, 9, 12). Also, there has been a sharp decline in staggered boards. In
2014, the percentage of S&P 500 companies with declassified, or non-staggered, boards was
93%, compared to 55% a decade earlier (Spencer Stuart 2014). According to Chief Justice
Strine, these developments have left boards increasingly subject to “the immediate whims of
stockholders” (Strine 2015, 40).

Shareholder proposals relating to proxy access rose from only 17 in 2014, to around 100 at
US public corporations during the 2015 proxy season. This was largely due to the efforts of
New York City Comptroller, Scott Stringer, who filed 75 proposals on behalf of New York
pension funds as part of the Boardroom Accountability Project. The Comptroller’s proposals
were precatory in nature, with a standardized 3%/3 year/25% proxy access proposal, in
accordance with the SEC’s vacated rule, Rule 14a-11. By late July 2015, shareholders had
considered 81 proxy access proposals, over 59% of which received a majority vote (Kess
2015).

Predictably, many public corporations faced with proxy access proposals in 2015 engaged in
pushback by, for example, issuing an opposition statement. Some went further, attempting to
preempt altogether a shareholder vote on the proposal. Whole Foods Market, Inc (“Whole
Foods”), for example, argued that the company was entitled to exclude a 3%/3 year/20%
shareholder proposal submitted by James McRitchie, because it directly conflicted the
company’s own proposals to amend the company’s bylaws to include a proxy access
provision. Yet, Whole Foods’ 9%/ 5 year/10% proposal was far less generous to shareholders
than Mr McRitchie’s. What is more, the company’s proposal only accorded proxy access to a
single shareholder, and prohibited shareholder aggregation or coordination to reach the high 9% stock threshold (Baker Botts LLP 2014, 3; Morgenson 2015).

Initially, the SEC legitimized the exclusion of Mr McRitchie’s proposal, by granting Whole Foods the no-action relief it sought under Rule 14a-8(i)(9) (Jacobson 2014). This pro-management precedent opened the floodgates, and over 20 other corporations submitted similar applications to the SEC in quick succession (Alliance Advisors 2015, 2). However, in January 2015, following a request by the Council of Institutional Investors (“CII”) for the SEC reconsider its Whole Foods “no action” decision (CII 2015), the regulator did a U-turn on this issue. SEC Chair, Mary Jo White, announced that, in the light of questions had arisen about the “proper scope and application” of the Rule 14a-8(i)(9) exemption, she had directed SEC staff to review and report on the rule (SEC 2015a). In a parallel move, the SEC announced that it would “express no views on the application of Rule 14a-8(i)(9) during the current proxy season” (SEC 2015b; Higgins 2015). This meant that corporations, including Whole Foods, which sought to substitute company proxy access proposals for shareholder proposals during the 2015 proxy season, now did so at their peril, as they could no longer rely on SEC no-action relief (Hodgson 2015; Business Roundtable 2015). If ultimately sanctioned by the SEC, the Whole Foods strategy will arguably amount to a classic modern example of the concept of “impoverished consent”, whereby shareholders may be forced to vote for a management-proposed rule, in spite of preferring a different rule (Eisenberg 1989, 1477).

In contrast to the Whole Foods saga, some boards, including those at Bank of America, Citigroup and General Electric (“GE”), have voluntarily adopted, or agreed to support, shareholder proxy access. In February 2015, the GE board, voluntarily (or at least preemptively) adopted 3%/3 year/20% bylaw, without submitting it to shareholder vote (Mann & Lublin 2015). However, GE’s board-adopted bylaw included an aggregation limit of 20 shareholders (GE 2015).

Proxy access is merely the tip of the corporate governance iceberg in the current battle between US shareholders and boards over allocation of power. ISS has stated, for example, that it will oppose directors, who adopt charter or bylaw provisions that “materially diminish shareholder rights”, without shareholder consent (ISS 2015, 5-6). This is no idle threat today, given the fact that changes, which have occurred in relation to majority voting, the ability of
shareholders to call special meetings, and the decline of staggered boards, has made directors more vulnerable to shareholder discontent.

5.3 Has There Been a Sea-Change in US Corporate Governance? Martin Lipton as Bellwether

Until recently, many anti-empowerment proponents adopted arguments presenting both institutional investors and activists in a negative light. In 2013, for example, Martin Lipton, who has been described as “one of the leading warriors against activists” (Barusch 2015), spoke scathingly of institutional investors. He warned that their voting power was being “harnessed by a gaggle of activist hedge funds who troll through SEC filings”, seeking short-term profit at the expense of both the company and the economy (Lipton 2013). This analysis depicted institutional investors as unfaithful servants, which collaborate with predatory hedge funds.

Nonetheless, the corporate governance developments discussed above, together with recent high profile proxy battles, such as the activist campaign of Trian Management Fund (“Trian Fund”) against DuPont (Davidoff Solomon 2015; Gara 2015), have had an interesting effect on anti-empowerment rhetoric. Only two weeks before DuPont’s decisive annual shareholder meeting in May 2015 (and, perhaps more significantly, only two days after the announcement that ISS would recommend that shareholders vote in favor of two of Trian Management Fund’s board nominees (MarketWatch 2015)), Mr Lipton departed from his familiar “take no prisoners” rhetorical style.

Adopting a new, more conciliatory tone, he stated that “Trian Fund and its founder, Nelson Peltz, have clearly established credibility and acceptability…They have become respected members of the financial community” (Lipton 2015a). Departing even further from his customary script, Mr Lipton suggested that corporations facing activist campaigns would be “well-advised to meet with the activist and discuss the activist’s criticism’s and proposals, which are frequently presented in the form of a well-researched white paper”. Finally, he commented that “[m]ajor institutional investors like BlackRock and Vanguard want direct contact with the independent directors of corporations” (Lipton 2015a).
Coming from Martin Lipton, these observations arguably bear the hallmark of a sea-change in the balance of power between US boards, activists and institutional investors. They constitute recognition of the implications of agency capitalism, in which traditionally passive can, nonetheless, be prompted into supporting activism by other market players (Gilson & Gordon 2015). Mr Lipton’s comments suggest that US institutional investors have become the corporate equivalent of swing voters in politics – it seems all sides are now out to woo them in an increasingly globalized investment world (Foley et al 2015).

6. Legal History, Comparative Corporate Governance and Shareholder Power

The level of controversy generated in the United States by the shareholder empowerment debate and recent shareholder proposal developments is puzzling to foreign eyes. Is it even appropriate to regard the current examples of private ordering in US corporations as “activism”? After all, prior to the decision in Business Roundtable v SEC (Business Roundtable v SEC 2011), private ordering was the recommended regulatory solution of many opponents to mandatory federal proxy access rules (Bebchuk & Hirst 2010). To describe private ordering as “activism” once it actually occurs, suggests that the initial appeal of a private ordering solution to opponents of mandatory proxy access may have been its likelihood of failure.

The shareholder rights that have been so controversial in the US context – including majority voting, the ability to convene shareholder meetings, nomination and removal of directors - are taken for granted in other common law jurisdictions, including the United Kingdom and Australia, and considered to be fundamental to corporate accountability. Indeed, just over a decade ago, it was the absence of such rights under US corporate law that caused consternation among Australian institutional investors when News Corp reincorporated in Delaware (Hill 2010b). It seems that, with increasing globalization, US institutional investors are now more aware of the rights held by shareholders in other jurisdictions. These fundamental investor rights are also present in Japan, a jurisdiction that has not historically been regarded as particularly protective of shareholder interests (Goto 2014).

---

2 Admittedly, Mr Lipton has subsequently reverted to the language of conflict, comparing corporate governance developments in the United States with the religious Thirty Years’ War of the 17th century (Lipton 2015b). In this memo, Mr Lipton describes proxy advisers, such as ISS, as “a brigade of mercenaries” (id, 3). Yet, the conciliatory tone to major institutional investors is still present, with Mr Lipton presenting them as the best hope for peace and “taming the activists” (id, 9-10).
In addition, the kind of engagement with corporate boards, which, according to Martin Lipton, major US institutional investors now seek (Lipton 2015a), is hardly contentious in other common law jurisdictions, such as the United Kingdom. Such engagement has a long history in the UK, and the 2003 Higgs Report proposed governance techniques specifically designed to ensure open communication and engagement between boards and institutional investors. These recommendations were subsequently translated into key principles under the UK Combined Code on Corporate Governance 2003. High-level engagement of this kind is also common in Scandinavian countries (Milne 2015; Morgenson 2015b; Sullivan 2013), and encouraged by recent corporate governance reforms in Japan (JSC 104; JCGC 2015, 33-34; JPX 2015b).

Comparative corporate law and legal history provide an important backdrop to the issue of shareholder power. They show that, in spite of a common legal heritage, there are major differences between US and UK company law. Not least of these is the fact that the United States and the United Kingdom had divergent historical starting points in terms of shareholder rights. These different starting points are directly related to the dichotomy between shareholder protection, via regulatory strategies, and empowerment, via governance strategies.

Although the theme of shareholder protection was a focal point of traditional US corporate law, shareholder empowerment was not. Rather, centralized board power represented a “cardinal precept” of US corporate law (CA, Inc v AFSCME Employees Pension Plan 2008), and shareholder incursions into managerial decisions were severely curtailed. The board occupied a guardian role, and shareholder’s role was restricted to that of supplicant, or, alternatively, rubber stamp\(^3\) (Continental Securities Co v Belmont 1912).

UK company law, on the other hand, displayed far more flexibility regarding allocation of power. Whereas in the United States, centralized board power derived directly from the state (Manson v Curtis 1918, 562) and was a mandated feature of early US corporate law, under UK company law, the board’s powers could be “as broad or as narrow...as desired” (Pennington 1967, 481). Decisions as to the breadth or narrowness of the board’s powers were within the shareholders’ remit, since the company’s constitution (“articles of

---

\(^3\) Professor Eisenberg describes such consent by shareholders for actions proposed by management as “nominal consent” (Eisenberg 1989, 1474-75).
association” or “articles”) were the source of board powers, and shareholders controlled the articles.⁴

The ability of shareholders to freely alter the articles by special resolution was a mandatory feature UK company law. Any provision attempting to contract out, or deprive, shareholders of this inherent power would be invalid under UK law as contrary to statute. Unlike in Delaware,⁵ UK shareholders could initiate changes to the constitution without board approval. The historic differences in power allocation under UK and US law accords with the view that, whereas the main focus in the United Kingdom was on attracting capital, in the United States it was on attracting managers (Rickford, 2003).

It has been suggested that this inherent power of the shareholders to alter the articles according to their own wishes constitutes the cornerstone of shareholder rights in the United Kingdom (Nolan, 2006, 554-6). The fact that a company’s articles were essentially contractual received explicit statutory recognition under UK company law (Gower 1956, 1376). Also, in contrast to the approach under traditional US corporate law, shareholders in the United Kingdom were potentially accorded strong participation rights from an early period. Thus, for example, the Regulations in Table B attached to the Joint Stock Companies Act of 1856 included the following rights:- shareholders with an aggregate of 20% of shares could requisition the directors to convene an extraordinary general meeting; any shareholder could submit resolutions by giving at least 3 days notice; shareholders could generally, by special resolution, remove a director from office prior to the expiration of the term office and appoint a replacement. Also, any two shareholders could summon an extraordinary general meeting.

These historical contrasts between US corporate law and UK company law are striking, and are underpinned by fundamentally different governance paradigms. US corporate law reflected a managerialist paradigm, in which directors received their authority from the state and occupied a role of gatekeeper/protector of shareholder interests (Bainbridge, 2006a, 771). UK company law, on the other hand, embodied a constitutional paradigm, under which authority was granted by the articles, which were subject to shareholder alteration. Although

⁴ Cf Watson 2011, who questions the significance of the fact that directors in the UK obtained their powers from the article of association, rather than statute.

⁵ Del G.C.L. s 242.
some C19th UK company cases interpreted this to mean that directors were mere agents of the shareholders, this paradigm was overturned in the early C20th, when it was made clear that the articles created separate and autonomous spheres of authority for both directors and shareholders. It was still possible for shareholders to give directions and advice to the boards of UK companies under this new paradigm, but only if this power were specifically allocated to shareholders by the articles (which was commonly the case).

What accounts for this divergence between UK company law and US corporate law? The answer seems to lie in their fundamentally different origins, combined with the concept of path dependence (Roe, 1997). Although the law in both jurisdictions has its roots in the United Kingdom, they derive from two different kinds of business organization.

US corporate law had quasi-public roots (Friedman 1985, 188-195), evolving from early UK municipal and government bodies (Gower 1956, 1370). These bodies, including government-sponsored “chartered corporations” such as the East India Company, can traced back to Tudor times. Charters were not freely available, but rather were determined by the state on a case-by-case basis (Patterson & Reiffen 1990, 164). Prior to 1844, the enactment date of the UK’s first general incorporation statute, the only legitimate methods of acquiring corporate personality in the United Kingdom were by charter or, alternatively, by Special Act of Parliament. In the light of these quasi-public origins, it has been stated that historically US corporate law “never regarded the corporation as simply a private contract” (Coffee 1988, 939; cf Butler & Ribstein 1990, 8-10). Chartered corporations provided for centralized board power, with protection of shareholder rights. The traditionally high level of deference accorded to the board of directors under US corporate law (and correspondingly narrow shareholder powers) reflects US corporate law’s distinctive historical roots.

Modern UK company law followed an entirely different route. Unlike US corporate law, it developed, not from chartered corporations, but from unincorporated joint stock companies, which were essentially partnerships and therefore had strong contractual elements to them (Gower 1956, 1371-72, 1376). The different origins of UK and US law in this area also explains differences in terminology, such as use of the terms “company law” and “articles of association” in the United Kingdom, as opposed to “corporations law”, “charters” and

---

6 The Joint Stock Companies Act 1844.
bylaws” in the United States. The consequences of those two different pathways are still playing out in corporate governance today in relation to shareholder power.

7. The Shareholder as “Governance Steward”

In the post-crisis era, there have been several developments, which represent shareholder power as a positive corporate governance attribute, and seek to harness it as a regulatory technique (Hill 2015, 64-68). One prominent example of this trend is “say on pay”, which became a popular regulatory technique around the world, including in the United States, following the crisis (Barontini et al 2013; Thomas & Van der Elst 2013). Another is shareholder stewardship, which constitutes a more generalized response to John Plender’s question, “where were the shareholders?”.

In some jurisdictions, such as the United Kingdom, the debate today is less about controlling shareholder power, than about how to encourage shareholders to exercise their existing rights. With this end in mind, in 2010, the United Kingdom adopted a Stewardship Code (FRC 2012) on the recommendation of the Walker Review on corporate governance in financial institutions (Walker 2009, 17). The Stewardship Code represented a shift away from the hands-off approach to corporate governance traditionally taken by UK institutional investors (Cheffins 2010, 1004). One of the Code’s underlying premises is that institutional shareholders have a non-delegable responsibility to engage with the companies in which they invest (Hughes 2009; Burgess 2009). The Code, which is aspirational in nature, states that institutional investors, as providers of capital, “set the tone” for stewardship (FRC 2012, 1). The UK Code encourages institutional investors to exercise their power in numerous “hands-on” ways – by means of voting, monitoring, and engaging in “purposeful dialogue” with companies about matters such as strategy, performance, risk and corporate governance (including culture and executive pay) (FRC 2012, 1, 6).

The UK Stewardship Code makes large claims. It asserts, for example, that “[e]ffective stewardship benefits companies, investors and the economy as a whole” (FRC 2012, 1).

---

7 The famous UK English Bubble Act of 1720 epitomized the differences and tensions between these two species of business organization.

8 See Dodd-Frank Act 2010, s 951.
Doubts have been raised about Code’s philosophical foundations. Some scholars have also suggested that the effectiveness of the Stewardship Code may be compromised by its voluntary, “comply or explain” nature (Cheffins 2010, 1013-1014; Micheler 2013, 45), and by the fact that domestic institutional investors today hold relatively low level of equity in UK-listed companies (Cheffins 2010; Davies 2015). It seems that some of this apprehension is shared by the UK Financial Reporting Council (“FRC”), which recently announced that it was concerned by the levels of collective engagement and general commitment to the Code (FRC 2015, 18, 20-22).

In spite of these concerns, the proclaimed economic benefits of the Stewardship Code have proven sufficiently alluring to warrant transplantation. In 2014, Japan adopted its own version of the Stewardship Code (Council of Experts 2014), as a component of the broad suite of monetary and fiscal policy reforms introduced by the Abe government since 2013 (Jones & Soble 2013). The philosophy behind these reforms, colloquially known as “Abenomics”, is that improving corporate productivity and “earning power” will benefit the entire Japanese economy (Japan Revitalization Strategy 2014, 2; Societe Generale 2015).

Japan’s new Stewardship Code falls within the “third arrow”\(^9\) of Abenomics, which comprises other significant corporate governance reforms, such as:- a Corporate Governance Code (JCGC 2015; JPX 2015b); reforms relating to independent directors (Nagata 2015); and a new stock index, the JPX-Nikkei 400, eligibility for which depends upon superior profits and governance practices (Benes, 2015; Japan Revitalization Strategy 2014, 107; JPX 2014; The Economist 2014b).

Contrary to popular Western belief, shareholders in Japan have relatively strong legal rights (Goto 2014; Shishido 2000). They have basic rights to:- alter the corporate constitution without board consent; elect directors by majority vote in both contested and uncontested board elections; nominate directors on the company’s ballot. Although Japan is a civil law jurisdiction, these rights closely parallel the law in some common law countries, such as the United Kingdom and Australia. Yet, under Delaware law, these rights are either absent, or

---

\(^9\) Namely, the *Japan Revitalization Strategy*. The other two arrows for economic revitalization are: (i) aggressive monetary policy; and (ii) flexible fiscal policy, including public works spending (G20 2014, 2-6).
available only by private ordering. Derivative suits are also easier to bring, and to maintain, against management in Japan than in Delaware (Goto 2014).

In spite of strong shareholder rights, investor activism in Japan has historically been rare, fraught with difficulty,\(^{10}\) and viewed with suspicion (McLannahan 2013). The most significant constraint on institutional investor activism was the existence of cross-shareholding (kabushiki mochiai) (Goto 2014). Cross-shareholding insulates management from outside shareholder influence, and some scholars have viewed it as the functional equivalent of US-style poison pills (Eguchi and Shishido 2015, 559-60; Milhaupt and Pistor 2008, 102; Skeel 2008, 707).

The “third arrow” structural reforms have been described as a “mini-revolution” (Pilling 2015), in terms of their potential effect on corporate governance and shareholder activism in Japan (Benes 2015). The Stewardship Code, for example, deliberately creates a “warmer climate” for activists and foreign investors (McLannahan 2014a; Osaki 2014, 1). The Code is voluntary, but already has a high sign-on rate by Japanese institutional investors. As at March 2015, 184 institutions, including GPIF, Japan’s 130 trillion yen (US$1.3 trillion) public pension fund, had adopted the Code (Aoyagi & Ganelli 2014, 15; GPIF 2014).

The UK and Japanese Stewardship Codes are similar in overall design, structure and content. Both apply to all listed companies in the jurisdiction, and include, not only institutional investors, but also proxy advisers (FRC 2012, 2; Japan’s Stewardship Code 2014, 2). Both are voluntary, and adopt a principles-based “comply or explain” approach. Although “comply or explain” regulation is a familiar part of the UK corporate governance landscape, it is entirely new to Japan (JSC 2014, 4, 13; Osaki 2014, 2). Both Codes, while recognizing that investors play an important accountability role, stress that this does not mean that shareholders are entitled to manage the company’s affairs (FRC 2012, 1; JSC 2014, 2).

In spite of these broad similarities, there are also interesting differences between the two Codes. For example, they are arguably responses to different policy problems. Risk control was a central policy factor behind the adoption of the Stewardship Code in the United Kingdom following the financial crisis (Walker 2009, 6, 12, 24-25). The Japanese version of

---

\(^{10}\) In 1991, for example, a defeated T. Boone Pickens lamented his inability as a 26% shareholder to have influence on the board of Koito Manufacturing (Pickens 1991).
the Code is, however, more focused on improving corporate profitability (Fujikawa & Pfanner 2014), and the mantras of “sustainable growth” and “medium to long-term corporate value” recur throughout it.

The Codes also display different approaches to activism intensity. The Japanese Code predominantly urges institutional investors to engage in “constructive dialogue” with management, rather than intervention (JSC 2014, 4, 10). The UK Code, however, provides a framework for much more aggressive conduct if the board is unresponsive to shareholder concerns. In these circumstances, it envisages escalation of conduct and states that institutional investors should establish guidelines as to “when and how” they will intensify their activism. Principle 4 of the UK Code specifies various forms of activist conduct, such as “intervening jointly with other institutions on particular issues” and requisitioning a shareholder meeting to remove directors from office (FRC 2012, 8).

Although couched in consensus-style language, the clear message of the Japanese Stewardship Code is that there needs to be more active communication between the board and shareholders, and an end to the “quiet-life equilibrium” of many Japanese companies (Eguchi and Shishido 2015, 564, 559, 564). This message seems to have been a welcome one for outside shareholders, and there has been a general rise in foreign investment. Between 2013 and 2015, for example, prominent US hedge fund, Third Point, took large stakes in Sony, Suzuki Motor Corp and Fanuc, a profitable, but insular, Japanese robotics company (Macfarlane 2015; Foley et al 2015). It is estimated that institutional investor ownership of shares in Japanese listed companies is currently around 60%, and that foreign investors hold almost one third of shares in these companies (JPX 2015a; The Economist 2014b).

These changes to Japan’s capital market are now being reflected at a corporate governance level. There has been a sizeable increase in the number of shareholder-initiated proposals at shareholder meetings of listed Japanese companies (McLannahan 2014b). Foreign investors are now influential in terms of voting results (Kurihara 2015), and Japanese institutions have followed suit in adopting a more active voting style (Eguchi and Shishido 2015, 563; Taguchi 2014).

To date, this new-style investor activism in Japan has mainly been used to seek higher investor returns, specifically by targeting “corporate cash-hoarding” (Fujikawa & Pfanner 2014; McLannahan 2014b; Sullivan 2014). Although corporate cash asset holdings have risen
around the world, the phenomenon is especially pronounced in Japan. The new JPX-Nikkei 400 index also provides incentives for corporations to increase investor returns through higher dividends and stock buy-backs. The ultimate policy goal of the “third arrow” reforms, however, is not solely to benefit shareholders. Rather, it is intended that improved profitability should be shared among corporate stakeholders through expanded employment and wage increases, in addition to increased dividend payments (Japan Revitalization Strategy 2014, 35).

Will Japan’s Stewardship Code, and other “third arrow” corporate governance reforms, work? It is too soon to tell. Cross-shareholding continues to be a potential obstacle to the effectives of the reforms (Goto 2014), though there has been a significant unwinding of cross-shareholdings since the 1990s (Eguchi and Shishido 2015, 561). There has also been resistance from Japan’s powerful business lobby group, Keidanren, toward some of the corporate governance developments, including reform proposals to increase the number of independent directors on Japanese company boards (which, it must be said, are modest by international standards (Hirata 2014; The Economist 2014b)).

Nonetheless, Japan’s embrace of shareholder stewardship stands in sharp contrast to some other Asian countries. In Korea, for example, corporate law amendments in 2007 imposed criminal sanctions on foreign investors seeking to “exert an influence” on Korean firms, which included demands for higher dividends, (Kim 2015, 540). More recently in Korea, events during the unsuccessful attempt by US hedge fund, Elliott Management to block a family controlled acquisition of Samsung C&T, exemplified a predatory image of foreign investors (Kurson 2015).

7.3 ASIC Regulatory Guide 128 - Is There a Regulatory Dividing Line Between “Good” and “Bad” Investor Activism?

The line between stewardship and activism is becoming blurred. In many jurisdictions, traditionally passive institutional investors have become more activist. Norway’s oil fund, the world’s largest sovereign wealth fund, with assets of US $870bn and a stake in 10,000 companies, has recently signaled an intention to depart from its traditional position as passive financial investor and adopt a more activist approach to corporate governance (Milne 2015).
Institutional investors are also increasingly willing to follow the lead of more aggressive activist investors (Gilson & Gordon 2015; Sullivan 2013). Further line-blurring occurs when investors act collectively and engage in coalition formation (Sullivan 2013). From a stewardship perspective, collective action is generally encouraged as a means of enhancing managerial accountability. In a 2013 review of the UK Stewardship Code, for example, the FRC strongly encouraged increased collaboration between international and UK-based institutional investors (FRC 2013, 23). Where shareholders are viewed as predators, however, collective or coordinated action merely exacerbates this negative image, as in the case of hedge funds, which have been compared to “swarms of locusts” (Müntefering 2004; The Economist 2005) and “wolf packs”.

Takeover law can compound this ambiguity in relation to collective action. Under the takeover regimes of many countries, “acting in concert” is subject to regulation (Eguchi and Shishido 2015, 565). This can pose difficulties for regulators, attempting to differentiate between legitimate and illegitimate coalition-building by shareholders.

In mid-2015, Australian Securities and Investments Commission (ASIC) issued Regulatory Guide 128 (RG 128), which highlights this matter. The central issue in RG 128 is when collective action by institutional investors will fall foul of the provisions of Australia’s broad takeover and substantial holding provisions under the Corporations Act. The Guide is intriguing in terms of the regulatory ambivalence it displays concerning institutional investor power and collaboration.

On the one hand, RG 128 recognizes that it is a fundamental principle of corporate governance that investors should be able to hold the board (and management) to account. The Guide also acknowledges that to do this, investors need to engage with the entity, and that engagement may involve collective action. However, recognition of the legitimacy of collective action is qualified. According to RG 128, “investors should be able to cooperate and coordinate their actions…in the interests of promoting long-term value for all investors” (and presumably not otherwise) (RG 128(2)).

RG 128 seeks to establish a divide between “good” and “bad” coordinated investor conduct for enforcement purposes. According to RG 128, its dual purposes are to promote the former, and deter the latter. Good collective conduct essentially involves conduct that promotes “good governance only”; bad collective conduct, on the other hand, amounts to an illicit
attempt to gain corporate control. Yet, the dividing line between “good” and “bad” collective investor conduct is far from clear, and the Guide suggests that many activities which would generally be regarded as the exercise of basic shareholder rights in jurisdictions such as Australia or the United Kingdom (and therefore an aspect of “good corporate governance”), are in fact problematic under RG 128. In the US, SEC Chair Mary Jo White has explicitly stated that it is not up to the SEC to determine whether activist campaigns are beneficial or detrimental; rather it is to ensure that shareholders have sufficient information and that “all play by the rules” (White 2015, 2).

Although RG 128 attempts to create a clear division between acceptable and unacceptable coordinated conduct by investors, it does not distinguish between investor type. An early exposure draft of the Guide specifically stated that the Guide applied to all investors, but that its focus was on institutional investors, in recognition that they were most likely to become closely engaged in governance issues. This provision was eliminated from the final version. Yet, it is possible that the very breadth of ASIC’s enforcement powers, and the vagueness of RG 128, may be intended to allow ASIC to distinguish between different types of investors, including hedge funds.

How does RG 128 compare with the approach to coordinated action by shareholders in the United Kingdom, which, in contrast to Australia, has explicitly adopted a Stewardship Code. In some ways, RG 128 is consistent with the UK Stewardship Code, and in other ways, remarkably different. The UK Stewardship Code, for example, emphasizes that it “does not constitute an invitation to manage the affairs of investee companies”, and this would also amount to unacceptable conduct under RG 128.

However, institutional investors in the United Kingdom have a long history of engaging in coordinated action both to influence management of investee companies directly, and to influence the setting of legal rules, which determine the balance of power between shareholders and management (Davies 2015, 355). The UK Stewardship Code focuses on the first of these forms of coordination. The Code’s raison d’être is to establish “purposeful dialogue” between the board and shareholders, and it also states that institutional investors should establish clear guidelines for escalating activism and be prepared to act collectively (pp 7-8), which is potentially unacceptable under RG 128.
Overall, RG 128 appears to lay down a far less robust role for investors than the UK Stewardship Code, which is more akin to the traditional supplicatory role for shareholders under US corporate law. In contrast to the UK Stewardship Code, which actively encourages coordinated conduct, RG 128 suggests that, if institutional investors engage in coordinated activities, they risk breach of the takeover and substantial holding provisions of the Corporations Act. This constitutes a significant disincentive to collective action and activism, and an obstacle to shareholder stewardship in Australia.

8. Conclusion

Competing images of the shareholder, particularly since the global financial crisis, have led to divergent regulatory trends around the world. The crisis provided an opportunity to reassess whether shareholders should be granted stronger power as a constraint on managerial control. Although there has been strong resistance by the US business community to granting shareholders stronger participatory rights in director elections, it appears that a paradigm shift may be underway in this regard. The paper examines the extent to which the focus under traditional US corporate law on shareholder protection, as opposed to shareholder empowerment, can be explained by corporate law history and path dependence.

As the paper demonstrates, there is schism between negative perceptions of shareholder power, highlighted by concerns about shareholder activism in the United States and positive images of shareholder power, which have provided the policy basis for shareholder Stewardship Codes. As the paper shows, international corporate governance is in a state of flux, as a result of the tension between competing images of the shareholder, and associated changes in the balance of power between shareholders and the board of directors.