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The Role of Institutional Shareholder Activism in Corporate Governance: A Comparative Study of the UK, US and China

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Submitted in fulfilment of the requirement for the Degree of Doctor of Philosophy in Law (PhD in Law)

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Abstract

Although institutional shareholders are still in their infancy in China, Chinese institutional shareholder activism in corporate governance is drawing public attention in state-owned enterprise (SOE) reform. Since the United Kingdom (UK) and United States (US) are at the forefront in this regard, a comparative study was conducted to explore whether Chinese institutional investors activism could influence corporate governance as their UK and US counterparts and whether the possibility of more institutional shareholder activism in China exists as the country rides on the current wave of economic reform.

A contractual perspective of the firm and principal–agent relationship between members provide a useful tool to get a better understanding of the internal structure of organizations. Therefore, the thesis begins with the agency theory and the analysis of agency problems existed in each jurisdiction serve as a foundation for further research. Apart from the legal research, historical and political perspective of research were adopted. On the one hand, the factors that promote the development of institutional shareholders are analysed with the evolution of the ownership structure. This retrospective assists with an understanding of the wider context in which institutional shareholder activism emerged. On the other hand, the socialist ideology and political legitimacy management by the Chinese Communist Party deeply influence every aspect of Chinese economy. The political influence is discussed and Chinese institutional shareholder activism analysed under the influence of political factors.

Given the fact that institutional shareholder activism operates within a complex framework, a breakdown of shareholder activism by typologies of institutional investors and forms of activism is presented. The extent of institutional shareholder activism in the UK, US and China was explored from an empirical perspective. Academic research, reports from institutional investors and industry associations, related news, and cases were collected to assist with the study. Although it appears that there is institutional shareholder activism with similar features in the UK, US and China, the role that institutional shareholder activism plays in corporate governance is different. Nine factors that contribute to the difference in institutional shareholder activism are presented. Based on these findings, the research suggests that although institutional shareholder activism is rational and beneficial to corporate performance under certain circumstances, and more institutional shareholder activism can be expected as it fits within a broad tapestry of economic reform, it is not easy for Chinese institutional shareholders to overcome their passivity and engage in corporate governance actively. The possible way forward was analysed at the end of the thesis.

Key words: agency theory, corporate governance, institutional shareholder activism, State Owned Enterprise reform

Contents

List of Figures v

List of Legislations vii

List of Cases x

Acknowledgement xi

Author's Declaration xiii

Abbreviations xiv

Introduction 1

Chapter 1: Agency Problems and Corporate Governance Mechanism 1

1.1 Contractual perspective of the firm and principal–agent relationship 1

1.2 The United Kingdom and the United States 6

1.2.1 Evolution of ownership structure and vertical agency problems 6

1.2.2 Internal corporate governance mechanism 11

1.2.2.1 Division of power 12

1.2.2.2 Directors and managers 15

1.2.2.3 Shareholders 17

1.2.3 External mechanism 18

1.2.3.1 External legal mechanism 19

1.2.3.2 External market mechanism 22

1.3 China 23

1.3.1 The background 23

1.3.1.1 Political legitimacy management 23

1.3.1.2 SOE reform and the evolution of its ownership structure 26

1.3.1.3 Vertical and horizontal agency problems 30

1.3.2 Dual corporate governance mechanisms 32

1.3.2.1 Internal corporate governance mechanism 35

1.3.2.2 External mechanisms 40

1.3.2.3 Political governance 44

1.4 Conclusion 50

Chapter 2: The Development and Typologies of Institutional Shareholders 54

2.1 The development of institutional investors in the United Kingdom and United States 54

2.1.1 Development of institutional investors in the United Kingdom 55

2.1.2 Development of institutional investors in the US 61

2.2 The landscape of institutional investors 66

2.2.1 Mutual funds 66

2.2.2 Insurance companies 69

2.2.3 Pension funds 71

2.2.4 Hedge funds 72

2.2.5 Others 74

2.3 The development of institutional investors in China 76

2.4 The landscape of institutional investors 82

2.4.1 Securities Investment Funds 82

2.4.2 Insurance companies 84

2.4.3 Pension funds 86

2.4.4 Qualified foreign institutional investors 90

2.5 Conclusion 90

Chapter 3: Institutional Shareholder Activism: Theoretical Perspective 93

3.1 Overview of shareholder activism 93

3.2 Theoretical foundation of shareholder activism 96

3.3 Institutional shareholder passivity 108

3.3.1 Internal factors 108

3.3.2 Legal and political environment 111

3.3.2.1 United Kingdom 111

3.3.2.2 United States 113

3.3.2.3 China 116

3.4 Reasons behind the growth of institutional shareholder activism 118

3.4.1 Reasons from the perspective of institutional shareholders 118

3.4.2 Reasons from a wider context 120

3.4.2.1 Agency problems and corporate governance deficiencies call for institutional shareholder activism 120

3.4.2.2 Deregulation and policy support 123

3.5 Conclusion 138

Chapter 4: Institutional Shareholder Activism in the United Kingdom and United States 141

4.1 Factors that influence institutional shareholder activism 141

4.2 Unveiling institutional shareholder activism in the United Kingdom and United States 143

4.2.1 Typology of institutional shareholder activism 144

4.2.1.1 Private meetings 144

4.2.1.2 Voting 149

4.2.1.3 Submitting proposals 156

4.2.1.4 Legal actions 158

4.2.2 Activism by different institutional shareholders 161

4.2.2.1 Mutual fund 162

4.2.2.2 Pension funds 164

4.2.2.3 Insurance companies 170

4.2.2.4 Hedge funds 173

4.2.2.5 Industry trade associations 176

4.3 Conclusion 181

Chapter 5: Institutional Shareholder Activism in China 186

5.1 Factors that influence institutional shareholder activism 186

5.2 Unveiling institutional shareholder activism in China 189

5.2.1 Typology of institutional shareholder activism 191

5.2.1.1 Private meeting 196

5.2.1.2 Voting 199

5.2.1.3 Submitting a shareholder proposal 201

5.2.1.4 Legal actions 203

5.2.2 Activism by different institutional shareholders 204

5.2.2.1 Securities investment funds 205

5.2.2.2 Insurance companies 211

5.2.2.3 Pension funds 212

5.2.2.4 Qualified foreign institutional investors 213

5.3 Conclusion 214

Chapter 6: Conclusion 218

6.1 Summary of the effects of institutional shareholder activism 218

6.2 Reasons for the differences in institutional shareholder activism 220

6.3 Possibility for more institutional shareholder activism 224

6.4 The way forward 226

Bibliography 232

List of Figures

Figure 1.1: Main classes of shares in China
Figure 1.2: Composition of corporate financing
Figure 1.3: The governance of SOEs
Figure 1.4: Anglo-American model of corporate governance
Figure 1.5: Chinese model of corporate governance
Figure 2.1: Beneficial ownership of UK shares by value from 1998 to 2014
Figure 2.2: Percentage of UK stock market owned by value in 2014
Figure 2.3: Ownership of corporate equities from 2004 to 2015
Figure 2.4: Percentage of US stock market owned by value in 2015
Figure 2.5: Funds managed by insurance and long-term savings providers, by asset class in the UK
Figure 2.6: Sovereign Wealth Fund rankings
Figure 2.7: The number of newly opened institutional account and the related policies, laws and regulations
Figure 2.8: Percentage of tradable A shares owned by value from 2004 to 2014
Figure 2.9: Percentage of tradable A shares owned by value in 2014
Figure 3.1: Empirical research of shareholder activism, 1993–2016
Figure 3.2: Percentage of different results in empirical research
Figure 3.3: United Kingdom regulatory structure
Figure 3.4: Regulatory framework in China
Figure 4.1: Internal factors that influence institutional shareholder activism
Figure 4.2: Factors that influence institutional shareholder activism
Figure 4.3: Relationship between factors in Figure 4.1 and activism level and different routines taken by institutional shareholders at different activism levels
Figure 5.1: Internal factors that influence institutional shareholder activism
Figure 5.2: Cases of institutional shareholder activism, 1994-2014
Figure 5.3: Types of institutional shareholders engaged in activism in Figure 5.2
Figure 5.4: Results of institutional shareholder activism in Figure 5.2 cases
Figure 5.5: Types of activism by institutional shareholders in Figure 5.2 cases
Figure 5.6: Number of institutional shareholder activism cases each year, 1994–2014
Figure 5.7 State-owned shares in Gree Electrical Appliance Inc. of Zhuhai, 2012

Figure 5.8: Main shareholders and their portion of shares on the day of the shareholder meeting
Figure 5.9: Votes gained by each director candidate
Figure 5.10: Internal factors that influence institutional shareholder activism
Figure 5.11: Relationship between factors in Figure 5.1 and activism level and different routines taken by institutional shareholders on different activism levels

List of Legislations

United Kingdom and United States

Status

Companies Act 1948

Pension Act 1995

Delaware General Corporations Law

The Securities Act of 1933

Glass–Steagall Act in 1933

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[1] Hereinafter ‘CSRC’.

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Zahn v. Transamerica Corp. 162 F.2d 36 (3d Cir. 1947)

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Li Xiaozhong and 28 other shareholders v Xiao Wuyong & Zhang Dingzhong re: Nanchuan Municipal Hardware Infrastructure Electric Chemical Industry Company Limited, Chongqing Nanchuan City Basic-Level People's Court (2006)

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Author's Declaration

I declare that, except where explicit reference is made to the contribution of others, this dissertation is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

Signature:

Printed name: Yaqi Ding

Date: 12/04/2018

Abbreviations

ABI	Association of British Insurers
AFL-CIO	The American Federation of Labor and Congress of Industrial Organization
ALI	American Law Institute
AITC	Association of Investment Trust Companies
CA 2006	Companies Act 2006 (UK)
CalPERS	California Public Employees' Retirement System
CBRC	China Banking Regulatory Commission
CCGINK	China Corporate Governance Index
CEO	Chief Executive Officer
CII	Council of Institutional Investors
CIS	Collective investment scheme
CIRC	China Insurance Regulatory Commission
CL 2005	The Company Law of the People's Republic of China
CPC	Communist Party of China
CPF	Corporate pension funds
CREF	College Retirement Equities Fund
CSDC	China Securities Depository and Clearing Corporation Limited
CSRC	Chinese Securities Regulatory Commission
DB	Defined benefits
DC	Defined contributions
DTR	Disclosure Rules and Transparency Rules
ERISA	Employee Retirement Income Security Act of 1974
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSMA 2000	Financial Services and Markets Act 2000
GDP	Gross domestic product
ICVCs	Investment companies with variable capital
IMA	Investment Management Association
IMMEA	Interim Measure for the Management of Enterprise Annuities Fund
ISC	Institutional Shareholders' Committee
ISS	Institutional Shareholder Services
IVIS	Institutional Voting Information Service
JSC	Joint stock companies
LLC	limited liability company
LLSV	Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny
LSE	London Stock Exchange
MoLSS	Ministry of Labour and Social Security
MOF	Ministry of Finance
NACD	National Association of Corporate Directors
NAPF	National Association of Pension Funds

NASDAQ	National Association of Securities Dealers Automated Quotations
NPC	National People’s Congress
NSSF	National Social Security Fund
NYSE	New York Stock Exchange
NYSTRS	New York State Teachers’ Retirement System
OECD	Organization for Economic Co-operation and Development
OEICs	open-ended investment companies
OUP	Oxford University Press
PBOC	People‘s Bank of China
PIRC	Pensions and Investment Research Consultants Ltd
PLSA	Pensions and Lifetime Saving Association
PRC	The People‘s Republic of China
QFII	Qualified Foreign Institutional Investor
RMB	Renminbi
SASAC	State-owned Assets Supervision and Administration Commission
SIF	Securities Investment Funds
SL 2005	Securities Law of the People's Republic of China
SOE	State Owned Enterprises
SSE	Shanghai Stock Exchange
SWF	Sovereign Wealth Funds
SZSE	Shenzhen Stock Exchange
TIAA	Teachers Insurance and Annuity Association
TUC	The Trade Union Congress
UITs	Unit investment trusts
UK	United Kingdom
US	United States of America
UTA	Unit Trust Association

Introduction

With the development of modern enterprises, and the separation between ownership and control, founders who provide ‘start-up’ capital for companies no longer completely control these companies. The result is that professionally trained managers are hired with the expectation that their specialised human capital could maximise profits. Given the fact that contracts between shareholders and managers cannot specify every possible aspect, some degree of control rights needs to be allocated to managers to allow them to make decisions when contingencies that were not foreseen in contracts occur at some point in the future. According to Jensen and Meckling, when one or more persons (the principal(s)) entrust other persons (the agent(s)) to act on their behalf with certain decision-making power passed on to the agent, an agency relationship is generated.[1] Therefore, a principal–agent relationship is formed between shareholders and managers. However, it has to be acknowledged that everyone has a self-interested utility-maximising motivation and managers are no exception in this regard. With considerable control rights and the advantage of information at their disposal, managers are likely to benefit themselves at the expense of shareholders’ profits. Therefore, agency problems are generated in this process.

Apart from the agency problems between shareholders and managers, the agency relationship between majority shareholders and minority shareholders could generate problems as well. To alleviate the agency problems, on the one hand, the distribution of powers among different participants in the business entities is sophisticatedly designed; on the other hand, those who are outsiders of the business entities, such as regulators, governments, trade unions, financial institutions and the market itself, exercise an external monitoring function. This system of checks and balances is corporate governance.[2] Although an attempt has been made to build a sophisticated mechanism to ensure that corporates operate efficiently with minimum agency costs, growing corporate scandals, the collapse of world-renowned companies and the recent worldwide financial crisis serve as evidence of some kind of failure in corporate governance mechanisms.

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[1] Michael C Jensen and William H Meckling, ‘Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure’ (1976) 3 Journal of Financial Economics 305.
[2] For a definition of *corporate governance*, see section 1.1.

‘Like poets and revolutionaries, corporate law scholars and policymakers dream. If only we could find the silver bullet, the wonder drug, we could solve the manager–shareholder agency cost problem that is the focus of much of corporate law.’[3] Institutional shareholders, with their large portion of equity holdings and ability to influence their investee companies, are regarded as the ‘wonder drug’ of corporate governance problems or, at least, a drug worth trying. However, the question of the role that institutional shareholders should play in corporate governance is a complex one and the call for increased institutional shareholder activism is not the subject of consensus.[4] The excessive risk taking and short-term actions bolstered the criticism against institutional shareholder activism. While there is no consistent consensus in the scholarly literature on the extent to which institutional shareholders should engage with their investee companies, most scholars agree that a certain degree of institutional shareholder activism is needed to improve corporate governance. During the past decades institutional investors have increasingly engaged in corporate governance activities in the United Kingdom[5] and United States of America[6]. In China, although institutional shareholders are still in their infancy, news about Chinese institutional shareholder activism is drawing public attention. Institutional shareholder activism appears to have come of age.

China is standing at the crossroads of state-owned enterprise[7] reform. In August 2015, Guidance Opinions on the Deepening of Reform of State-owned Enterprises[8] were issued by the Central Committee and the State Council. The Guidance Opinions provide 30 specific guidelines for mixed ownership reform of China’s SOEs. In the period 2015–2017, various guidelines and opinions were issued to map out SOE mixed ownership reform. The mixed ownership reform is aimed at diversifying the ownership structure of SOEs in order to boost the efficiency in SOEs.[9] Given the fact that SOEs

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[3] Edward B Rock, ‘Institutional Investors in Corporate Governance’ in *Oxford Handbook on Corporate Law and Governance* (2015) University of Pennsylvania, Institute for Law & Economics Research Paper No. 14–37.
[4] See Chapter 3.
[5] Hereinafter ‘UK’.
[6] Hereinafter ‘US’.
[7] Hereinafter ‘SOE’.
[8] Hereinafter ‘the Guidance Opinion’. ‘Guidance Opinions on the Deepening of Reform of State-owned Enterprises’ [中共中央、国务院关于深化国有企业改革的指导意见] 2015 <http://www.gov.cn/zhengce/2015-09/13/content_2930440.htm> accessed 8 November 2016.
[9] See section 3.4.2.1.3 of this thesis.

are large in size, small companies and individuals are too weak to participate in this reform process. Hence, institutional shareholders and some powerful companies are expected to play a major role in the reform. A senior officer responsible for SOE reform remarked that institutional investors – like national social security funds and insurance funds – are top priorities when looking for private investors in the mixed ownership reform.[10] Institutional shareholders are given the expectation that they could engage in corporate governance actively as their UK and US counterparts so as to alleviate severe agency problems within SOEs. This boils down to a foundational question: do Chinese institutional investors have the capacity to perform the role now expected of them?

In order to answer this core question, this thesis adopts a comparative scholarship between the UK, US and China. Given the fact that institutional shareholder activism operates within a complex framework, the comparative study focuses on (1) the different agency problems that institutional shareholders encounter; (2) reasons for the development of institutional investors; (3) the influence from the wider context, such as political, ideological and legal factors; (4) typologies of institutional investors and different forms of activism; (5) and the differences in the effects of institutional shareholder activism and reasons behind such differences. There are two reasons for choosing the UK and US as objectives when doing the comparison. First, the UK and US enjoy the reputation of being leaders in corporate governance,[11] and they keep their advantages in the area of research on institutional shareholder activism. An in-depth comparison is beneficial in that it provides either experiences or lessons to inspire their Chinese counterparts. Second, although there are huge differences between the UK, US and China in terms of ideology, state power, economic structure and share ownership structure, the development of company law and corporate governance in China is itself a continual borrowing process from the UK and US, and there are many resemblances between these three countries. There is, therefore, comparability between these countries and legal transplantation is possible.

[10] Yitian Zhu, 'Pension funds and Chinese investors are top priorities in SOE reform' [国企混改优先考虑社保和中国投资者] (*Wall Street News,* 29 December 2014) <https://wallstreetcn.com/articles/212537> accessed 8 November 2016.

[11] The UK and US scored the top among 49 countries in a survey conducted by the World Bank. World Economic Forum 2003, cited in Qiao Liu, 'Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants' (2006) 52 CESifo Economic Studies 432.

Considering that the contractual perspective of the firm and principal-agent relationship between members not only provide a useful tool to get a better understanding of the internal structure of organizations, but also permeate and drive the whole corporate governance discourse, the thesis begins with the contractual theory of the firm and uses agency theory as the analytical basis for this research. This is followed by corporate governance mechanisms that are aimed at relieving agency problems. Chapter 2 probes the reasons for the development and growth of institutional investors, and data are presented to characterize the size of the different institutional investors in the UK, US and China. The third chapter provides a detailed theoretical analysis of institutional shareholder activism. In essence, three question are answered in this chapter: (1) is shareholder activism rational? (2) what are the reasons for institutional shareholder passivity? and (3) why is there currently a growth in institutional shareholder activism. Chapter 4 deals with institutional shareholder activism in the UK and US in an empirical way. It first reviews the factors that influence institutional shareholder activism, then the typologies of activism, followed by how different institutional shareholders deploy these types of activism. This chapter ends with an analysis of how the factors mentioned at the beginning influence the engagement activities of UK and US institutional shareholders. Chapter 5 looks at institutional shareholder activism in China in an empirical way. The research was conducted under a similar structure to that used in Chapter 4. Chapter 6 concludes the thesis. It contains a summary of the findings in Chapters 4 and 5 on the different influences of institutional shareholder activism in corporate governance in these three countries, and then cites the reasons that led to these differences. Finally, the chapter explores the possibility of developing Chinese institutional shareholder activism and the possible way forward.

This thesis offers three original approaches: first, it adopts a historical perspective in the first two chapters, and takes stock of the evolution of share ownership structure and the development of institutional shareholders. This retrospective assists with an understanding of the wider context in which, and push factors that resulted in, the emergence and development of institutional shareholder activism. Second, the political control of SOEs by the State is a force that cannot be ignored and this thesis brings this political influence into discussion. The theme of political legitimacy management by the Chinese Communist Party[12] runs throughout the thesis and this is the first time that institutional shareholder activism under the influence of the state has been analysed. In Chinese context, the political reform and governmental influence play an vital role in influencing every aspects of corporate governance. Only by embedding institutional shareholders into this broader political territory, can we get a clear picture about its nature and function. Third, this thesis situates institutional shareholder activism within a more complete framework and treats this form of activism as a kind of behaviour adopted by various types of subjects that are different in aims, objectives, motives and preferences. The contribution of this thesis lies in exploring that whether Chinese institutional investor activism could influence corporate governance as in the same way its UK and US counterparts and whether the possibility of more institutional shareholder activism in China exists as the country rides on the current wave of economic reform by taking both legal and political elements into account.

[12] Hereinafter 'CPC'.

Chapter 1: Agency Problems and Corporate Governance Mechanism

The purpose of this chapter is to provide an overview of the background information that is necessary for the later discussion on institutional shareholder activism in this research. Corporate law and governance can only fulfil their role appropriately if the problems that need to be addressed are known. A contractual perspective of the firm and principal–agent relationship between members provide a useful tool to get a better understanding of the internal structure of organizations. Therefore, this chapter starts with an examination of the contractual theory and agency problems. Sections 1.2 and 1.3 deal with the UK, US and China respectively. Each section begins with a description of the evolution of share ownership structure, followed by the kind of agency problems that are generated in certain share ownership structures. These sections then examine the corporate governance frameworks that have been designed to relieve agency problems. Section 1.4 concludes with a brief summary.

1.1 Contractual perspective of the firm and principal–agent relationship

Before Coase published *The Nature of the Firm* in 1937,[1] the conventional theory of the firm, which is often referred to as the 'neoclassical theory of the firm', was the dominant theory in economics.[2] Put briefly, the reasons for the existence of the firm, in the eyes of economists, were that the firm 'was a means of realizing economies of scale in the production of goods and services'.[3] Firms could collect different inputs, combine their effectively by means of their specialization and output it as final products.[4] As a response to the radical change in the economic and political landscapes[5] in the late 1970s, neoliberalism came onto the stage and Coase's theory became part of the standard microeconomic literature as it focused on the perspective that was ignored by

[1] Ronald H Coase, 'The Nature of the Firm' (1937) 4 Economica 386.
[2] Thomas S Ulen, 'The Coasean Firm in Law and Economics' (1992) 18 Journal of Corporate Law 301.
[3] Ibid.
[4] Brian R Cheffins, *Company Law: Theory, Structure, and Operation* (Clarendon Press 1997) 4.
[5] Such as the stagflation in this period and competition with new-born economies such as Japan and West Germany. See details in David Harvey, *A Brief History of Neoliberalism* (2005 Oxford University Press).

neoclassical theory, that is, what precisely it is that went on in this 'black box'.[6] Coase's central thesis is that the emergence of a firm to supersede a market is because the difference in costs, that is, the costs of operating institutions are lower than the operation of a market.[7] Transactions will be undertaken within the firm when the cost of an internal transaction is lower than the external market as firms and markets are alternative forms of contracting, with the minimization of transaction costs determining the choice of the two. However, the utilization of 'some authority to direct the resource'[8] is not free of charge.[9] The boundaries of the firm would be settled when the costs of using the organizational structure are equal to the expenses of organizing such a deal in the market.[10]

Coase's work paved the way for the further development of contractual theory, including transaction cost economics and principal–agent theory, which are two main strands of scholarship, with the former focusing on the relationship between the firm and the market and the latter focusing on the internal organizational structure of the firm.[11] Alchian and Demsetz developed the theory that the emergence of the firm was a response to the benefits of team production.[12] Williamson made a deep and far-reaching analysis of transaction cost economics by pointing out that post-contractual opportunism could result in the problem of shirking and that bringing a transaction from the market into the firm could mitigate this opportunistic behaviour.[13] Principal–agency theory recognizes conflicts of interest between different economic actors. As a result, careful monitoring within a production team is necessary.[14] Jensen and Meckling first formulated the conception that the corporation was 'a nexus of contracts' and further

[6] Ronald H Coase, 'The Institutional Structure of Production' (1992) 82 The American Economic Review 713.
[7] Steven NS Cheung, 'The Contractual Nature of the Firm' (1983) 26 The Journal of Law and Economics 12.
[8] Coase (n 1) 391.
[9] The information asymmetry and administration of employees in the hierarchical structure in the firm would also be costly.
[10] Coase (n 1) 395.
[11] Oliver Hart, 'An Economist's Perspective on the Theory of the Firm.' (1989) 89 Columbia Law Review 1762.
[12] Armen A Alchian and Harold Demsetz. 'Production, Information Costs, and Economic Organization' (1972) 62 The American Economic Review 777.
[13] Oliver E Williamson, 'Transaction Cost Economics: The Comparative Contracting Perspective' (1987) 8 Journal of Economic Behaviour & Organization 627. See also Henry N Butler, 'The Contractual Theory of the Corporation' (1989) 11 George Mason University Law Review 99, 100.
[14] Alchian and Demsetz (n 12) 790.

investigated the agency relationship by giving it an exact definition[15] and demonstrated other related issues.[16] As mentioned above, the agency theory focuses on the internal organizational structure of the firm. It is therefore a great lens with which to look inside the firm to see how the corporate governance mechanisms work. Before discussing agency problems and corporate governance frameworks, it is necessary to clarify this theoretical foundation:

Agency theory is a useful tool for looking at corporations in the free market economy, such as the UK and US, as contractual theory requires a free and competitive market to survive. It is therefore not surprising that the rationality behind using agency theory in the Chinese context might be challenged as the extent of market orientation of the Chinese economy is still debatable. There are two reasons for explaining its appropriateness. First, almost all the theories are imperfect and the contractual theory is, to some extent, unsatisfactory. Although the contractual theory is meant to point out the voluntary, market-orientated nature of the firm, it has gone too far to neglect that there is no distinct line between the public and private elements in the lives of most persons and institutions, which means that the world is neither a complex of contracts, nor is it a delegated sovereign authority.[17] As Bratton pointed out: 'freedom of contract is freedom to ask the sovereign to confer power constraining your freedom on another party. At the same time, contract cannot exist where sovereign control is complete, it requires some minimum of individual autonomy.'[18] Therefore, it is hard to make a thorough distinction between the market and the political environment, since they are intermixed to some extent. Eisenberg also stated that the contractual theory only caught half of the truth and the firm was not only a hierarchical organization, but also a 'bureaucratic hierarchical organization'.[19] Therefore, Bratton claimed that the complex coexistence (i.e., contracts, hierarchies and the state) should be accepted as a starting

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[15] In Jensen and Meckling's opinion, an agency relationship is 'a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent'. See Michael C Jensen and William H Meckling. 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure.' (1976) 3 Journal of Financial Economics 305.
[16] Ibid 306.
[17] William W Bratton, 'Nexus of Contracts Corporation: A Critical Appraisal' (1988) 74 Cornell Law Review 407.
[18] Ibid.
[19] Melvin A Eisenberg, 'The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm.' (1998) 24 The Journal of Corporate Law 819.

point of the theory. Secondly, as will be discussed later in this chapter,[20] since the first company law promulgated in 1993, liberalistic and market-oriented reform has never stopped in China, and the reform of SOEs and the promulgation of 2006 companies law was under the direction of 'free-market and contractual theory'.[21] Therefore, a market with state intervention should not be viewed as a market that rejects free contracting to prevent the application of contractual theory. The theory serves as a useful tool to examine the elements of corporate relationship closer. Therefore, it may seem inappropriate at first glance to apply contractual theory to the Chinese context. However, this theory was widely applied and works well when considering the internal relationship within companies in China.

Having clarified this theoretical foundation, this chapter moves on to the principal–agent relationship. When one or more persons (the principal(s)) entrust other persons (the agent(s) to act on their behalf with certain decision-making power passed on to the agent, an agency relationship is generated.[22] There are three kinds of agency relationships that could exist in business firms: (1) a vertical agency relationship between shareholders and managers; (2) a horizontal agency relationship between majority shareholders and minority shareholders; and an (3) agency relationship between a firm itself and other contractual parties.[23] As the third kind of agency relationship could be regulated by other laws, such as contract law and tort law, it is, therefore, beyond the present discussion in the area of company law. However, the interest may not always be aligned between principals and agents, therefore, agency cost arises between the shareholders (principals) and the managers (agents) in three aspects: 'the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.'[24] To lessen the agency costs, controlling and monitoring mechanisms are put in place within the organization to align the interests of various parties. This checks-and-balances system is corporate governance.[25] The corporate

[20] See section 1.3.1.2.
[21] Weiying Zhang, *Corporate Theory and the Reform of Chinese Companies*[企业理论与中国企业改革] (Peking University Press 1999) 25.
[22] Jensen and Meckling (n 15) 309.
[23] Reinier Kraakman, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn Oxford University Press 2017) 36.
[24] Jensen and Meckling (n 15) 312.
[25] David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and their Consequences* (Pearson Education 2015). However, there is no accepted definition of *corporate governance* and it has been said to be an ambiguous concept. One of the classic and often cited

world today can be divided into the rival system of concentrated and dispersed ownership, under which the balance of power may differ: shareholders may be more powerful in one jurisdiction, whereas shareholders are in an inferior position in other jurisdictions. Therefore, the agency problems may vary in jurisdictions with different ownership structures and the corporate governance mechanisms aimed at alleviating agency costs may be different. According to Cheffin's classification, corporate governance systems in particular countries divide into two categories: 'outsider/arm's-length' and 'insider/control-oriented'.[26] The 'outsider' typology is a kind of share ownership where the shares are not concentrated in one or more blockholders who enjoy decisive influence, it is the individual investors and the institutional investors that own the majority of the shares.[27] The term 'arm's length' represents the situation where investors are less likely to intervene in the operation of a business and keep a rational distance from the management team.[28] The 'insider' typology is the kind of situation where share ownership is concentrated in the hands of a few people. The term 'control-oriented' signifies that 'core' shareholders are capable of excising considerable influence and they hold the control rights tightly in their hands. Although this dichotomy could mislead to some extent,[29] it is basically accurate when only

definitions of corporate governance is taken from the Cadbury Report where it is said that 'corporate governance is the system by which companies are directed and controlled with boards of directors responsible for the governance of the company while the role of the shareholders in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate structure is in place.' The Organisation for Economic Co-operation and Development (OECD) provided a narrower explanation saying that corporate governance is 'a system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation … By doing this, it also provides the structure through which company objectives are set, and the means of attaining those objectives and monitoring performance … it also provides the structure through which the objectives are set, and the means of attaining objectives, and monitoring performance, are determined.'

[26] Brian R Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford Scholarship Online 2010) 5 <http://ukcatalogue.oup.com/product/9780199236978.do>, accessed 25 January 2017.

[27] John Armour, Brian R Cheffins and David A Skeel Jr, 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 1 Faculty Scholarship <http://scholarship.law.upenn.edu/faculty_scholarship/712\nThis> accessed 3 September 2017.

[28] Ibid.

[29] According to Coffee, first, the assumption that something about the common heritage of the 'Anglo-Saxon' countries – their common law, politics, cultural heritage, or whatever – explains their unique convergence on a 'dispersed ownership' system of corporate governance simply does not hold up under closer analysis. Australia and Canada have origins at least as 'Anglo-Saxon' as the United States, but in these countries concentrated ownership is more common than dispersed ownership. Second, an even more fundamental problem with attempts to attribute dispersed ownership to a particular set of legal or political circumstances is that companies with dispersed ownership are present in virtually all developed economies. See details in John C Coffee, 'Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension Between 'Lumpers' and 'Splitters'' (2010) Columbia Law and Economics Working

considering the UK, US and China. The UK and US belong to the former camp which is characterised by an outsider/arm's-length system of corporate governance, while insider/control-oriented corporate governance predominates in China. In the following section the different agency problems and corporate governance mechanisms in these two camps respectively are analysed.

1.2 The United Kingdom and the United States

1.2.1 Evolution of ownership structure and vertical agency problems

Since Berle and Means published *The Modern Corporation and Private Property*, it has been widely accepted that modern large corporations, wherever located, will follow American norms under which share ownership would be widely dispersed.[30] However, the empirical work carried out during the 1990s changed the perceptions markedly and revealed that a separation of ownership and control was the exception worldwide rather than the rule.[31] Although dispersed ownership is not the norm, it is received wisdom that the UK and US are the spokespersons of dispersed ownership. However, most business enterprises start their life with high insider ownership.[32] The control power of the firm is in the hand of the owners – one or more founders who provide the 'start-up' capital that is needed to form an enterprise. The divorce of corporate ownership and control can only occur when the blockholders are prepared to unwind or dilute their stakes and there are sizeable amounts of capital available for the purchase of shares. What follows is a brief historical description of the trajectory of the evolution of UK and US ownership structures.

Paper No. 363 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1532922>, accessed 4 September 2017.

[30] Adolf A Berle and Gardiner C Means. *The Modern Corporation and Private Property* (Macmillan 1932).

[31] See, for example, Marco Becht and Colin Mayer, 'Introduction' in Fabrizio Barca and Marco Becht (eds), *The Control of Corporate Europe* (Oxford University Press 2001) 1–2, 20; Stijin Claessens, Simon Djankov and Larry HP Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) Journal of Financial Economics 58, 81.

[32] Jean Helwege, Christo Pirinsky and René Stulz, 'Why Do Firms Become Widely Held? An Analysis of the Dynamics of Corporate Ownership' (2007) 62 Journal of Finance 995.

In UK, the word ‘company’ was first used when merchant adventurers were granted a Royal Charter for the purposes of trading overseas[33] and business corporations emerged as a production of the Royal Charter in the seventeenth century. At the end of the seventeenth century, companies could be established without reference to any form of explicit state endorsement or involvement.[34] Hence, ‘The Bubble Act’ came into force in 1720 to underscore the problematic legal status of such enterprises, followed by the bursting of the South Sea Bubble. The Industrial Revolution between 1760 and 1830 provided conditions that were propitious for the widely held company to emerge.[35] By the end of the eighteenth century, professional brokers and dealers were well developed and this led to the formation of an effective market for the trading of securities, the London Stock Exchange. By the mid-nineteenth century, a sizeable number of enterprises, operating in fields such as utilities, transport, banking, insurance and mining, had publicly traded shares and the largest railways were seen to be pioneers of the modern-style divorce of ownership and control[36] as they had a sizeable shareholder base and lacked powerful blockholders. However, at this stage, while a certain amount of separation between ownership and control had emerged, control was still in the hands of blockholders.[37] The late nineteenth and early twentieth centuries witnessed a rapid growth in the number of companies that had made the move to the stock market, not only on the London Stock Exchange, but also on provincial stock exchanges.[38] Besides, tax law provided a fresh incentive to the diffusion of share ownership. Considerations of the next generation, the irresistible generous exit offers and the capital-raising for mergers were constant incentives to unwind the controlling status.[39] The transformation

[33] Paul L Davies, *Gower & Davies: The Principles of Modern Company Law* (Sweet & Maxwell, 9th edn, 2012).
[34] Cheffins (n 26) 134.
[35] On the period covered, see Joel Mokyr, ‘Editor’s Introduction: The New Economic History and the Industrial Revolution’ in Joel Mokyr (ed), *The British Industrial Revolution: An Economic Perspective*, (2nd edn Westview press 1999) 1, 3.
[36] François Crouzet, *The Victorian Economy* (Routledge 1982) 293; Geoffrey Channon, ‘A Nineteenth Century Investment Decision: The Midland Railway’s London Extension’, (1972) 3 Economic History Review 449; Terry Gourvish, *Railways 1830–70: A Business History* (Cambridge University Press 2011) 83.
[37] According to Cheffins in *Corporate Ownership and Control,* market forces may be blamed for the deterrence in the growth of modern corporate enterprises. Factories usually operated on a small scale with no requirements for large capital and a sense of individualism prevailed at that time, and blockholders had no incentives. Therefore, they declined to exit.
[38] Edward Victor Morgan, *The Stock Exchange: Its History and Functions* (Elek Books 1969) 133. There are several reasons behind such growth. First is the decline of the factors that hampered diversified ownership structure; second is the rise of institutional shareholders. This point will be analysed in more detail at Chapter 2.
[39] Cheffins (n 26) 134.

to diffused ownership structure still continued. From the late nineteenth and early twentieth century, the pace was accelerated to a fully-fledged outsider/arm's-length system of ownership and control. Even though Britain's economy experienced a decline in the middle of the twentieth century, competitive pressure, tax rules, company law reform and revisions of stock exchange listing rules paved the way for UK companies to become dispersed ownership structures. First, profits declined in the middle of the twentieth century and legal reforms deterred firms from creating anti-competitive alliances to seek refuge, which tempted blockholders to exit. Besides, merger activity and public offerings of shares were associated with rising stock prices, making the offer to blockholders to exit too good to refuse. Second, company law made its contribution to the separation of ownership and control at this stage.[40] Third, even though company law is a crucial determinant of ownership structure, it arrived too late to act as a catalyst for the divorce of ownership and control. Instead, Stock Exchange listing rules filled the gap. The London Stock Exchange and provincial stock exchanges each imposed requirements on companies seeking to list shares for trading, with the relevant regulations being unified after the exchanges federated in 1965.[41] Fourth, tax played an important role in forcing individual investors to quit. Given the fact that high rates of tax were imposed on dividends, those private investors with large incomes therefore turned to forms of savings that received more favourable tax treatment.[42] Besides, the development of institutional shareholders and the establishment of some institutional investment organisations during this stage, such as the Institutional Shareholders Committee[43] in 1973 and the Association of British Insurers[44] in 1985, also contributed to the diversification of shareholder ownership in the UK. By 1990, the separation of ownership and control had become the norm in large business enterprises in the UK.[45]

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[40] The Companies Act 1967 further deepened the regulation on disclosure by imposing additional requirements to disclose financial data and compelled blockholders to disclose more confidential information. The Companies Act 1980 bumped the score from '3' to '5' on La Porta et al's anti-director index and this was attributed to the requirement that companies issuing new shares make the equity available on a pro rata basis to existing shareholders in accordance with the percentage of shares already owned unless shareholders waived this protection. The Companies Act 1980 also criminalized insider dealing for the first time. See details in Rafal La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W Vishny 'Law and Finance' (1998) 106 Journal of Political Economy <http://faculty.som.yale.edu/zhiwuchen/EmergingMarkets/LawAndFinance.pdf> accessed 27 September 2017.

[41] Davies (n 34) 135.

[42] Marshall E Blume, 'The Financial Markets' in Tony Buxton, Paul Chapman, Paul Temple (eds), *Britain's Economic Performance* (2nd edn Routledge 1997) 317.

[43] Hereinafter 'ISC'.

[44] Hereinafter 'ABI".

[45] Cheffins (n 26) 19.

Although it is in the UK rather than in the US that the corporate form of business was originated and developed, the suitable soil and climate in the US made it a satisfactory place for the growth of corporations.[46] Until the nineteenth century, corporations established in the US were limited to public interest enterprises[47] and they were mainly in the form of individual proprietorship and partnership. During the nineteenth century, there were isolated examples of companies with widely held shares and well-developed managerial hierarchies.[48] Throughout the nineteenth century business enterprises were mainly held privately and in industrial enterprises, family control was very much the norm.[49] The 'corporate revolution' occurred between 1880 and 1930.[50] During this era, ownership evolved from private to public and the contour of the dispersed ownership structure took shape. By World War I, Chandler claimed that the crucial transformation, with more extensive managerial hierarchies and clear-cut separation of management and ownership, was developed.[51] Stock market capitalism thrived in the US during this stage. The number of companies traded on the stock exchanges increased rapidly, from 682 in 1900 to 2,659 in 1930.[52] Some factors could account for this 'corporate revolution'. First, the growth of the public securities markets in the nineteenth century was driven by a lack of capital. Owing to the greater geographic distances to be connected in the US, the capital demands on the infrastructure industries, such as railroads, steel, auto and telephone, were exceptionally large. Therefore, these large-scale enterprises needed to draw capital from widely dispersed shareholders and the infusion of foreign capital. However, the administrative tasks were too numerous and complex in these giants, specially trained full-time managers were needed to deal with the day-to-day businesses. The combination of a huge enterprise, special management team, and diversified shareholders shifted the control power from the hand of shareholders to that of managers. This became the quintessential characteristics of

[46] Lori Verstegen Ryan and Marguerite Schneider. 'The Antecedents of Institutional Investor Activism.' (2002) 27 Academy of Management Review 568.
[47] Berle and Means (n 30).
[48] Naomi R Lamoreaux, 'Entrepreneurship, Business Organization, and Economic Concentration' (2000) 2 *The Cambridge Economic History of the United States*, 418.
[49] Ibid 412–13; Thomas R Navin and Marian V Sears. 'The Rise of a Market for Industrial Securities, 1887–1902' (1955) 29 Business History Review 112.
[50] Walter Werner, 'Corporation Law in Search of Its Future' (1981) 81 Columbia Law Review 1636.
[51] Alfred D Chandler Jr, 'The United States: Seedbed of Managerial Capitalism' in Alfred D Chandler and Herman Daems (eds) *Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise* (Harvard University Press 1980) 9; Alfred D Chandler Jr, *Scale and Scope: The Dynamics of Industrial Capitalism* (Harvard University Press 1990) 52, 84–85.
[52] Mary O'Sullivan, 'The Expansion of the US Stock Market, 1885–1930: Historical Facts and Theoretical Fashions' (2007) 8 Enterprise & Society 498.

constructing enterprises in the twentieth century.[53] Second, tax rates exerted great influence on stock ownership. A sharp wartime increase in taxation of the income of the wealthy drove those with high income to switch to tax-favoured investments and equities.[54] Although this fever halted abruptly in 1921 due to the fall of the high marginal tax rates, new economic optimism developed by revelations of new products and technologies, speculative excess and promising stock market fortified the demand for shares.[55] Third, the special legislative system under federalism paved the way for this significant change. Corporate law was left to the states, and the states developed very liberal laws regarding corporations in efforts to attract capital to them. The Constitution of the US contained no provisions that dealt with incorporation.[56] In addition, the economic panic of 1907 resulted from massively over-leveraged stock-market trading schemes on the largely unregulated New York Stock Exchange, which promoted the promulgation of the Securities Act of 1933 and 1934, which is the first sweeping legislative attempts with the aim of regulating the securities market and reforming business entities. From then on, a constant stream of legislation instilled the concept of corporate governance into US businesses. The good legal environment promoted the dispersion of shares. By 1930, the separation between ownership and control had been established in the US. The years after that saw the consolidation of the dispersed ownership structure. The pace of separating ownership from control had accelerated markedly in the following 30 years. The shares held by individual shareholders were only 6.5 million in 1952 and the number increased to 15 million in 1961.[57] A number of the studies conducted in the 1960s and 1970s indicated that there was a surging demand for shares by institutional investors and dispersed ownership was the norm.[58]

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[53] Alfred D Chandler, Jr, *The Visible Hand: The Managerial Revolution in American Business* (Harvard University Press 1993) 87.

[54] Mark Smith, *Toward Rational Exuberance: The Evolution of the Modern Stock Market* (Farrar Straus Giroux 2001) 64–70; Steven A Bank and Brian R Cheffins, 'Tax and the Separation of Ownership and Control,' in Wolfgang Schön (ed), *Tax and Corporate Governance* (Springer 2008) 111, 136–37.

[55] Steve Fraser, *Wall Street: A Cultural History* (Faber & Faber 2005) 340–50.

[56] Roberta Romano, *The Genius of American Corporate Law* (AEI Press 1993). Not everyone is happy with this decentralization, with many analysts thinking it leads to rules that overly favour managers. For more see William L Cary, 'Federalism and Corporate Law: Reflections upon Delaware' (1974) 83 Yale Law Journal 663, 705; Lucian Arye Bebchuk, 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law' (1992) Harvard Law Review 1437.

[57] Smith (n 52) 179. Berle (n 30) 62.

[58] Brian Cheffins and Steven Bank, 'Is Berle and Means Really a Myth?' (2009) 83 Business History Review 454.

Under the dispersed ownership structure in the UK and US, founders who provide 'start-up' capital no longer fully control the company and professionally trained managers are hired with the expectation that their specialised human capital could maximise profits. An effective contract between shareholders and managers to specify what managers should do with the capital and how the returns will be allocated is possible.[59] However, complete contracts are impossible as future contingencies cannot be anticipated.[60] Therefore, some degree of control rights needs to be allocated to managers to allow them to make decisions when contingencies that were not foreseen in the contract arise. According to Jensen and Meckling, 'the relationship between the stockholders and the managers of a corporation fits the definition of a pure agency relationship'.[61] One has to admit that everyone has a self-interested utility-maximising motivation and managers are no exception to this. With the considerable control rights and advantage of information in hand, managers are likely to act opportunistically to benefit themselves. In contrast, the principal has to ensure that the agent is performing as promised, and exercises some kind of monitoring and controlling behaviour to ensure the quality of the agent's performance. Therefore, costs are inevitable in this process and corporate governance was developed to respond to this problem. What corporate governance concerned with is how to deal with the relationship between principals and agents; how to assign the power and responsibilities between them, and how to cut agency costs. The corporate governance structure was built with the aim of controlling conflict between them and to reduce these agency costs.

1.2.2 Internal corporate governance mechanism

The starting point to building a corporate governance framework may be from the internal structure, given the fact that the balance of power between different actors within the company may be affected by how the company is operated. Under traditional corporate structures, shareholders elect the board of directors who control the operation of the company and choose the managers to run the day-to-day business on their behalf. Internal corporate governance encompasses the mechanisms that are designed to

[59] Oliver D Hart, 'Incomplete Contracts and the Theory of the Firm' (1988) 4(1) Journal of Law, Economics, & Organization 121.
[60] Eugene F Fama and Michael C Jensen, 'Separation of Ownership and Control' (1983) 26 The Journal of Law and Economics 304.
[61] Jensen and Meckling (n 15) 326.

coordinate the relationship between various actors inside the firm: the company's management, its board and the shareholders, and this is the foremost set of controls for a corporation. The issue of the allocation of power within the corporation and the need to control management's power without harming the operation of the business has long been the focus of corporate law.[62] A discussion of the internal corporate governance framework begins with the division of power within business entities, followed by detailed analyses of the power and responsibilities of shareholders, directors and managers.

1.2.2.1 Division of power

In the United Kingdom, The Companies Act 2006,[63] which came into force in 2009 with the aim to 'create an effective corporate statute to ensure shareholders are informed and involved, to promote a good understanding and effective shareholder engagement between company and investors and thus to enhance company long-term performance'[64] is the main legislation in terms of the division of power. Although the CA 2006 is as long as 955 pages,[65] it does not have a clear statement about the power of the shareholder body or the board of directors. The general distribution of power is set out as a default rule in the Model Articles for public and private companies, which used to be Table A before the promulgation of the 2006 Act. The division of power is stated as follows:

> 3. Directors' general authority
>
> Subject to the articles, 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
>
> (1) The shareholders may, by special resolution, direct the directors to take, or refrain from taking, specified action.

[62] Arthur R Pinto and Gustavo Visentini (eds), *The Legal Basis of Corporate Governance in Publicly Held Corporations: A Comparative Approach* (Kluwer Law International 1998) 259.
[63] Hereinafter 'CA 2006'.
[64] Secretary of State for Trade and Industry, *Company Law Reform Bill White Paper 2005* (2005) <http://webarchive.nationalarchives.gov.uk/+/http:/www.dti.gov.uk/cld/WhitePaper.pdf> accessed 27 January 2017.
[65] Including the schedules to the Act.

(2) No such special resolution invalidates anything which the directors have done before the passing of the resolution.

5. Directors may delegate

(1) Subject to the articles, the directors may delegate any of the powers which are conferred on them under the articles—

(a) to such person or committee;

(b) by such means (including by power of attorney);

(c) to such an extent;

(d) in relation to such matters or territories; and (e) on such terms and conditions; as they think fit.

(2) If the directors so specify, any such delegation may authorise further delegation of the directors' powers by any person to whom they are delegated.

(3) The directors may revoke any delegation in whole or part, or alter its terms and conditions.[66]

As the rules about the distribution of power above are default rules, it is left to the shareholder body to determine the content of the articles and it could be altered only by special resolution[67] by the shareholder body. Therefore, if the shareholder body does not grant any power to the board through the articles, the board would be powerless. According to Kershaw, 'the originating power of the company is located in the shareholder body acting in general meeting' in UK company law and it is the shareholder body that empowers the board of directors. [68]

In the US, things are quite different. Unlike the system of government in the UK, the iconic federalized government in the US leaves much regulatory authority to the 50 state governments according to the 'internal affair rule', with little intervention by the federal government. Company law, which is usually referred as *corporate law* in the US, is an area where the main regulations are provided by the states, although there are several areas of regulation that affect companies that are provided for by federal

[66] Model Articles for public and private companies <http://www.legislation.gov.uk/uksi/2008/3229/pdfs/uksi_20083229_en.pdf> accessed 27 January 2017.

[67] Companies Act 2006, section 21.

[68] David Kershaw, *Company Law in Context: Text and Materials* (Oxford University Press 2012) 213.

legislation.[69] Each state has its own judiciary and legal system, separate from the federal system and the state law is enacted by the state legislatures. Every state has its own corporate law statute that provides the corporate rules, such as the way in which to incorporate, the basic structure of the board of directors, shareholders' and directors' power and responsibilities, and financial and legal capital rules. Besides, each states also has its own body of common law. Corporations have the freedom to choose their incorporation state and it is widely accepted that Delaware is the winner in this battle for incorporation as it has the most sophisticated and most developed corporate law in the US.[70] Accordingly, in this thesis the primary, although not the exclusive, US corporate legal reference point will be Delaware law. It is state law that usually provides the rules and regulations governing the division of power between the shareholders, directors and managers and their interrelationship. So the sphere of corporate law of concern here is the corporate law in Delaware.

In contract to the way shareholders who distribute management power to the board of directors in the UK, the board's power in Delaware corporations is provided by the Delaware General Corporations Law. Section 141(a) of this law provides as follows:

> (a) the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation. If such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.'[71]

[69] Among them, are some pieces of legislation that are important, such as the US Securities Act 1933 and the US Securities Exchange Act 1934. For more detailed discussion see chapter 2.1.2.
[70] Kershaw (n 68) 214.
[71] Delaware General Corporation Law, Section 141 <http://delcode.delaware.gov/title8/c001/sc04/index.shtml> accessed 03 March 2017.

That is to say, it is the statute rather than the shareholders that empowers the board to exercise the power of the company.[72] As for the power of the managers, Delaware General Corporations Law authorises the board to appoint and to delegate powers to executive directors,[73] which is the same as in the case of its UK counterpart.

1.2.2.2 Directors and managers

As the link between managers and shareholders, the board of directors is a fundamental element of good investor relationships and good corporate governance, and, hence, determines the success of the company.[74] In the UK, although it is open to companies to choose a one-tier or two-tier board as the law has no mandatory rules about it, companies are more willing to have a single or unitary board of directors.[75] The unitary board of directors comprises executive directors and non-executive directors, with the former responsible for the management and performance of the company, and the latter exercising the monitoring role of executive directors. In Table A, the predecessor of the Model Articles, it is prescribed that the 'company shall be managed by the directors'.[76] In art. 3 of the Model Articles, the board is said to be 'responsible for the management of the company's businesses.'[77] This change represents a shift away from the management function, to focus more on the delegation and monitoring function.[78] Therefore, it is the managers who are responsible for the management of the company and, in practice, the board of directors will delegate certain degrees of managerial power to full-time managers, just as art. 5 of the Model Articles of Association prescribed that 'the directors may delegate any of the powers which are conferred on them to persons they think fit'.[79] That is to say the board has the discretion to decide the extent to which

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[72] Kershaw (n 68) 213.
[73] Delaware General Corporation Law, ss 141 and 142.
[74] Ben G Pettet, John P Lowry and Arad Reisberg. *Pettet's Company Law: Company Law and Corporate Finance* (Pearson Education 2012).
[75] Kershaw (n 68) 230. Although the Companies Act has no mandatory rules about board structure, in various reports such as the Cadbury Report (UK) and Higgs Report (UK) the unitary board structure was preferred to the two-tier structure. It is an illustration of 'path-dependency' in terms of a company's preference in selecting board structure.
[76] Table A, Companies Act 1948 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/386507/comm1July48CoAct1948_P1.pdf> accessed 03 March 2017.
[77] Model Articles for Public and Private Companies, article 3.
[78] Kershaw (n 68) 235.
[79] Model Articles for Public and Private Companies article 5(1).

managers exercise management power on their behalf. In addition, art. 5 also empowers the board to revoke this delegation.[80]

As for the duties of the directors, it was set out in case law until the Companies Act restated it. The general duties of directors are set out basically in Part 10 of the CA 2006. The duties of directors begins with s 170 which addresses the scope and nature of the duties, and are followed by the substantive duties owed by the directors: s 171 Duty to act within powers; s 172 Duty to promote the success of the company; s 173 Duty to exercise independent judgement; s 174 Duty to exercise reasonable care, skill and diligence; s 175 Duty to avoid conflicts of interest; s 176 Duty not to accept benefits from third parties; s 177 Duty to declare interest in proposed transaction or arrangement.[81] Besides, the board structure and composition also matters in the corporate governance framework. The role of the non-executive directors and the design of the board enable it to function and discharge its task properly.[82] As the duties and design of the directors is a broad topic that involves sophisticated design, it will not be expanded here given the limited space.

In the United States, the unitary board of directors is also the statutory norm. Section 141(a) of the Delaware General Corporations Law gives the board of directors the authority to manage the corporation.[83] As in the UK, the board is empowered to appoint and delegate powers to managers.[84] In the US, as with its UK counterpart, directors owe a duty of care and a duty of loyalty to the corporation, and these duties require the directors to act diligently and make decisions based on the corporation's best interest. The duty of care is not prescribed precisely in the Delaware General Corporations Law, rather, it is in the case law. The case of *Sinclair Oil Corp. v. Levien* provides that 'the directors of a Delaware corporation use that amount of care which ordinarily careful and prudent men would use in similar circumstances and consider all material information reasonably available in making business decisions.'[85] Besides, directors are protected by the 'business judgement rule'. It is a kind of presumption that 'in

[80] Ibid.
[81] Companies Act 2006, Part 10
[82] Marc Moore and Martin Petrin, *Corporate Governance: Law, Regulation and Theory* (Springer, 2017) 171.
[83] Delaware General Corporation Law, section 141.
[84] Delaware General Corporation Law, Sections 141 and 142
[85] *In re Walt Disney Derivative Legislation* (Chancery Court) 825 A 2d 275 (2003).

making a business decision the directors of a corporation acted on an informed basis . . . and in the honest belief that the action taken was in the best interest of the company.'[86] This presumption applies when there is no evidence of fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment on the part of the directors for the purpose of guaranteeing the corporation is managed under the direction of its boards with minimum interference from the court. This also shows the difference in attitude towards the power relationship between shareholders and directors in the UK and US.

1.2.2.3 Shareholders

The fact that management power is delegated to a board of directors does not necessarily mean that shareholders do not have any control over the company. On the one hand, art. 4 of the Model Articles provides the shareholder body with a reserve power; that is, the shareholder body retains the power to give the board direction by passing a special resolution. On the other hand, as observed by MacNeil, Nolan, Davies, and Rickford, the UK corporate legislation system entitles shareholders to a wide range of powers that enable them to act collectively to monitor the management team.[87] The powers the CA 2006 confers on shareholders are the 'power to change the company's constitution; 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;[88] power to remove directors;[89] power to call a special meeting and to submit proposals.'[90] In a number of cases, the approval of shareholders is required for certain managerial actions, such as the award of long-term service contracts to directors[91] and substantial property transactions with directors.[92] In Delaware, shareholders have similar powers to that

[86] *Sinclair Oil Corp v Levien*, 280 A2d 717, 720 (Del. 1971)
[87] Iain G MacNeil, 'Activism and Collaboration among Shareholders in UK Listed Companies' (2010) 5 Capital Markets Law Journal 425; Richard C Nolan, 'Indirect Investors: A Greater Say in the Company?' (2003) 3 *Journal of Corporate Law Studies* 77; Paul Davies and Jonathan Rickford, 'An Introduction to the New UK Companies Act: Part II.' (2008) 5 European Company and Financial Law Review 239.
[88] CA 2006 s 21(1).
[89] CA 2006 s 168.
[90] CA 2006 s 303, 314.
[91] CA 2006 s 188.
[92] CA 2006 ss 190–196.

enjoyed in the UK, such as the power to call a special meeting[93]; and the power to remove directors.[94] Section 141(k) provides that

> (k) Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors, except as follows:
>
> > (1) Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is classified as provided in subsection (d) of this section, stockholders may effect such removal only for cause.

Equipped with these rights, shareholders could, although they may seem passive most of the time, exert influence on the operation of the company to some extent. In addition, the removal rights held by shareholders could threaten directors to let them know that removal rights will be exercised if they wish to pursue self-serving opportunistic behaviour. Accordingly, less agency costs will be incurred.

1.2.3 External mechanism

As analysed above, the internal governance mechanism divides the power between shareholders, directors and managers, and directors are expected to act within their power to fulfil their duties to promote the success of the company. However, on the one hand, the cost incurred in exercising shareholders' rights causes their passivity. Even though the benefits exceed the cost, 'free-riders' would rather let someone else, especially large shareholders, enforce rights on their behalf. This rational apathy of the shareholder body leaves the directors much room to exercise their own interests. On the other hand, although the board has the power to appoint, monitor and remove management, and non-executive directors are supposed to monitor the exercise of corporate power, in practice, the board and management are dissolved into each other and non-executive directors often do little apart from rubber stamping what their 'paymaster' executive directors have told them to do.[95] Therefore, the mechanism for

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[93] *Kidsco Inc v Dinsmore*, 674 A.2D 483 (Del. Ch. 1995) permitting stockholders holding at least 10% of the votes to call a special meeting.
[94] Delaware General Corporation Law, s 1414.
[95] Kershaw (n 68) 191.

controlling management and reducing managerial agency cost does not work as it is supposed to. The inadequacy of internal control mechanisms has fuelled the need for other external mechanisms.[96]

At the heart of proper corporate governance is the identification and correction of inefficiencies in the running of a firm. As corporations developed within market economies, a framework of law and regulation has evolved to bring order to their activities, to maintain competition and to ensure fair treatment of those who interact with corporations. In pursuing this objective, firms rely not only on their own internal mechanisms but also on external instruments. External mechanisms are exercised by those outside the business entities such as regulators, governments, trade unions and financial institutions. Here the focus will be on the legal and market external governance devices available to monitor the activities of the organization, and take corrective actions when the business goes off track.

1.2.3.1 External legal mechanism

This part describes legal strategies employed to address agency problems. According to Kraakman, some of the legal strategies are 'regulatory' in nature given that these rules constrain the actions of corporate actors directly; while others are 'governance' in nature given that these rules focus on the balance within the company to reduce opportunism.[97] In general, regulatory and governance strategies will be deployed together to mitigate the vulnerability of principals to the opportunism of their agents.[98]

In the UK an attempt was made to reach a balance between the flexibility in the business entities themselves and their accountability and responsibility. Therefore, a 'market-based approach' was developed and this was done primarily through non-statutory voluntary codes and guidance. The codes operate on the 'comply or explain' basis. It identifies good governance practices from which one can choose or not. If companies choose to adopt a different approach that is more suited to their situation, they have to

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[96] Pinto (n 62) 226.
[97] Reinier H Kraakman, *The Anatomy Of Corporate Law: A Comparative and Functional Approach*. (Oxford University Press on Demand, 2009) 23.
[98] Ibid.

explain their reasons for doing so to their shareholders. The 'comply or explain' approach supports companies, investors and regulators in the UK, given its flexibility on a case-by-case basis. It has increasingly been adopted as a model in other markets.

The key statute related to the regulatory strategies are the CA 2006 and the Financial Service and Market Act 2000.[99] Apart from the division of power between shareholders, directors and managers, the CA 2006 also contains rules governing dishonest and fraudulent management. FSMA 2000 provides the framework for the regulation of the financial services industry in the UK. The law relating to public offers of shares and listing can be found in Part VI of the FSMA 2000. Stock exchanges also have a role to play. The London Stock Exchange is comprised of the main market and the Alternative Investment Market [100] which comprises mainly smaller, growing companies. Companies listed on the main market and AIM are required to abide by continuing obligations. These include the requirements to publish accounts that conform to Generally Accepted Accounting Principles, adopt the Model Code and do regulatory filings in accordance with company law and listing rules. [101] In addition, listed companies can expect scrutiny by the Financial Conduct Authority[102] which performs many of the functions that the Financial Services Authority used to perform as the UK listing authority.

In the US, the framework of external legal governance mechanisms consists of a series of related but separate statutes that are administered by the Securities and Exchange Commission. The Securities Act of 1933 mainly regulated the offering of securities to the public. It specifies the information that companies must provide when issuing securities in the public markets. It requires prospectuses with a significant amount of affirmative disclosure, including financial and other significant information to be provided to investors before public sale.[103] The Securities and Exchange Act of 1934 focuses on the trading of securities and the regulation of brokers, dealers, stock

[99] Hereinafter 'FSMA 2000'.
[100] Hereinafter 'AIM'.
[101] Institute of Chartered Accountants in England and Wales, 'Effective Corporate Governance Frameworks: Encouraging Enterprise and Market Confidence' (2006) 19 <https://www.icaew.com/-/media/corporate/files/technical/corporate-governance/dialogue-in-corporate-governance/effective-corporate-governance-frameworks.ashx > accessed 04 March 2017.
[102] Hereinafter 'FCA'.
[103] Thomas Clarke, *International Corporate Governance: A Comparative Approach* (Routledge 2007) 141.

exchanges and the over-the-counter markets. It also covers anti-fraud and anti-manipulation rules that may directly or indirectly affect corporate governance.

Furthermore, the U.S. Securities and Exchange Commission[104] was created by the Securities and Exchange Act of 1934 to guarantee the sound operation of the primary and secondary financial markets. The SEC has the authority to 'regulate securities exchanges (such as the Nasdaq Stock Market[105], the New York Stock Excahnge[106] and the Chicago Mercantile Exchange); bring civil enforcement actions against companies or executives who violate securities law; ensure the quality of accounting standards and financial reporting; and oversee the proxy solicitation and annual voting process'.[107] As in the UK, US companies are also required to comply with the listing requirements of the exchanges on which their securities trade. Unlike the UK, the US has no single national, authoritative corporate governance code. However, this does not mean corporate governance codes are absent. One analysis identified 25 unique codes, which means the process of developing standards is decentralized,[108] such as Analysis and Recommendations of Corporate Governance published by the American Law Institute[109], the Business Roundtable Principles of Corporate Governance, the National Association of Corporate Directors'[110] Report on Director Professionalism, the Conference Board's Recommendations, the Council of Institutional Investors Policies,[111] the California Public Employees' Retirement System's[112] Corporate Governance Principles, Teachers Insurance and Annuity Association[113] and College Retirement Equities Fund's[114] Policy Statement, the American Federation of Labor and Congress of Industrial Organization[115] Voting Guidelines, and Institutional

[104] Hereinafter 'SEC'.
[105] Hereinafter 'NASDAQ'.
[106] Hereinafter 'NYSE'.
[107] Larcker and Tayan (n 25) 145.
[108] Ruth Aguilera and Alvaro Cuervo-Cazurra, 'Codes of Good Governance' (2009) *Corporate Governance: An International Review* 17(3) 380.
[109] Hereinafter 'ALI'.
[110] Hereinafter 'NACD'.
[111] Hereinafter 'CII'.
[112] Hereinafter 'CalPERS'.
[113] Hereinafter 'TIAA'.
[114] Hereinafter 'CREF'.
[115] Hereinafter 'AFL-CIO'.

Shareholder Services'[116] Best Practices User Guide and Glossary.[117] With tremendous variation in wording, emphasis and many specifics, each of these codes applies to different companies in different fields, which are flexible enough to deal with special situations.[118]

1.2.3.2 External market mechanisms

There are several market mechanisms that serve as additional constraining forces. First is the market for corporate control. The market for corporate control mainly refers to 'the market for acquisitions and mergers where underperforming or undervalued firms become attractive takeover targets by potential acquirers'.[119] Poor corporate performance is always associated with insufficient internal governance and, therefore, the market for corporate control will kick in when necessary. The potential acquirers might buy and build up large portions of the target firm's shares with a view to replacing the incompetent management by taking control of the board. The aim of a takeover is to revitalize a poorly run company and achieve higher profitability after restructuring. The threat of the market for corporate control can serve as a useful external governance mechanism by aligning the goals and interests between management and shareholders and thus reduce agency costs. The second mechanism is capital market competition. Capital markets set the prices for the elements traded on the market. When capital markets are efficient, the price of the traded elements is the actual reflection of its value based on the information available to both parties in a transaction. Accurate pricing is necessary for firms to make rational decisions about allocating capital to its most efficient uses. Companies are held to a 'market standard' of performance. Those that fail to meet the standard are punished with a decrease in their share price. In this way, efficient capital markets act as a disciplining mechanism by putting share price pressure

[116] Hereinafter 'ISS'.
[117] Gotshal Weil and LLP Manges, 'Comparison of Corporate Governance Principles and Guidelines: United States' <https://corpgov.law.harvard.edu/wp-content/uploads/2012/02/Weil_Comparison-of-Corp-Gov-Practices.pdf> accessed 12 March 2017
[118] Nolan Haskovec, 'Codes of Corporate Governance: A Review', (2012) A Working Paper published by the Millstein Center for Corporate Governance and Performance <http://web.law.columbia.edu/sites/default/files/microsites/millstein-center/Codes%20of%20Corporate%20Governance_Yale_053112.pdf> accessed 12 March 2017
[119] Brian A Korman, 'The Corporate Game of Thrones and the Market for Corporate Control' (2016) 12 Journal of Business and Technology Law 165.

on the management team.[120] There is also a market for managers which encourages managers to do an efficient job because it enhances their ability to move to another position and product or service market in which the product and service provided by the company are competed, and the company could fail and the managers would lose their position if its products do not compete successfully in the market for products.

1.3 China

Unlike the UK and US with one principal kind of agency problem, incurred by the separation of ownership and control, China, however, suffers from two forms of agency costs, namely (1) vertical agency problems between shareholders and managers; and (2) horizontal agency costs between majority shareholders and minority shareholders. These circumstances are due to the special political and economic structure in China. These special circumstances also lead to the dual corporate governance mechanisms run within the SOEs. Before analysing these two agency costs and the governance structure in China, some background information is needed.

1.3.1 The background

In this section a political approach to analysing the influence of legitimacy management on the operation and governance of SOEs is adopted with a view to demonstrating the logic behind the SOE reform – the maintenance of political legitimacy.

1.3.1.1 Political legitimacy management

In China the culture of worshipping the authority has been deeply rooted in the history of the country which could be traced to its origins thousands of years ago.[121] Feudal society heavily relied on an agrarian economy with the individual farmer being the major structure. Hence, the centralisation of power was needed to safeguard social stability to ensure that agricultural production could continue in this economic model.

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[120] Raghuram G Rajan and Luigi Zingales, 'Power in a Theory of the Firm' (1998) 113 The Quarterly Journal of Economics 415.

[121] Qingjuan Wang, Rick D Hackett, Xun Cui and Yiming Zhang, 'Cultural Differences and Applicants' Procedural Fairness Perceptions: A Test of a Chinese Culture-based Model' (2012) 6 Chinese Management Studies 358.

From 221 BCE, a system of centralised hierarchical governance was established in China, which represented the most administrative order in the world.[122] The duty of obedience owed by an inferior to his or her superior led to collectivism, which began to emerge in this unchallengeable governance regime. In addition, Confucianism was preached by the emperor, largely because it set up a moral system in which sacrificing personal interests for the collective's best interests and it was considered a good virtue.[123] As a consequence, the individual interest was subordinated to that of the collective.[124] The collapse of the Qing dynasty marked the beginning of a new era. Having suffered from wars and turbulence for hundreds of years, the Chinese Communist Party of China[125] came to power and led the development of a new China under the 'banner of Marxism'. Nevertheless, the influence of the centralised bureaucratic state is still with us today but in the form of a socialist system - a socialist system with Chinese characteristics. The socialist system is the cornerstone of the political institutional structure and policy-making system. According to Hayek, the emergence of various kinds of social orders are not dependent on the intentional creation and planning of interested individuals, but evolve spontaneously.[126] Unlike the 'spontaneous order' in the capitalist system, the essence of the socialist system is the rational construction of the scientific socialism theory, which means the elements of various social orders are designed and created intentionally.[127]

The key to an understanding of the socialist system is the structure of power and the fundamental institution in the power structure is the Communist Party. As the only party that is in power, it has to prove its political legitimacy. *Political legitimacy* can be defined as 'citizens' trust in public officials and their conviction that governmental institutions are fair, responsive, and valuable'[128] and it could explain 'who deserves to

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[122] John O Haley, 'Law and Culture in China and Japan: A Framework for Analysis.' (2005) 27 Michigan Journal of International Law 899.
[123] Bee Chen Goh, *Law Without Lawyers, Justice Without Courts: On Traditional Chinese Mediation* (Routledge 2016) 57.
[124] Qingxiu Bu, 'Will Chinese Legal Culture Constrain Its Corporate Governance-related Laws?' (2015) 15 Journal of Corporate Law Studies 103-125.
[125] Hereinafter the 'CPC'.
[126] Friedrich August Hayek, *Studies in Philosophy, Politics and Economics* (Routledge & Kegan Paul 1967).
[127] Janos Kornai, *The Socialist System: The Political Economy of Communism* (Oxford University Press1992).
[128] Bert Useem and Michael Useem, 'Government Legitimacy and Political Stability' (1979) 57 Social Forces 848.

have authority and why'.[129] As Lipset points out, it also 'involves the capacity of the [political] system to engender and maintain the belief that the existing political institutions are the most appropriate ones for the society'.[130] As the CPC cannot base its legitimacy on democratic election, it must use other means to hold on to power, which are mainly focused on two aspects: (1) controlling resources and (2) delivering performance.[131] Controlling resources is aimed at binding citizens to the Party by controlling the country's economic, political and social resources, and delivering performance is aimed at gaining the support of the citizens by improving living standards for the Chinese people through economic growth.[132] Therefore, political legitimacy management has focused on two main aspects, with the ultimate goal of preserving the CPC's power base.[133] The first is the control financial resources. It is necessary to have sufficient financial resources to constitute the financial basis for a legitimate regime. This demand determines the orientation of the policy towards state and privately owned enterprises. The SOEs fulfil this economic duty and provide a financial foundation for the CPC's reign. Therefore, the CPC is fully aware of the vital importance of SOEs and, as will be shown later, that the Party exercises tight and direct control of SOEs and, to some extent, SOEs determine the economic reform pattern. The second is maintaining the official ideology. As some scholars have noted, 'ideology fulfils various functions crucial to political, social and economic life, such as interpreting political order, cementing national identity, mobilizing support and reducing economic transaction costs by enhancing social trust'.[134] The official ideology is codified in the Party's resolution, the party leader's speeches and writings, articles in the Party's media and other official pronouncements.[135] Therefore, Party organizations

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[129] Baogang Guo, 'Political Legitimacy and China's Transition' (2003) 8 Journal of Chinese Political Science 6.

[130] Seymour Martin Lipset, *'Political Man: The Social Bases of Politics'* (Johns Hopskins University Press 1981).

[131] Adam S Hersh, 'China's State-owned Enterprises and Nonmarket Economics' (*Center for American Progress* 5 March 2014), < https://www.americanprogress.org/issues/security/reports/2014/03/05/85372/chinas-state-owned-enterprises-and-nonmarket-economics/> accessed 07 March 2017.

[132] Jiangyu Wang, 'The Political Logic of Corporate Governance in China's State-Owned Enterprises' (2014) Cornell International Law Journal 634.

[133] There are also other perspectives on which political legitimacy management focused, such as maintaining social stability, managing interest groups and pursuing good policy. The reason for focusing on only the two agendas here is that they are closely related to the economic reform and corporate governance structure. For more, see Wang, ibid.

[134] Bruce Gilley and Heike Holbig, 'The Debate on Party Legitimacy in China: A Mixed Quantitative/Qualitative Analysis' (2009) 18(59) Journal of Contemporary China 348.

[135] Janos Kornai, *The Socialist System: The Political Economy of Communism* (Oxford University Press 1992).

are established within the SOEs to ensure its ideological influence. The following discussion shows that legitimacy management to strengthen the ruling position of the CPC is embodied in every aspect of SOEs, from their reform to their governance structure.

1.3.1.2 SOE reform and the evolution of its ownership structure

As early as the revolutionary period, the CPC established factories and shops in provinces under its control which could be regarded as the origins of SOEs.[136] The establishment of the People‘s Republic of China in 1949 marks the beginning of the rapid growth of SOEs. By carrying out ‘Three Great Transformations’,[137] the assets and enterprises once owned by capitalists and foreign investors were expropriated and nationalized as state property. In order to guarantee the concentration and preservation of power, the CPC adopted a central planned economy, and enterprises were owned and controlled by the state (or claimed as being owned by the whole people) which was deeply influenced by the ‘Soviet model’.[138] In this period the ownership structure was totally concentrated. Under the centralized economy, resources, products, the labour force and the essential consumption were allocated according to state plans as a basic unit to implement production plans, and as markets did not exist, SOEs did not consider supply and demand, and the state was responsible for any results and served as the ‘last resort’ lifesaver.[139] Within the enterprises, top-down state agencies, such as a ministry, provincial government or local government, used strict administrative commands to ensure that the enterprises were under rigid supervision and control. The so-called managers had almost no independence of management as all the input and output of production were determined by the state. In addition, they were appointed by the state and its agencies, and their performance was not evaluated by the financial performance of enterprises, as long as the assigned production plan was fulfilled.[140] Moreover, SOEs

[136] See Jinglian Wu, *Understanding and Interpreting Chinese Economic Reform* (Texere 2005). See also Furen Dong, *The Economic History of the People’s Republic of China* [*中华人民共和国经济史*] (Economic Science Press 1999) <http://bjzc.org/lib/11/gljx/ts011043.pdf> accessed 27 March 2017

[137] *Three Great Transformations* means the socialist transformation led by the CPC aimed at changing the private ownership into public ownership in aspects of agriculture, manufacture and the capitalist industries.

[138] Dong (n 135) 146.

[139] Wang (n 131) 638.

[140] Guanghua Yu, *Comparative Corporate Governance in China: Political Economy and Legal Infrastructure* (Routledge 2007).

have multiple roles and objectives given the fact that they are 'grassroots organizations of the Party–state political system with extensive social functions'.[141] As noted:

> The state regarded SOEs as instruments to achieve its political and economic objectives, such as to establish a strong military industry and to catch up with and surpass Western countries. Therefore, managers of SOEs were regarded as cadres of the party and were governed in the same way under the same system as staff of the party and government organs. Moreover, SOEs integrated the functions of employment, social security, and social relief, providing a full spectrum of social services from cradle to grave.[142]

As a consequence, production inefficiency and economic stagnation have prevailed in China. Therefore, the market-oriented 'reform and opening up' was initiated in 1978. The main aim of the reform in terms of the enterprises was to increase managerial autonomy by allowing SOEs to retain a part of the profits and have discretion over the output produced in excess of the plan.[143] In 1984, the Third Plenary Session of the Twelfth CPC Central Committee promulgated the 'Decision of the Central Committee of the CPC on Reform of the Economic Structure', which permits the 'enterprise contracting system'.[144] Under this policy, the management of SOEs signed a contract with the government department concerned to entrust it with the responsibilities of management on the government's behalf. SOE managers were only agents hired by the government and in order to institutionalize this reform, the National People's Congress[145] promulgated 'The Law on Industrial Enterprise Owned by the Whole People', which still governs SOEs yet to be corporatized.[146] It should be noted that the reform at this stage focused on the incentives that could boost the efficiency of the SOEs within the original ownership structure. The state still held the controlling power

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[141] Wu (n 135) 140.
[142] Wang (n 131) 639. See also Wu (n 135).
[143] Stoyan Tenev, Chunlin Zhang and Loup Brefort. *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (World Bank Publications 2002) < http://www.ifc.org/wps/wcm/connect/93111800485831c58971e9fc046daa89/Corporate+Governance+in+China.pdf?MOD=AJPERES> accessed 10 October 2016.
[144] 'Decision of the Central Committee of the Communist Party of China on Reform of the Economic Structure' [中共中央关于经济体制改革的决定] issued by the 12th Central Committee of the Communist Party of China at its Third Plenary Session on 20 October 1984.
[145] Hereinafter 'NCP'.
[146] 'Law on Industrial Enterprises Owned by the Whole People' [中华人民共和国全民所有制工业企业法] adopted at the First Session of the Seventh National People's Congress and promulgated by Order No. 3 of the President of the People's Republic of China on 13 April 1988, and effective as of 1 August 1988 <http://english.mofcom.gov.cn/article/lawsdata/chineselaw/200303/20030300072563.shtml> accessed 27 March 2017.

of these enterprises. However, these reforms could not reach their target because central planning constrained the effectiveness of incentive contracts between the government and management. To make things worse, the heavy tax burden starved the companies of capital, consequently, loans could not be repaid and the financial assets in the banking sector declined rapidly. China stood on the doorstep of revolutionary reform.

In 1990, the Shanghai Stock Exchange[147] and Shenzhen Stock Exchange[148] were established, indicating the beginning of a market economy and Chinese capital market. In 1992, Deng Xiaoping's (the former Chinese president) speech about creating a market economy during his visit to the south of China marked the beginning of a new era and the China Securities Regulatory Commission[149] and Securities Commission of the State Council were set up in that year. In 1993, the Third Plenary Session of the 14th Party Congress issued the 'Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure'[150] and officially adopted the policy of establishing a socialist market economy.[151] The Decision also established 'modern corporations' as a new form of enterprise reform. The main target of the enterprise reform at this stage was to clarify the property rights and transfer large SOEs into legal entities through corporatization. In 1993, the Company Law of the People's Republic of China was launched, which provided a legal foundation for the deepening reforms. Pursuant to art. 3 of the 1993 Company Law, joint stock companies[152] and limited liability companies[153] became the standard form of company and 'all incorporated companies were legal persons with independent personality in law, and responsible for their own behaviour'.[154] Through the process of 'corporatization', former SOEs were restructured into forms of company governed by company law and some of them could issue shares by being listed on the SSE or SZSE and a flood of foreign investors forming joint ventures with SOEs. At least theoretically, the state became the shareholder of a corporation rather than the direct owner and controller. The ownership structure of the

[147] Hereinafter 'SSE'.
[148] Hereinafter 'SZSE'.
[149] Hereinafter 'CSRC'.
[150] Hereinafter 'Decision'.
[151] Decisions of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economy System [中共中央关于建设社会主义市场经济体制若干问题的决定] issued by the Third Plenary Session of the CPC Fourteenth National Congress on 14 November 1993.
[152] Hereinafter 'JSC'.
[153] Hereinafter 'LLC'.
[154] Company law of the People's Republic of China 1993, article 3.

SOEs began to change. In the non-public sector, after being permitted in the late 1980s, private ownership became an irresistible force in the economy, from about 40,000 in 1978 to about 450,000 private enterprises in 1994.[155] The Fourteenth and Fifteenth CPC National Congress gave birth to the subsequent amendment to the Constitution in 1999 and it is prescribed that 'non-public sectors of the economy, including the individual and private sectors, constituted an important component of the socialist market economy.'[156] Multiple forms of ownership structure, particularly private ownership, burgeoned.

However, the necessity of legitimacy management requires the CPC to control financial resources and, therefore, limits SOE reform. As SOEs are permitted to list on the stock exchange and anyone can buy the shares of SOEs, the state is afraid of the risk of changing the nature of SOEs to privately owned or foreign-owned. Hence, 70% of the stock is non-tradable, held by the state and legal person. 30% of the stock is tradable, which could be traded on the stock exchange. The split ownership structure established at this time is widely seen as an impediment to the further reform of SOEs and despite the incredible growth in China's securities markets, stock-issuing activities were still very limited and the 'big-brother directorship' became, as will be seen later, the main problem of Chinese corporate governance.

During this stage, the ownership of non-tradable shares was fragmented and controlled by many bureaucracies, from central ministries to departments of local governments. In 2003, the State-owned Assets Supervision and Administration Commission of the State Council[157] was established. With 'a combination of powers previously dispersed among different ministries and agencies',[158] SASAC exercises the 'duties and responsibilities of the state investor'[159] and this could be regarded as CPC's efforts to consolidate the control rights over SOEs.

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[155] Joseph CH Chai, 'China: Transition to a Market Economy' (Oxford University Press 2000) 179.
[156] 'Clarification of the Important Role of Non-Public Ownership in a Socialist Market Economy System' [明确非公有制经济是社会主义市场经济的重要组成部分], information database on Chinese reform, < http://www.reformdata.org/special/107/ > accessed 25 March 2017.
[157] Hereinafter 'SASAC'.
[158] Barry Naughton, 'The State Asset Commission: A Powerful New Government Body' (2003) 8 China Leadership Monitor 9.
[159] David C Donald, *A Financial Centre for Two Empires: Hong Kong's Corporate, Securities and Tax Laws in Its Transition from Britain to China* (Cambridge University Press 2014) 49.

Having existed for decades, the split ownership structure seriously affected the development of Chinese capital market. Therefore, in 2005, the Chinese government issued the Notice of the China Securities Regulatory Commission on Piloting the Share-trading Reform of Listed Companies,[160] Guidance Notes on the Split Share Structure Reform of Listed Companies[161] and Measures on the Administration of Split Share Structure Reform of Listed Companies[162] to guide the split share structure reforms which were aimed at lowering the state shareholding by converting non-tradable shares into tradable shares. By the end of 2008, the vast majority of listed companies had completed the process of converting part of non-tradable shares to tradable shares.[163] The reform of the split share structure enables the controlling shareholders to be exposed under the pressure of the market and offers both individual and institutional investors a fairer environment with more accessible protection. The reform represents one big step forward on the way to develop a mature stock market and it has produced wide effects on the governance structure of Chinese companies.[164] However, as Figure 2.8 shows,[165] the portion of shares which transferred from non-tradable to tradable is still held by the government, but in another form. Therefore, the CPC's control over SOEs is through reform, and SOE reform is part of the CPC's effort to rebuild and maintain political legitimacy.[166]

1.3.1.3 Vertical and horizontal agency problems

Against the background sketched above, the agency problems within the SOEs are discussed below:

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[160] 'Notice of the China Securities Regulatory Commission on Piloting the Share-trading Reform of Listed Companies' [中国证券监督管理委员会关于上市公司股权分置改革试点有关问题的通知], No. 32 [2005] of the China Securities Regulatory Commission.

[161] 'Guidance Notes on the Split Share Structure Reform of Listed Companies' [上市公司股权分置改革指导意见], clause 2, issued on August 23, 2005, jointly by the CSRC, the SASAC, the Ministry of Finance, the People's Bank of China and the Ministry of Commerce.

[162] 'Measures on the Administration of Split Share Structure Reform of Listed Companies' [上市公司股权分制改革管理办法] issued by the CSRC in September 2005 <http://www.csrc.gov.cn/n575458/n4001948/n4002120/4069846.html> accessed 12 March 2017.

[163] Jingjing Yang, Jing Chi and Martin Young. 'A Review of Corporate Governance in China' (2011) 25 Asian-Pacific Economic Literature 19.

[164] Bo Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (Routledge 2013) 234.

[165] See page 81.

[166] Wang (n 131) 639.

First, vertical agency problems between managers and shareholders exist within SOEs. During the process of SOE reform, autonomy was granted to the management for the benefit of boosting production. However, this creates enormous opportunities for managers to expropriate assets and infringe the interests of shareholders.[167] The state, as the delegation of all the people in China, is expected to play a monitoring role of managers. However, the state is only a conceptual existence and the central governments, local governments, and the SASAC at central and local level act as agencies that represent the state. On the one hand, the multiplicity of agencies may lead to a race to maximize departmental interest. On the other hand, supervision responsibilities are evaded in this lengthened agency chain. In addition, officials within the government lack information and skill to exercise proper monitoring. Their monitoring role is limited given the great number of SOEs. Managers of SOEs are mainly appointed by the government and the focus of their work is not only on daily management but to coordinate relationships with local government. Therefore, the managers could take advantage of this autonomy and discretion given to them to maximize their own profits.

Second, the agency costs generated by the conflicts between majority shareholders and minority shareholders give rise to the horizontal agency problems in Chinese SOEs. According to research conducted by SASAC in 2009, 900 out of 1,600 listed companies are controlled by the government and SOEs occupied more than 80% of the total share value of all listed companies.[168] One may argue that the state, acting on behalf of all the people may not act against the interest of minority shareholders as the minority shareholders are part of the people. However, this might not always be the case as government interests may not always align with the interests of minority shareholders or even the company itself[169] because the government needs to consider political, social and environmental issues when making a decision. A large percentage of SOEs are now controlled and monitored by local government and the local authority plays a key role

[167] Qing Shao 'The Scandal of CAOS: Absence of Supervision' [透视中航油时间：产权不清导致内外风险监控缺失] (people website, 2005) <http://www.cnki.com.cn/Art. /CJFDTotal-CQDK200503019.htm> accessed 17 June 2017.

[168] Lu Wang, 'Direct shareholding by SASAC will be Carried out next Year' [国资委直接持股明年实施] (Tecent Finance, 19 December 2009) <http://finance.qq.com/a/20091219/001279.htm> accessed 17 June 2017.

[169] Andrei Shleifer and Robert W Vishny, 'A Survey of Corporate Governance.' (1997) 52 Journal of Finance 737, 758-761.

in deciding which SOE should be listed. The criteria for selecting ‘best’ companies are not just financial performance, but also social and political importance. Those companies with bad financial performance but social and political importance, have to do something to meet the listing requirements. On the one hand, false listing documents may be produced; on the other, all the prime and core assets are transferred to the companies to be listed, while the bad assets and redundant debt are transferred to their parent or related company. Therefore, minority shareholders and the company itself were sacrificed. As some scholars pointed out, ‘many SOEs are debt-ridden enterprises ‘repackaged’ for listing and continue to be controlled by their parent companies who, having successfully seen to their IPO, look towards them as cash cows for ready milking.’[170] Furthermore, SOEs sometimes have the responsibilities to rescue other SOEs when they are in financial trouble to ensure social stability. Besides, many forms of tunnelling activity are undertaken by controlling shareholders to maximize their own benefits.[171] Given the fact that the controlling right is too powerful and the voice of minority shareholders is often overlooked or ignored, minority shareholders can do nothing when their rights are infringed and it is minority shareholders who pay for this ultimately.

1.3.2 Dual corporate governance mechanisms

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[170] Lay Hong Tang and Jiangyu Wang, ‘Modelling an Effective Corporate Governance System for China’s Listed State-owned Enterprises: Issues and Challenges in a Transitional Economy’ (2007) 7 Journal of Corporate Law Studies 151.

[171] There are many ways of tunnelling among which there are three main activities. First, provide soft loans or guarantees to controlling shareholders. For more information about this, see Notice on Public Criticism on Shanghai Lengguang Shiye plc [关于对上海棱光实业股份有限公司公开谴责的公告], Shanghai Stock Exchange, (6 November 1999); <http://business.sohu.com/history/990613/stock/file/853security.html> accessed 29 April 2016; Notice on Public Criticism on Beijing Zhongguancun Keji Fazhan plc [关于对北京中关村科技发展股份有限公司予以公开谴责的公告], Shenzhen Stock Exchange (28 September 2001) <http://vip.stock.finance.sina.com.cn/corp/view/vCB_AllBulletinDetail.php?stockid=000931&id=34900> accessed 29 April 2016; Guohua Jiang, Charles Lee and Heng Yue, ‘Tunneling in China: The Surprisingly Pervasive Use of Corporate Loans to Extract Funds From Chinese Listed Companies’ (2005) Cornell Univeisty Johnson School Research Paper Series 31-06. Second, transfer companies’ assets at an under-value or unfair price to a third party who is in a relationship with a controlling shareholder(s). For this point, see Notice on Public Criticism of Hubei Xingfu Shiye plc [关于对湖北幸福实业股份有限公司公开谴责的公告], Shanghai Stock Exchange <http://finance.sina.com.cn/stock/company/sh/600743/24/30.shtml> accessed 29 April 2016. Third, the companies’ assets are appropriated or misused by the controlling shareholder(s) directly. For this point, see Notice on Public Criticism on Hubei Meierya Gufen Youxian plc [关于对湖北美尔雅股份有限公司及有关人员予以公开批评的公告]; CSRC 12 September 2001 <http://www.csrc.gov.cn/pub>, accessed 29 April 2016; Notice on Public Criticism on Ningxia Huagong plc [关于对宁夏化工股份有限公司及有关人员予以公开批评的公告] CSRC <http://www.csrc.gov.cn/pub> accessed 29 April 2016.

As discussed above, in order to guarantee the concentration and preservation of power, the CPC needs to control financial resources and SOEs are the main part of the power base. Therefore, the CPC places great emphasis on the governance of SOEs. The existing literature on Chinese corporate governance largely focuses on the universal model of corporate governance which comprises the internal governance system that governs the division of power within the company and external governance mechanism that relevant laws, codes and markets have a role to play, as in the UK and US. However, it should be noted that SOEs in China are subject to parallel corporate governance structures.[172] One is the UK and US model of corporate governance and the other is political governance, in which the control power of personnel appointments and decision-making in SOEs are in the hands of CPC-related departments. With the political governance run in the shadows, these two governance mechanisms coexist in Chinese SOEs.

Before analysing these two governance structures in detail background information on the typology of companies and classes of shares will be provided.

Two forms of company are stipulated in Chinese company law: (1) Joint Stock Companies and (2) Limited Liability Companies. Joint Stock Companies are similar to public companies in the UK and their shares are open to the public. Meanwhile, LLCs are similar to private companies in the UK and are incorporated by small business entities.

The distinction between tradable and non-tradable shares is the primary basis when talking about classes of shares. As mentioned above, afraid of losing control of SOEs, the state assigned 70% of the listed stock are non-tradable shares and the remaining 30% of the stock are tradable and could be traded on the stock exchange. Tradable shares can be divided into different types according to their nature. 'A' shares are the most common type of tradable shares and they are exclusively available to Chinese domestic investors.[173] 'B' shares are those shares that are only available to foreign individuals and institutions. In addition, a small part of China's stocks are 'Red chips', 'L' shares,

[172] Wang (n 131) 644.
[173] Since the launch of the Qualified Foreign Institutional Investors (QFIIs) Programme in 2002, qualified foreign institutions have been able to buy 'A' shares within the quotas allocated by the Government

‘H’ shares and ‘N’ shares.[174] ‘Red chips’ are stocks ‘traded on the Hong Kong Stock Exchange and issued by Hong Kong-registered companies that have a mainland Chinese shareholder holding of at least 35% of the shares.’[175] ‘L’, ‘H’ and ‘N’ shares refer to shares issued by Chinese companies that are listed on the London Stock Exchange, Hong Kong Stock Exchange and New York Stock Exchange. Non-tradable shares are subject to strict restrictions on their circulation and they could be divided into ‘state shares’ and ‘legal person shares’; the former owned by the state and the latter retained by government-related organizations with legal personalities.

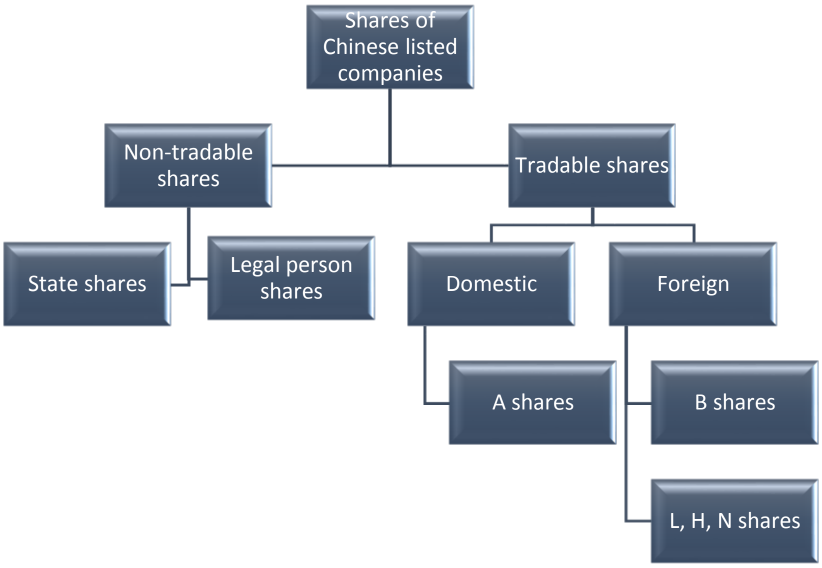

Figure 1.1: Main classes of shares in China

For an analysis of the Anglo-American sector, the anatomy of corporate governance is presented from the internal and external perspective. For the discussion of the Chinese sector, the same approach is followed. First, the legal governance, which is the same as that of the UK and US, is analysed from the internal and external perspective, followed by the political governance.

[174] Jun Lin, Ming Liu, and Xu Zhang, ‘The development of corporate governance in China’ (2006) 1 Asia-Pacific Management Accounting Journal 32.
[175] Official website of CSRC <http://www.csrc.gov.cn/gansu/xxfw/tzzzsyd/200608/t20060821_92669.htm> accessed 17 June 2016.

1.3.2.1 Internal corporate governance mechanism

No matter what the ownership structure, political system or ideology, internal checks and balances are necessary to work as a basic incentive and restraint system to solve agency problems. The same approach applies to China. From the beginning when the Chinese internal governance mechanism was started, the process of learning never stopped. The division of power within Chinese companies not only drew on the Germanic two-tier governance system, but also benefitted from the single-tier governance structure in the Anglo-American system. According to the company law of 2005, three organs have to be established within a public company, which will be discussed below.

1.3.2.1.1 Division of power

Unlike the Anglo-American model of company law, which does not have a clear statement about the power of the shareholder body or the board of directors, Chinese company law clearly states the powers that belong to the shareholder in art. 4: ‘The shareholders of a company shall, according to law, enjoy such rights of owners as benefiting from assets of the company, making major decisions and selecting managerial personnel.’[176]

Article 37 states that ‘it shall be the authority of the company’, which shares some commonalties with its UK counterparts that the shareholders meeting is the source of power and authority; this is a kind of ‘shareholder primacy’. Article 38 clearly states the rights enjoyed by the shareholders meeting.[177]

As for the board and management, the powers enjoyed by them are also clearly stated in arts. 47 and 50. As in the UK and US, managers are appointed by the directors and are responsible for the management of the company. The powers held by managers are listed in art. 50:

[176] Company Law 2005 art. 4.
[177] Company Law 2005 s 37.

> A limited liability company shall have a manager, who shall be appointed or dismissed by the board of directors. The manager shall be responsible to the board of directors and shall exercise the following functions and powers: (1) to be in charge of the production, operation and management of the company, and to organize the implementation of the resolutions of the board of directors; (2) to organize the implementation of the annual business plans and investment plans of the company; (3) to draw up plans on the establishment of the internal management organs of the company; (4) to draw up the basic management system of the company; (5) to formulate specific rules and regulations of the company; (6) to recommend the appointment or dismissal of the deputy manager(s) and of persons in charge of the financial affairs of the company; (7) to appoint or dismiss management personnel other than those to be appointed or dismissed by the board of directors; (8) other functions and powers granted by the board of directors.[178]

1.3.2.1.2 Board of directors and supervisory board

According to company law, a board of directors and supervisory board are required to be established within listed companies in order to separate the management power from monitoring power. Therefore, a two-tier board structure is adopted in China.[179] The board of directors exercises the following powers:

(1) to be responsible for convening shareholders' meetings and to report on its work to the shareholders meetings;
(2) to implement the resolutions of the shareholders meetings;
(3) to decide on the business plans and investment plan of the company;
(4) to formulate the annual financial budget plan and final accounts plan of the company;
(5) to formulate plans for profit distribution and plans for making up losses of the company;
(6) to formulate plans for the increase or reduction of the registered capital and issuance of company bonds;
(7) to formulate plans for the merger, division, transformation and dissolution of the company;
(8) to decide on the establishment of the company's internal management organs;

[178] Company Law 2005 s 50.
[179] Company Law 2005 s 52.

(9) to decide on appointment and dismiss the company's manager and the matter on the manager's remuneration, and, upon recommendation of the manager, to decide on appointment and dismiss the company's deputy manager(s) and persons in charge of the financial affairs of the company and the matters concerning their remuneration;

(10) to formulate the basic management system of the company;

(11) to exercise other functions and powers provided in the articles of association of the company.[180]

The board is required to 'bear the duties of loyalty and due diligence towards the company . . . shall not, by taking advantage of their positions and powers, accept bribes or other unlawful incomes, nor may they misappropriate the property of the company.'[181] These prescriptions are, to some extent, the same as the directors' duty to exercise reasonable care, skill and diligence and avoid conflicts of interest in the UK. Article 149 lists the boards of directors' and senior management's responsibilities clearly:

> The directors and senior executives of a company shall not commit any of the following acts:
>
> (1) Misappropriate the company's funds;
>
> (2) Deposit the company's assets in their own personal accounts or in personal accounts of other individuals;
>
> (3) In violation of the company's articles of association and without the consent of the shareholders' meeting or the shareholders' general meeting or the board of directors, lend the company's funds to others or use the company's property to provide guarantee to others;
>
> (4) In violation of the company's articles of association or without the consent of the shareholders 'meeting or the shareholders general meeting or the board of directors, enter into contracts or conduct transactions with the company;
>
> (5) Without the consent of the shareholders' meeting or the shareholders' general meeting, by taking advantage of their positions, seek for themselves or others the commercial opportunity that should belong to the company, or operate for themselves or others the same category of business as that of the company;

[180] Company Law 2005 s 47.
[181] Company Law 2005 s 148.

(6) Accept and possess the commission in the transaction between others and the company;
(7) Disclose the company's secrets without authorization;
(8) Commit other acts in violation of the duty of loyalty to the company.[182]

A joint stock limited company is required to set up a board of supervisors with no fewer than three persons and art. 118 also requires that

> [t]he supervisory board shall be composed of shareholders' representatives and an appropriate proportion of representatives of the staff and workers of the company, the proportion of such representatives shall not be less than one-third and the specific proportion shall be provided for by the articles of association of the company. Directors and senior executives shall not serve concurrently as supervisors.[183]

The powers of the supervisory board are as follows:

(1) to examine the financial affairs of the company;
(2) to supervise the acts of the directors and senior executives performing their functions, and to bring the proposal to dismiss those directors and senior executives violating the laws, administrative regulations, the articles of association of the company or the resolutions of the shareholders' meetings;
(3) to demand directors and senior executives to make corrections if any of their acts is found to have damaged the interests of the company;
(4) to propose the convening of interim shareholders' meetings, and to convene and preside over the shareholders' meetings in case the board of directors fails to its function of convening and presiding over the shareholders' meetings as provided by this Law;
(5) to bring proposal to the shareholders' meetings;
(6) to bring a lawsuit against the directors or senior executives in accordance with the provisions of Article 152 of this Law; and
(7) to exercise other functions and powers as provided in the articles of association of the company.[184]

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[182] Company Law 2005 s 149.
[183] Company Law 2005 s 118.
[184] Company Law 2005 s 54.

The responsibilities of the supervisory board are prescribed in art. 148. They share the same responsibilities with the directors and managers. Article 148 states that '[t]he directors, supervisors and senior executives of a company shall comply with the laws, administrative regulations and the articles of association of the company, and bear the duties of loyalty and due diligence towards the company. The directors, supervisors and senior executives of a company shall not, by taking advantage of their positions and powers, accept bribes or other unlawful incomes, nor may they misappropriate the property of the company.' However, no detailed forbidden acts are cited as for the directors and managers, given the quite weak position of supervisory boards in China.

1.3.2.1.3 Shareholders

Article 38 of the company law grants shareholders' meeting the following powers:

(1) to decide on the business policy and investment plan of the company;
(2) to elect and recall directors and supervisors not acted as by the representatives of the staff and workers, and to decide on matters concerning the remuneration of directors and supervisors;
(3) to examine and approve reports of the board of directors;
(4) to examine and approve the reports of the supervisory board or supervisors;
(5) to examine and approve the annual financial budget plan and final accounts plan of the company;
(6) to examine and approve plans for profit distribution of the company and plans for making up losses;
(7) to adopt resolution on the increase or reduction of the registered capital of the company;
(8) to adopt resolutions on the issuance of company bonds;
(9) to adopt resolutions on matters such as the merger, division, transformation, dissolution and liquidation of the company;
(10) to amend the articles of association of the company;
(11) to exercise other functions and powers as stipulated in the articles of association.[185]

Article 10 prescribe the responsibilities held by shareholders:

[185] Company Law 2005 s 38.

> The shareholders . . . shall not abuse their rights to damage the interests of the company or other shareholders nor abuse the independent status of corporate legal person and shareholders' limited liability to damage the interests of the company's creditors. The shareholders, who abuse their rights so as to cause losses to the company or other shareholders, shall undertake the liability for compensation. If the shareholders of a company abuse the independent status of corporate legal person and shareholders' limited liability to avoid debts and damage the interests of the company's creditors, they shall undertake the joint and several liability for the company's debts.[186]

Although shareholders in the UK are very powerful in terms of the powers granted to them, the rights enjoyed by their Chinese counterparts are far more extensive. Apart from the powers enjoyed by UK shareholders, some powers belonging to the UK directors are part of powers enjoyed by Chinese shareholders, namely the powers to determine the company's operational guidelines and investment plans. Therefore, the general meeting of shareholders could be considered the supreme power in corporate governance.[187] The rationale behind the institutional arrangement still lies in the legitimacy of management. The state, who plays a role as shareholder in companies, uses its role as the legislator outside the companies to maintain legitimacy. Therefore, there is no doubt that the state gives shareholders as much power as possible to strengthen its position.

1.3.2.2 External mechanisms

As with UK and US, the internal mechanism that is aimed at building a checks-and-balances system within the company sometimes does not work as it is supposed to. The inadequacy of internal control fuelled the need for other external mechanisms.[188] Therefore, how these external mechanisms operate in the Chinese context require examination.

1.3.2.2.1 External legal mechanisms

[186] Company Law 2005 s 20.
[187] Junhai Liu, 'Experience of Internationalization of Chinese Corporate Law and Corporate Governance: How to Make the Hybrid of Civil Law and Common Law Work' (2015) European Business Law Review 113. <https://ssrn.com/abstract=2611556> accessed 22 April 2017.
[188] Pinto and Visentini (n 62).

In a socialist society, which features departmentalism, the hierarchical system can be seen in all government-related areas, including the legislative process. The discussion that follows is structured in line with the top-down hierarchical legal system. Here, a brief description about the hierarchy in legislative power is provided. In a socialist country where people's democracy is an indispensable part of socialism with Chinese characteristics, one way to achieve democracy is for people to elect their own delegates through a multi-tiered representative electoral system, which form the National People's Congress[189]. The NPC is the organ with supreme power. Therefore, the NPC has the highest legislative power of the state[190] and this kind of legislation is described as *state law* or *basic law*. This is the first layer of the legislative system that is enacted by central authorities. The second layer are those administrative regulations and rules promulgated by the State Council, including the central government and the Ministries under the State Council.[191] The ministries of the State Council could formulate legislation within the power conferred upon them.[192] The third level are those regulations and rules formulated by local government.[193] They fill the gaps left by the first two layers of legislative power according to their local circumstances.[194]

Laws in the first layer, including company law and securities law, are promulgated by the standing committee of the NPC. Company law, which focuses on the creation and the internal governance of the company, has been discussed above. The Securities Law 2005[195] focuses on the regulation of securities markets, such as general listing requirements, share offering and information disclosure.[196] The second layer comprises the rules and regulations published by the CSRC. There are 28 ministries and

189 Hereinafter 'NPC'.
190 Legislation Laws of the People's Republic of China (Hereinafter Legislation Law) s 7.
191 The formulation of legislation to govern the following matters is authorised: (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; and (c) when the NPC and its standing committee authorized the SC to formulate administrative regulations for matters originally under the responsibilities of the NPC and its standing committee. Legislation Law s 56.
192 Legislation Law s 71.
193 Legislation Law, ss 63, 71.
194 Jiangyu Wang, 'An Overview of China's Corporate Law Regime' (2008) <https://ssrn.com/abstract=1222061 or http://dx.doi.org/10.2139/ssrn.1222061> accessed 23 April 2017.
195 Hereinafter 'SL 2005'.
196 Enacted by the standing committee of the NPC on 29 December 1998, first revised on 28 August 2004, second and most recent revision on 27 October 2005, effective on 1 January 2006. Applied to the issuance and transaction of stocks, corporate bonds and any other securities as lawfully recognized by the SC within the territory of the People's Republic of China.

commissions in the State Council and the CSRC is one of them. It is a ministerial-level public institution under the direct control of the State Council.[197] CSRC is responsible for 'enacting rules governing companies such as corporate structure, information disclosure, listing of companies, shareholder protection and directors' system'.[198] The CSRC is regarded as the central regulatory institution in Chinese corporate governance systems given the fact that it is responsible for almost every aspect of corporate governance, such as information disclosure, shareholder protection and listing rules.

The CSRC places great emphasis on good corporate governance and its main effort is the promulgation of various regulations, circulars, standards and guidelines.[199] Among these regulations, the Code of Corporate Governance for Listed Companies in China is the most comprehensive code regulating the governance of public companies listed on China's stock exchange and unlike the 'comply or explain' approach in UK corporate governance code, the Chinese code requires mandatory compliance. Besides the power of legislation, the CSRC is also entitled to sanction those who fail to comply with its regulations. The third level concerns the local regulations and rules of local government. Unlike the state's role in the US corporate area, Chinese local government does not use its legislative power frequently in terms of corporate governance. Unlike the Anglo-American system, the stock exchange operates as a self-regulatory body to govern the behaviour on the stock exchange. However, in China, the SSE and SZSE are two subsidiaries of the CSRC, and the CSRC appoints their senior personnel. Therefore, the regulations published by the SSE and SZSE could be regarded as the third layer in the legislative system. Similar to many other stock exchanges, the SSE and SZSE are not only markets that provide capital-raising and share-trading functions, but also undertake a number of regulatory tasks, such as rules and standards in trading, listing,

[197] Official website of China Securities Regulatory Commission <http://www.csrc.gov.cn/pub/csrc_en/about/> accessed 23 April 2017.

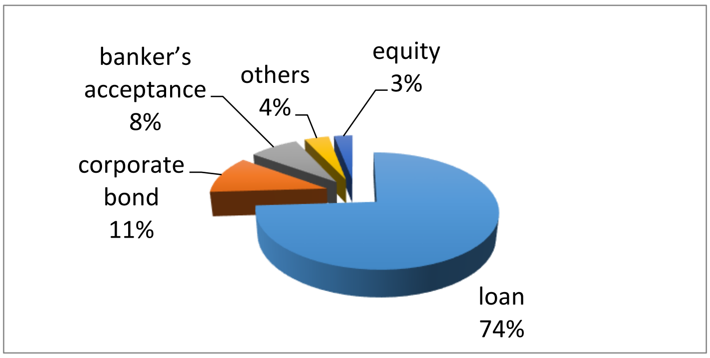
[198] Ibid.

[199] These include 'August 2001 Guidance Opinion on the Establishment of an Independent Directors System in Listed Companies'; 'January 2002 Code of Corporate Governance for Listed Companies; December 2004 The Provisions on Strengthening the Rights and Interests of Public Shareholders'; 'March 2006 Guidelines on Articles of Association for Listed Companies'; 'March 2006 Rules on the General Shareholders' Meeting of Listed Companies'; 'January 2007 Administrative Measures for the Disclosure of Information of Listed Companies'; 'July 2007 Interim Measures for the Administration of State-owned Shareholders' Transfer of Their Shares of Listed Companies'; 'October 2014 Measures for the Administration of the Takeover of Listed Companies'; 'October 2014 Several Opinions on Reforming, Improving and Strictly Implementing the Delisting System of Listed Companies'.

disclosing and investor protection.[200] These rules clearly illustrate the rights and responsibilities of any one who participates in the stock exchange market and serve as a significant tool in regulating the behaviour of market players.

1.3.2.2.2 External market mechanism

There are several market mechanisms that serve as additional constraining forces. The first is the capital market. A well-developed financial market is extremely important when considering its role in disciplining the behaviour of companies. It is beyond argument that the UK and US both have the most effective capital markets in the world and this plays a great role in promoting business entities. Although China established its stock exchange in the 1990s and has experienced great development during recent years, the development of the capital market is still restricted by political and ideological factors. Given the inefficient capital market, companies must instead rely on alternative sources of financing for growth, such as influential wealthy families, large banking institutions, other companies or governments. Figure 1.2 shows that loans from various sources comprise the major portion of financial capital and equity remains a small component in China. As providers of capital, these parties' objectives may differ from the pure financial returns that the investing public seeks. Therefore, their capacity to act as a disciplining mechanism might not coincide with the interests of shareholders and stakeholders, and the effect of the capital market as an external governance mechanism is quite disappointing.



[200] These include: Trading Rules of Shanghai Stock Exchange; Trading Rules of Shenzhen Stock Exchange; Rules Governing the Listing of Stocks on Shanghai Stock Exchange; Rules Governing Listing of Stocks on Shenzhen Stock Exchange; Guidelines on Protection of Investor Rights and Interests for SME Board

Figure 1.2: Composition of corporate financing[201]

The second mechanism is the labour market. In China, as will be analysed later, the Chinese government is in the position to appoint key personnel to listed companies and exert great political influence over these companies' operations. It is therefore not surprising that the labour market is quite undeveloped.

The third mechanism is the product or service market. Given the fact that most SOEs benefit from a monopoly position, the product or service market is not fully functional in China and even if the company is poorly run and its products do not compete successfully, SOEs will not be affected due to its monopoly position. However, the market for corporate control, which is regarded as an important market discipline in the UK and US, exercises limited influence in the Chinese context. On the one hand, according to one commentator, 'the presence of highly concentrated ownership structures with large blocks of non-tradable shares, combined with inadequate information disclosure, regulatory barriers and inexperienced management suggest that the market for corporate control remains under-developed and ineffective'.[202] In a market like this, misconduct suffers from limited punishment. On the other hand, companies that perform badly could easily conceal their failure through manipulating or misleading investors; for example, the losses caused by low share prices could be transferred to investors through insider trading. In such a market, the function of a corporate control mechanism is impaired substantially.

1.3.2.3 Political governance

As has been shown, the management of legitimacy to guarantee the CPC's ruling position requires it to maintain control of SOEs, which constitutes the most important pillar of the Chinese economy. In order to maintain official ideology, Party organizations are established within SOEs to ensure the Party's ideological influence.

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[201] Data selected from *China Statistical Yearbook* China (Statistics Press 2012) and analysed by the present author.

[202] Thomas W Lin, 'Corporate Governance in China: Recent Developments, Key Problems and Solutions' (2004) Journal of Accounting and Corporate Governance < https://msbfile03.usc.edu/digitalmeasures/wtlin/intellcont/04JACG-LIN_CHINA%20CorpGov-1.pdf> accessed 06 September 2017.

Therefore, political governance is exercised from two perspectives: (1) the SASAC and other ministries, who act as the de facto shareholders,[203] and tightly control the SOEs and (2) Party organizations continue to influence the operation of SOEs from inside.

State assets belong to the state, namely the Chinese people as a whole, according to State Assets Law.[204] Therefore, the State Council represents all the people to exercise the functions and responsibilities of the 'shareholders' and claims it regulates for the public good.[205] The State Council further delegates or assigns powers to SASAC, as well as other ministries according to the nature of the enterprises. At the central government level, several ministries and commissions are responsible for SOEs separately. SASAC is only responsible for the central SOEs that provide public products, such as telecommunications, petroleum, infrastructure and other industrial goods. All financial SOEs are monitored and regulated by the China Insurance Regulatory Commission,[206] China Banking Regulatory Commission[207] and the CSRC. Other ministries and commissions are responsible for SOEs in their own department, such as tobacco, gold, publication and broadcast.

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[203] Although they exercise shareholders' rights, duties and responsibilities, they are not entitled to receive the benefits or receive distributed dividends that belong to shareholders. It is the central and local government that do so. Therefore, to some extent, SASAC and other ministries are regarded as de facto shareholders only insofar as it exercises only some of shareholders' power.
[204] Law on State-owned Assets in Enterprises [中国人民共和国企业国有资产法], promulgated by the Fifth Session of the Standing Comm. National People's Congress, 28 October 2008, effective 1 May 2009. (China) (hereinafter 'State Assets Law') art. 3.
[205] State Assets Law art. 4.
[206] Hereinafter 'CIRC'.
[207] Hereinafter 'CBRC'.

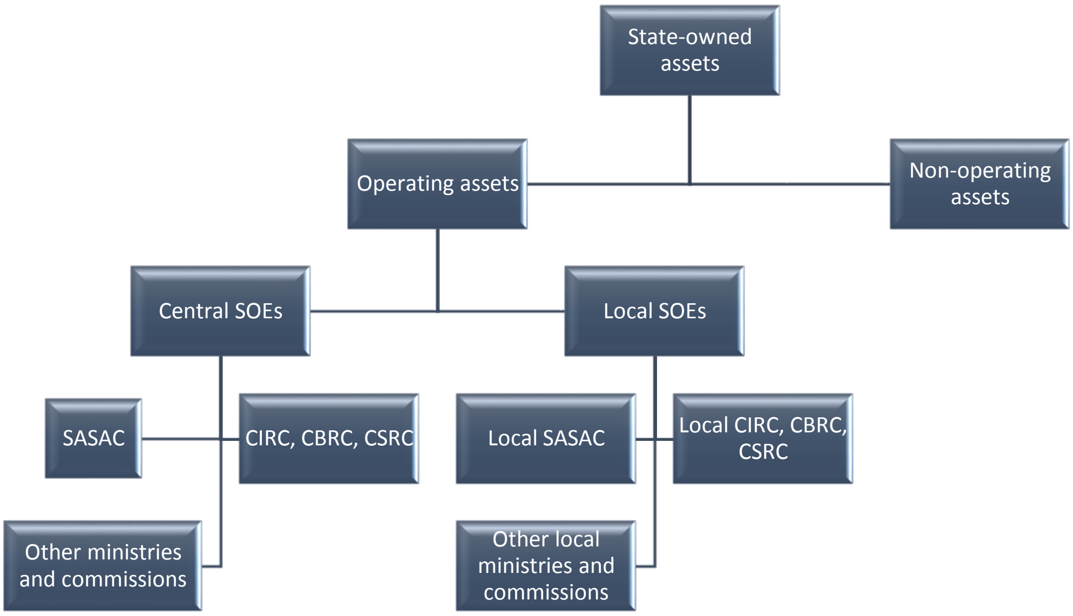

Figure 1.3: The governance of SOEs[208]

According to the Constitution of the CPC, the Party's leadership role in the country 'means mainly political, ideological and organizational leadership'.[209] A 1997 resolution of the CPC Central Committee detailed this leadership in the following manner:

> Maintaining the Party's political leadership over SOEs is a principle of fundamental importance that shall never be shaken and undermined. The political leadership of the Party is embodied in the following aspects: adhering to the Socialist direction of SOEs to ensure that the Party's line, principles, policies as well as state laws and regulations are thoroughly implemented in SOEs; adhering to the principle of Party control of the cadres by lawfully selecting or recommending property representatives on behalf of the state or persons in charge of managing the SOEs according to the respective administrative authorities of the Party organizations concerned, as well as, taking charge of their education, training, evaluation and supervision; and ensuring that the Party

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[208] State-owned assets could be divided into operating assets and non-operating assets. *Non-operating assets* refers to assets that are owned by the state, but not used for operation, such as in real estate or for hospitals and schools owned by government sectors. Reference to listed SOEs, normally refers to the companies that own the operational assets.

[209] Constitution of the Chinese Communist Party [中国共产党章程], promulgated by the Ninth Nat'l Congress Communist Party, effective Apr. 14, 1969, revised by the Eighteenth National Congress Communist Party 14 November 2012) (hereinafter 'CPC Constitution'), Preamble, see <http://www.china.org.cn/ chinese/18da/2012-11/19/content_27156212_2.htm> accessed 16 October 2017.

> organizations play the role of the political core and that individual Party members play exemplary roles in SOEs. The emphasis on upholding the Party's political leadership of SOEs does not mean that the Party should act on behalf of or to replace the government or the enterprise.[210]

Therefore, there are four mechanisms through which the Party exercises its control power:

i All Party members need to advocate and comply with the Party line

The Constitution of the CPC requires all CPC members to comply with the Party's political line[211] and study, understand, and implement the Party line, principles, policies and resolutions, putting 'the interest of the Party and the people above everything, abiding by the Party's discipline, upholding the Party's solidarity and unity, maintaining close ties with the masses to ensure that the Party's policies are implemented, and collecting public views and feedback to inform the Party.'[212] In China, being a CPC member is regarded as being the most advanced individuals in all walks of life, and most of the executives and management are CPC members. Therefore, the Party formed control over SOEs by implementing the Party line along with other rules and regulations. Under certain circumstances, the execution of Party line and Party orders outmatches other duties.

ii The CPC decides on the appointment and dismissal of important personnel in SOEs

The primary principle regarding to the personnel system within the Party is the Principle of Party Control of Cadres.[213] According to this principle, the CPC dominates the

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210 Notice of the Central Committee of the CPC on Further Strengthening and Improving the Party Building Work in SOEs [中共中央关于进一步加强和改进国有企业党的建设工作的通知] promulgated by the CPC Central Committee, Part II, available at <http://cpc.people.com.cn/GB/64162/71380/71382/71383/ 4844844.html> (hereinafter 1997 CPC Notice on Party Building in SOEs).
211 CPC Constitution (n 209) art. 3
212 CPC Constitution, ibid, art. 3.
213 Sebastian Heilmann and Sarah Kirchberger. *The Chinese* Nomenklatura *in Transition: A Study Based on Internal Cadre Statistics of the Central Organization Department of the Chinese Communist Party* (Center for East Asian and Pacific Studies Trier University 2000).

appointment and dismissal of all state officials in China. As the top executives in SOEs enjoying administrative ranks, the CPC regulates and approves their appointment and promotion CPC. CPC members who are accused of wrongdoing are investigated by the related Party department and punished under Party disciplinary codes. Therefore, the CPC 'maintains the nomenclature system that covers cadre selection and appointment in all state-related institutions in China'[214] through this personnel system. This unified management system 'reaches into almost every important nook and cranny in the public sector of the Chinese system'. [215] The Joint Opinions of the CPC Central Organization Department and the SASAC Party Committee prescribe the following:

a. The Party Control of Cadres system requires the Party organization's participation in the appointment, management and supervision of all SOE officers above the middle level. The main responsibility of the Party organization is to set the selection criteria, select the initial candidates, carefully examine these candidates, and recommend these candidates for final appointment. In addition, the Party organization, not the board or general manager, is in charge of supervising the SOE's personnel system.

b. In principle, a balance should be maintained between the principle of Party Control of Cadres and the requirements of China's corporate laws that authorize the board to appoint managers and the general manager to appoint lower-level officers. Technically, the selection of personnel can adopt market-based mechanisms to recruit the most competent and competitive candidates.

c. The appointment of senior corporate executives should follow these steps: (1) the Party organization department's examination of the qualifications of the candidates; (2) the Party Committee's full deliberation of the candidates; and (3) the appointment of the candidates by the board of directors based

[214] Wang (n 131) 639.
[215] Gaye Christoffersen, 'Governing China: From Revolution Through Reform' (1995) 3 China Review International 487.

> on the recommendation of the Party Committee, following all legal procedures and formalities.[216]

In this way, the CPC exercises further controls over SOEs.

iii Party departments are established within the SOEs to ensure that the operation of the company is consistent with the Party line

Each SOE has at least one Party department, known either as the *Party Group* (dangzu), *Party Committee* (*dangwei*) or *Party Subgroup* (*dangzhibu*). The functions of the Party department in SOEs are defined in the CPC Constitution as follows:

> In a state-owned or collective enterprise, the primary Party organization acts as the political nucleus and works for the [better] operation of the enterprise. The primary Party organization guarantees and supervises the implementation of the principles and policies of the Party and the state in its own enterprise and backs the meeting of shareholders, board of directors, board of supervisors and manager (factory director) in the exercise of their relevant functions and powers according to law. It relies wholeheartedly on the workers and office staff, supports the work of the congresses of representatives of workers and office staff and participates in making final decisions on major questions in the enterprise. It works to improve its own organization and provides leadership over ideological and political work, efforts for cultural and ethical progress and the trade unions, the Communist Youth League and other mass organizations.[217]

The 1997 CPC Notice on Party Building in SOEs states the powers and obligations of the Party department in a more explicit way. It requires that the Party organization . . . supervise[s] the enterprise in order to ensure that the CPC line is faithfully implemented, and authorizes it to participate in the decision-making on material and important matters

[216] Joint Opinions on Strengthening and Improving Party Building Work in Central SOEs [关于加强和改进中央企业党建工作的意见], promulgated by the CPC Central Organization Department and SASAC Party Committee (2004), available at <http://cpc.people.com.cn/GB/64162/71380/102565/182143/10993484.html> art. 10. The text was translated by Wang (no 131)

[217] Constitution of the Communist Party of China [中国共产党章程] art. 32 para 2.

of the SOE and provide support to the factory leader/general manager, shareholders' general meeting, board of directors and supervisory board to perform their duties according to law.'[218] Therefore, the board of directors or general manager is required to 'consult and respect the opinion of the Party organization 'before making any important decisions, and brief the Party organization on the implementation of said decision.[219]

1.4 Conclusion

In this chapter the agency problems and the corporate governance mechanisms in the UK, US and China were discussed. In the first section it is shown that the UK model of corporate governance shares many similarities with that of the US (Figure 1.4). These similarities may contribute to the commonalities between these two jurisdictions in terms of legal traditions, regulatory approach, social value, ideology and capital market structure. Under the Anglo-American system, there is usually a shareholder body that formally has the right to use its voting power to select the board of directors and decide on key issues in the company; a single board of directors who enjoy the power to manage the company and appoint the management team. However, no single mechanism can provide an answer to the vertical agency problems between shareholders and management. Therefore, external mechanisms have a role to play in mitigating this agency cost. The UK and US place great emphasis on transparency and disclosure to ensure business is conducted in an open and transparent way. In addition, both these countries have highly decentralized and well-developed equity markets, and are greatly dependent on equity finance, which promotes the market for corporate control and the role of takeover is quite dynamic and its functions can be effectively brought into play.

218 Central Committee of the CPC, 'Notice of the Central Committee of the CPC on Further Strengthening and Improving the Party Building Work in SOEs' [中共中央关于进一步加强和改进国有企业党的建设工作的通知], promulgated by the CPC Central Committee, Zhong Fa [1997] 4 Hao, 24 January 1997) part II, available at <http://cpc.people.com.cn/GB/64162/71380/71382/71383/4844844.html> (hereinafter '1997 CPC Notice on Party Building in SOEs').

219 Ibid, 1997 CPC Notice on Party Building in SOEs, part IV.

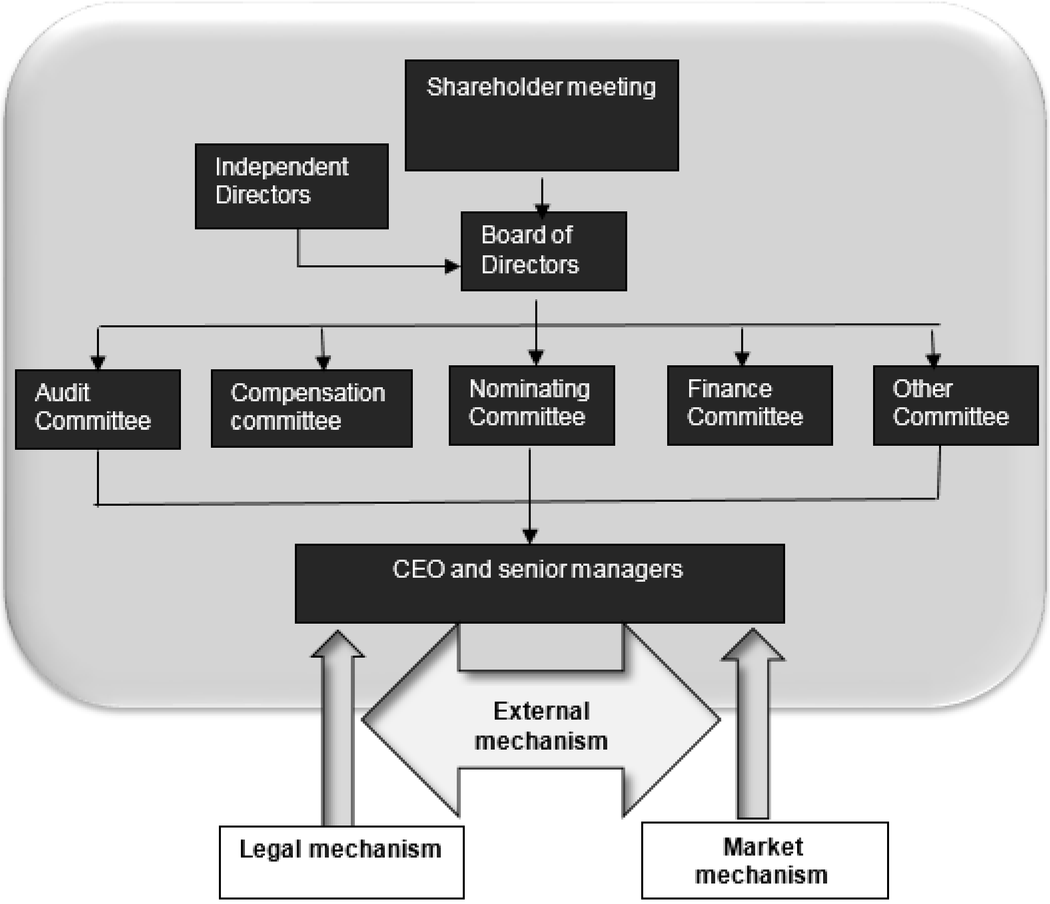

Figure 1.4: Anglo-American model of corporate governance

In China the legitimacy management to strengthen the ruling position of the CPC is embodied in every aspect of SOE development and, therefore, leads to both vertical and horizontal agency problems within SOEs. The corporate governance framework in Chinese SOEs could be regarded as a combination of features from different jurisdictions, but working together to guarantee that SOEs are within the CPC's control. In terms of the internal governance structure, unlike the 'permissive regime' adopted by its UK counterpart, the Chinese internal governance system relies heavily on a mandatory approach to prescribe a clear allocation of decision-making power among shareholder meetings and the board of directors. In order to make the control system more efficient, a two-tier governance system was established, which benefits from the independent directors of the single-tier governance structure in the Anglo-American system and supervisory board of two-tier governance system in Germany. In terms of the external mechanism, the role of the external market mechanism in China, that is, capital market, labour market, product or service market, and market for corporate control, is limited. The most important feature embodied in the Chinese model of corporate governance is the ruling position of the CPC. Although SOEs are organized in the corporation form, the Party still controls SOEs through both general requirements on policy compliance and specific powers such as appointing the senior executives of SOEs (Figure 1.5).

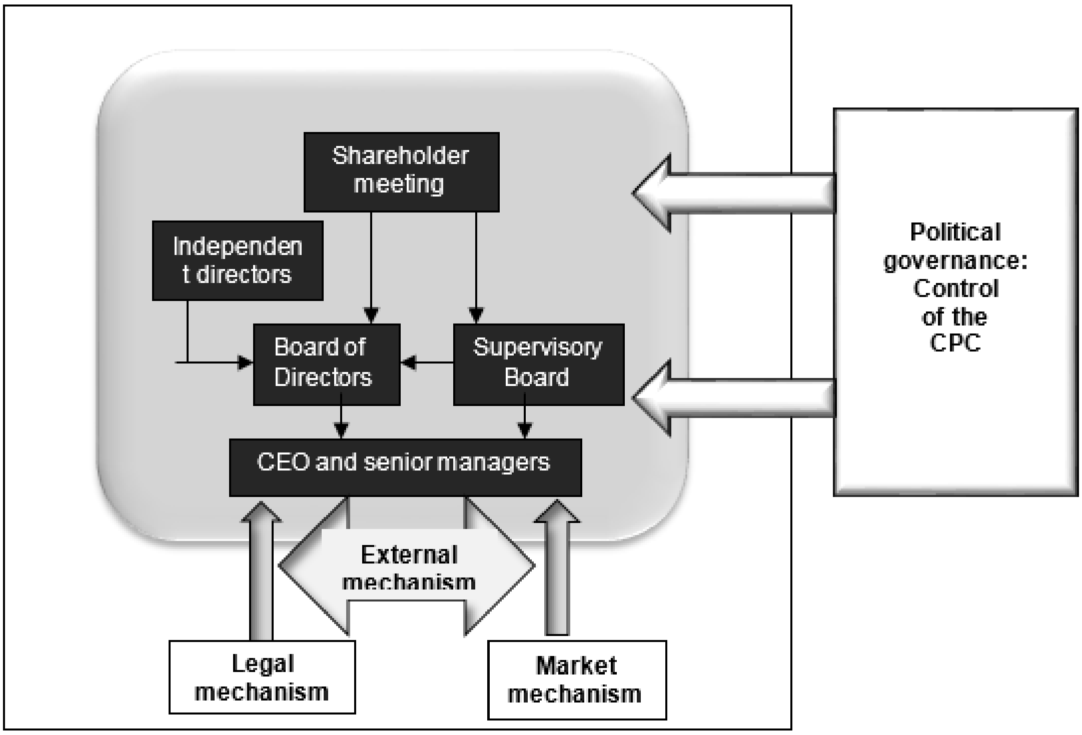

Figure 1.5: Chinese model of corporate governance

This chapter points out that two classic mechanisms are usually deployed to mitigate agency costs. One is the utilization of legal measures. By allocating powers and responsibilities sophisticatedly between the shareholders, directors and managers, the company could operate with minimum internal friction. In addition, the rules and regulations could act as deterrents by punishing misconduct. The second is the market mechanism. The market for corporate control, capital market, labour market, product or service market work together to provide a second layer of protection. Although an attempt has been made to build a sophisticated mechanism to make sure the corporate is operated efficiently with minimum agency costs, the defects in the corporate governance system make it hard to realize. In recent decades increasing power has emerged in the UK, US and in China through the rise of the institutional shareholders.

The massive developments in the scale of institutional investors, together with increases in their level of corporate governance activity, suggest the possibility of the beginning of a new era in the relationships between investment institutions and the corporates in which they invest. Institutional shareholder activism, for many scholars and officials, is the solution to corporate governance problems. Do they fulfil this expectation? The following chapters will attempt to answer this question.

Chapter 2: The Development and Typologies of Institutional Shareholders

From the early twentieth century institutional investors have been developing rapidly in the UK and US. Although Chinese institutional investors have had a late start, they have been catching up quickly in recent decades. Although there is no simple and fixed definition of *institutional investors*, it usually means ‘specialized financial institutions that manage savings collectively on behalf of small investors toward a specific objective in terms of acceptable risk, return maximization, and maturity of claims’.[1] This chapter examines the evolution of institutional shareholders to see how they have become a viable and important player in the securities market through time. A clear picture of the environment in which institutional investors developed provides a better understanding of their behaviour. Data that characterizes the growth and size of institutional investors is then presented. As institutional investors vary in their purpose, objects, operations and organizational form, it is necessary to look into different types of institutions. However, although the present author is fully aware of the fact that the list of institutional investors is incomplete, given the limited available data, space constraints in the thesis and the influence exerted on corporate governance, only institutional shareholders, which accounted for a relatively large percentage according to the share ownership figures will be examined. Other types of institutional investors, such as foundations and endowments could form part of future studies. The chapter ends with a probe of the reasons for the development of institutional investors and a conclusion is drawn at the end.

2.1 The development of institutional investors in the United Kingdom and United States

The emergence of institutional investors was related to the Age of Discovery in the seventeenth century when the extensive exploration and the establishment of overseas colonies by the Europe powers dominated the economy. Frequent trading spawned the merchant class and, among them, the elite and economists who proposed Mercantilism.[2] Mercantilism was aimed at promoting governmental regulation of the economy for the

[1] E Philip Davis and Benn Steil. *Institutional Investors* (MIT Press 2004) 12.
[2] Robert B Ekelund Jr and Robert F Hébert, *A History of Economic Theory and Method* (5th edn, Waveland Press 2007).

purpose of augmenting state power and one way was to accumulate monetary reserves through a positive balance of trade. The expansion and exploitation of the colonies therefore gave birth to the first collective investment scheme in the world: the Foreign and Colonial Government Trust in the UK.[3] The emergence of the very first institutional investors marks the beginning of the development of institutional investors. As discussed in chapter 1, the dispersed ownership structure in the UK and US took decades to come into being, and the rise and development of institutional investors was part of this process. The following section looks at the rise and development of institutional shareholders in the UK and US respectively from a historical perspective and the factors that promoted their development.

2.1.1 Development of institutional investors in the United Kingdom

Chapter 1 showed that professional brokers and dealers were well developed at the end of the eighteenth century and led to the formation of an effective market for the trading of securities (the London Stock Exchange). By the 1830s a sizeable number of enterprises, operating in fields such as utilities, transport, banking, insurance and mining, had publicly traded shares. Company law reform occurring in this stage improved the legal climate for corporate enterprise, giving those operating businesses a straightforward and reliable procedure to incorporate a company with full legal personality, transferable shares, limited liability and other essential corporate attributes.[4] This greatly promoted the growth of corporate enterprises and by the mid-nineteenth century the largest railways seemed to be the pioneers of the modern-style divorce between ownership and control,[5] and they had a sizeable shareholder base. The late nineteenth and early twentieth centuries witnessed a rapid growth in the number of companies that made the move to the stock market, not only on the London Stock

[3] David Chambers and Rui Esteves, 'The First Global Emerging Markets Investor: Foreign and Colonial Investment Trust 1880–1913' (2014) 52 Explorations in Economic History 13.
[4] Brian R Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford Scholarship online 2010) 165 <http://ukcatalogue.oup.com/product/9780199236978.do> 5 accessed 25 January 2017.
[5] François Crouzet, *The Victorian Economy* (Routledge 1982) 293; Geoffrey Channon, 'A Nineteenth Century Investment Decision: The Midland Railway's London Extension' (1972) 3 Economic History Review 449; Gourvish, Terry Gourvish, *Railways 1830–70: A Business History* (Cambridge University Press 2011) 57, 83.

Exchange, but also on provincial stock exchanges.[6] In addition, most large railways and some banks had established pension plans for their employees. Pension funds grew rapidly and life insurance companies were also an important kind of institutional investor.[7] However, as research conducted by some scholars indicates, corporate shares were not the first option of investment at this stage. Insurance companies generally preferred to invest in debentures[8] and industrial equities made up only 3.9% of total invested assets as of 1903.[9] As for pension funds, they invested almost entirely in fixed interest securities issued by British and overseas governments, and by public utilities.[10] Therefore, institutional investors were relatively minor players at this stage and the shares were still in the hands of blockholders and individual shareholders.[11] Private investors owned upwards of 80% of the securities traded on the London Stock Exchange in the early 1930s.[12] The *Financial News*'s explanation was that '[i]nvestors, on the whole, seem to prefer to have the fun of managing their investments themselves through their own stockbrokers rather than to entrust their savings to an insurance company, an investment trust or a building society.'[13]

This trend remained prevalent and individuals investing on their own behalf dominated the buy side in the UK until after World War II.[14] What needs to be mentioned here is that although the number of individuals owning shares in UK companies kept growing in the interwar years, institutional investment grew in importance at this stage, but

[6] Edward Victor Morgan and William Arthur Thomas. *The Stock Exchange: Its History and Functions* (St. Martin's Press 1971).
[7] William P Kennedy, *Industrial Structure, Capital Markets and the Origins of British Economic Decline* (Cambridge University Press 1987) 131-132.
[8] See Lance E Davis and Robert E Gallman, *Evolving Financial Markets and International Capital Flows: Britain, the Americas and Australia* (Cambridge University Press 2001) 163; see also Mae Baker and Michael Collins, 'The Asset Portfolio Composition of British Life Insurance Firms' (2003) 10 Financial History Review 153.
[9] H.A.L (Hugh Anthony Lewis) Cockerell and Edwin Green, *The British Insurance Business: A Guide to its History and Records*, (2nd edn Sheffield Academic Press 1994) 114.
[10] Leslie Hannah, *Inventing Retirement: The Development of Occupational Pensions in Britain* (Cambridge University Press 1986) 10–12, 18–19.
[11] Gordon Boyce, *Information, Mediation and Institutional Development: The Rise of Large-Scale Enterprise in British Shipping, 1870–1919* (Manchester University Press 1995) 89.
[12] Ranald C Michie, *The London Stock Exchange: A History* (Oxford University Press 1999) <https://books.google.co.uk/books/about/The_London_Stock_Exchange.html?id=DygTDAAAQBAJ&printsec=frontcover&source=kp_read_button&redir_esc=y#v=onepage&q&f=false> accessed 25 January 2016 258; Bank of England, 'Historical United Kingdom Overseas Investments 1938-1958' <http://www.bankofengland.co.uk/archive/Pages/digitalcontent/historicpubs/ukoi.aspx> accessed 25 January 2016.
[13] Michie, *ibid.*
[14] P Sargant Florence, *The Logic of British and American Industry: A Realistic Analysis of Economic Structure and Government* (Routledge 2003) 187–189.

nevertheless played only a supporting role in comparison to direct investment in shares by individuals. On the one hand, life insurance companies, who are the first institutional investors, began to treat UK equities as a serious investment option during the interwar years, with nearly 10% of British life assurance assets being invested in ordinary shares by 1937.[15] On the other hand, institutional investment organisations, such as the Pensions and Lifetime Saving Association[16] established in 1932, the Association of Investment Trust Companies[17] formed in 1932, and the Association of Unit Trust Managers[18] formed in 1959. They represent the interest of different institutional shareholders, play an active role in the growth of institutional investment.

In 1957, detailed statistics on share ownership were published for the first time and individual investors held 66% of the shares of UK public companies. By 1969, retail investors no longer owned a majority of the shares of UK public companies and institutional investors largely filled the gap. A survey of London's financial district observed that institutional shareholders had become 'the mainstay of the stock markets' as '(t)he rich and well-to-do who used to invest their savings through the Stock Exchange are not now able to save on any scale' and 'only the institutions . . . have "new money" to invest'.[19] By 1975 pension funds and insurance companies held more than 33% of the shares of UK public companies.[20] Investment trusts and unit trusts were of lesser importance but still qualified as the third and fourth legs of the institutional market.[21] The fact that institutional investors became the dominant buyers of UK shares after World War II could be attributed to several aspects. First, tax was of central importance. Given the fact that high rates of tax were imposed on dividends, those private investors with large incomes therefore turned to forms of savings that received more favourable tax treatment and this provided them with strong incentives to invest

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[15] Cheffins (n 4), ch 8.
[16] Hereinafter 'PLSA'. It used to be the National Association of Pension Funds (NAPF).
[17] Hereinafter 'AITC'.
[18] In 1976, the Association of Unit Trust Managers was renamed the *Unit Trust Association* (hereinafter 'UTA'). The UTA was rebranded *the Association of Unit Trusts and Investment Funds* (hereinafter 'AUTIF') in 1993. In 2002, AUTIF merged with the Fund Managers' Association (hereinafter 'FMA') and created the Investment Management Association (hereinafter 'IMA').
[19] Quoted by Cheffins (n 4) from Oscar R. Hobson, *How the City Works* (5th edn News Chronicle Book Department 1955) 120.
[20] Cheffins (n 4) 134.
[21] Peter G Moore, 'The Wilson Committee Review of the Functioning of Financial Institutions: Some Statistical Aspects' (1981) Journal of the Royal Statistical Society Series A (General) 35.

through financial intermediaries.[22] As the *Economist* observed in 1979, 'Tax efficiency has replaced productive efficiency as the main criterion in many investment decisions because of tax rates that make the actual returns on capital almost irrelevant to personal investors.'[23] Pension funds were the beneficiaries that benefited from the tax privilege. With no tax being levied on pension funds' investment income or on capital gains, pension funds were regarded as 'gross funds'. [24] Life insurance was another example of a tax-advantaged investment vehicle. Private investors therefore turned to these forms of tax-favoured institutional investment by forsaking their direct ownership of shares.[25] As the *Economist* stated in 1977, 'The enormous advantages of institutional saving for the rich who might once have invested in equities but who are now prevented from doing so by tax, explains the overwhelming dominance the institutions have acquired in the stock market.'[26] The second factor would be the attraction of UK equities. On the one hand, British investors used to allocate a sizeable proportion of capital to overseas assets, particularly in the late nineteenth and early twentieth centuries. However, the regulatory regime, which was initially introduced under the Exchange Control Act 1947, tightly restricted overseas portfolio investment.[27] On the other hand, the 1979 election brought Margaret Thatcher's market-friendly Conservatives to power, and the corporate profitability rebounded strongly after slumping in the 1960s and 1970s.[28] Institutional investors selected corporate equities as a good option when investing. Returns for investors during the 1980s were higher than in any other decade during the twentieth century.[29] The third reason would be company law and stock exchange regulation. In the decades following World War II, amendments made to company legislation and alterations made to stock exchange listing rules both played a role. The Companies Act 1948 stated that the annual profit

[22] Committee to Review the Functioning of Financial Institutions (Chairperson, Sir Harold Wilson) (hereinafter 'Wilson Committee'), 'Evidence on the Financing of Trade and Industry', vol. 3 (1977) 269; Marshall E. Blume, 'The Financial Markets' in Richard E Caves and Lawrence B Krause (eds), *Britain's Economic Performance* (Brookings Institution 1980) 317.
[23] 'Personal Finance' (Survey) *The Economist* (24 March 1979) 22; cited by Cheffins (n 4)
[24] David Blake, *Pension Schemes and Pension Funds in the United Kingdom* (2nd edn Oxford University Press) 38–40.
[25] Blume (n 22) 317.
[26] Cheffins (n 4) 49.
[27] Benjamin J Cohen, 'The United Kingdom as an Exporter of Capital', in Fritz Machlup, Walter S Salant and Lorie Tarshis (eds), *International Mobility and Movement of Capital* (Columbia University Press 1972) 25, 37; Stephen Bond, Evan Davis and Michael Devereux, *Capital Controls: The Implications of Restricting Overseas Portfolio Capital* (Pearson Education Limited 1987) 18–23.
[28] Christine Oughton, 'Probability of UK Firms' in Kirsty Hughes (ed), *The Future of UK Competitiveness and the Role of Industrial Policy* (Policy Studies Institute 1993) 55, 58.
[29] Cheffins (n 4) 353.

and loss accounts, which were previously only available to shareholders, required to be filed publicly.[30] An additional 1948 departure from past practice was detailed regulation of the form and content of both the balance sheet and the profit and loss account.[31] Another innovation was to require company accounts to be prepared so that they gave a 'true and fair view' of a company's financial position.[32] Finally, the 1948 Act tightened up disclosure requirements for holding companies and their subsidiaries.[33] Under the new scheme, a holding company's balance sheet, and profit and loss account had to be presented in the form of group accounts giving a true and fair view of the state of the affairs of the group as a whole. Further changes were made to disclosure regulation in the 1980s. The Companies Act 1981 obliged companies for the first time to require that accounts be prepared in a standardized format.[34] The Financial Services Act 1986 empowered the Stock Exchange's listing rules with the status of subordinate legislation as the Stock Exchange is regarded as the competent authority responsible for promulgating and enforcing listing requirements for companies with publicly traded shares.[35] The Act also specified the Stock Exchange's enforcement powers, stipulating that the Exchange could suspend trading in a company's shares and publicize breaches of its listing rules.[36]

From then on, institutional investors acted as the dominant players in the UK equity market. Owing to scientific and technological progress, and financial innovation, mutual funds grew rapidly and hedge funds emerged in the recent decade. Figure 2.1 shows that pension funds, insurance companies, mutual funds and hedge funds are the main institutional investors in the UK and from 1998 to 2014, the ownership was still widely held by individuals and various financial intermediaries, such as pension funds, unit trusts and insurance companies. The rest of the world witnessed tremendous growth, holding 53.8% in 2014. Figure 2.2 shows that among institutional shareholders, insurance companies, pension funds, unit trusts and other financial institutions, collectively accounted for a large percentage of shares by value.

[30] Companies Act 1948, ss 126(1), 127(1), 156(1).
[31] Companies Act 1948, s 149(2).
[32] Companies Act 1948, s 149(1).
[33] Companies Act 1948, ss 150–53.
[34] Companies Act 1981, s 62.
[35] Financial Services Act 1986, ss 142(6), 143–44.
[36] Financial Services Act 1986, ss 145(b), 153.

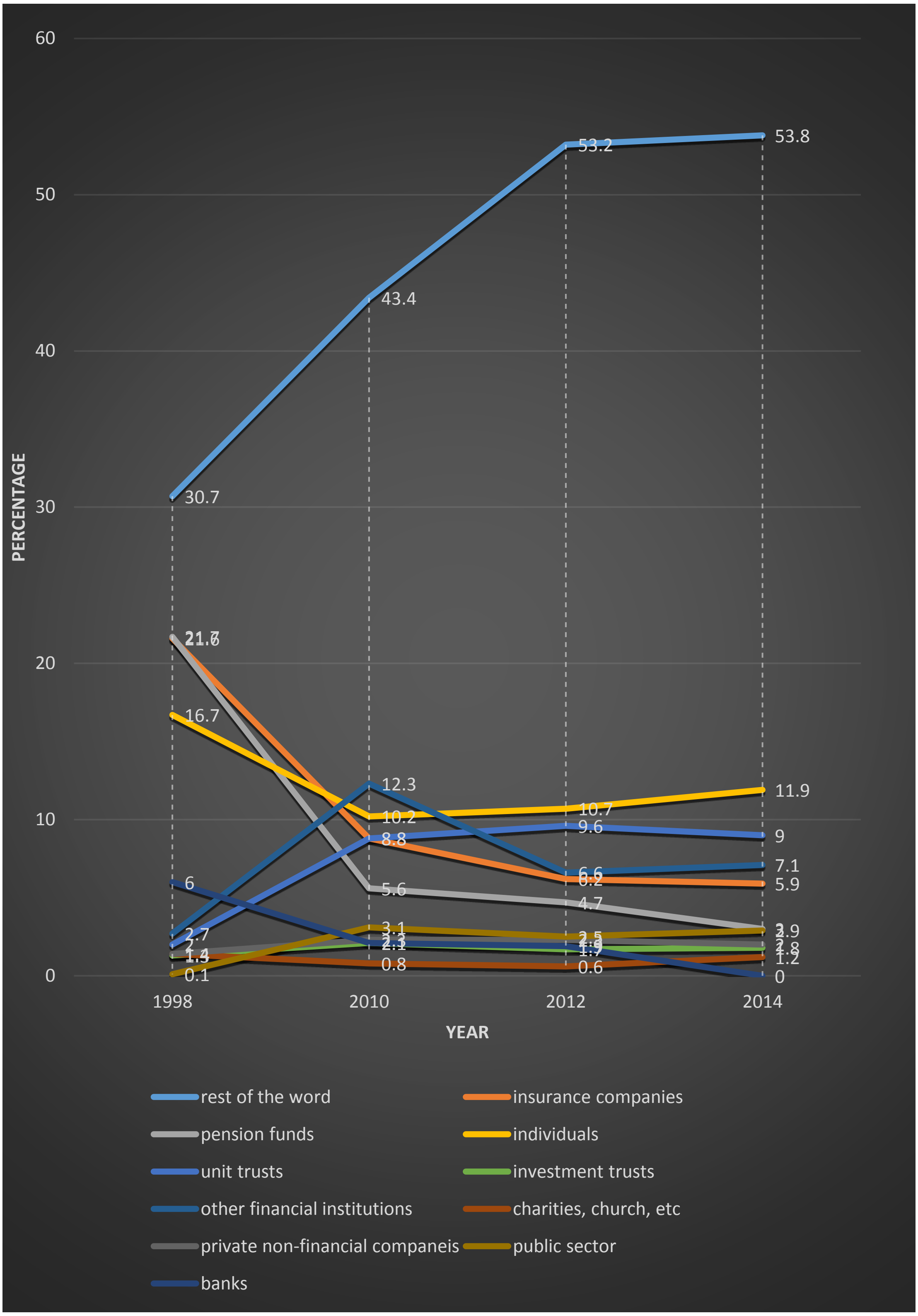

Figure 2.1: Beneficial ownership of UK shares by value from 1998 to 2014[37]

[37] Data reproduced from National Statistics Online Database <http://www.ons.gov.uk/ons/rel/pnfc1/share-ownership---share-register-survey-report/2014/stb-shared-ownership.html > accessed 02, Feb, 2016. Analysed by the author.

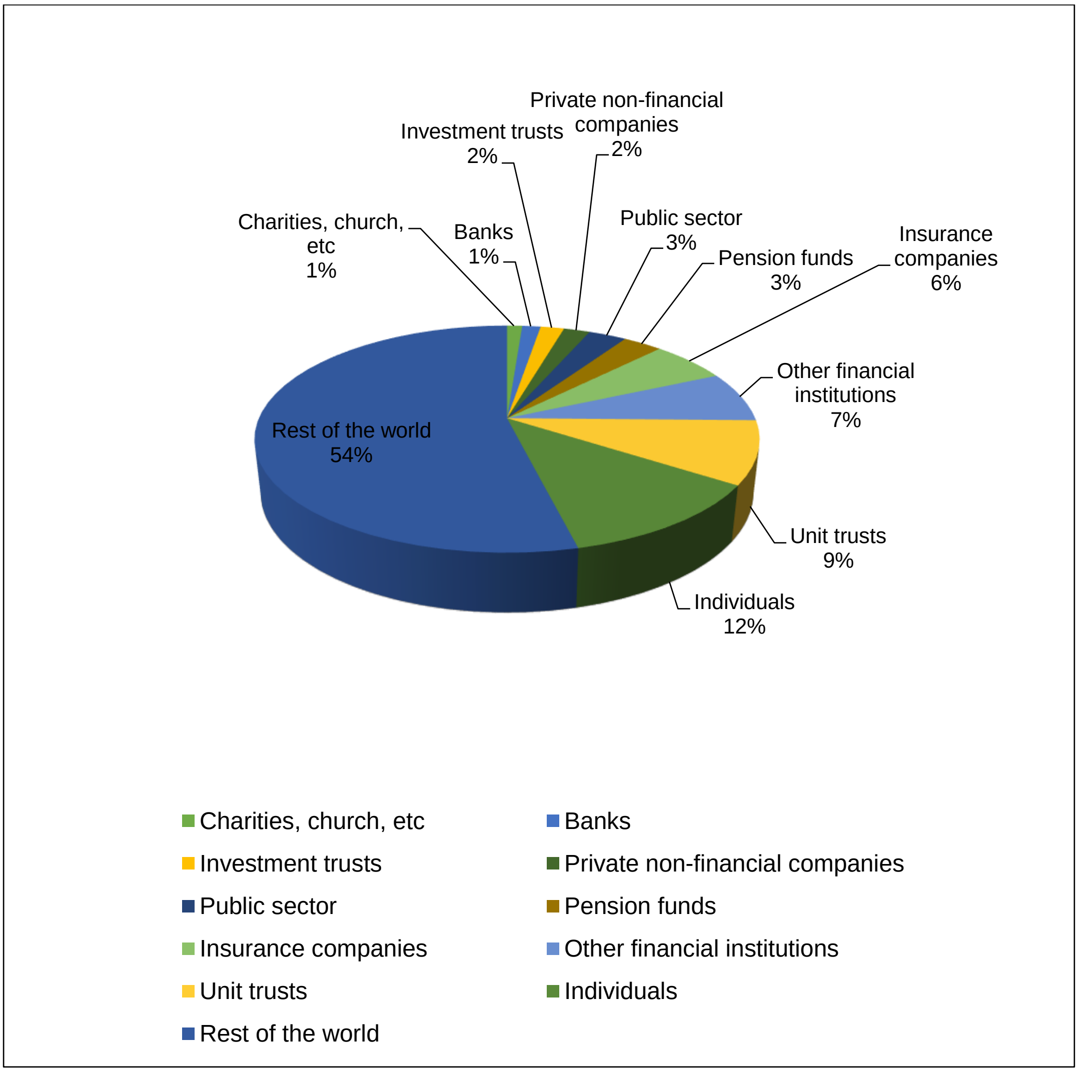

Figure 2.2: Percentage of UK stock market owned by value in 2014 [38]

2.1.2 Development of institutional investors in the US

As explained in Chapter 1, until the nineteenth century, corporations established in the US were limited to public interest enterprises[39] and they were mainly in the form of individual proprietorship and partnership and business enterprises. Throughout the nineteenth century mainly privately held industrial enterprises with family control was

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[38] Analysis based on figure 2.1.

[39] Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property* (MacMillan 1932).

very much the norm.[40] The 'corporate revolution',[41] which occurred between 1880 and 1930, witnessed the flourishing of the stock market and the public securities market.[42] During this stage, as Berle and Means described in their work *The Modern Corporation and Private Property*, there was 'a shift in corporate ownership . . . of almost revolutionary proportions'.[43] Data compiled by Means reveal that the number of Americans who owned shares rose dramatically between 1916 and 1921, with the middle class being the main contributors.[44] Although the ownership was, to some extent, dispersed during this stage, institutional investors were negligible and their holdings were small.[45]

The stock market crashed in 1929 which greatly influenced the US economy in the 1930s and the damages to institutional investors were inevitable. Many reasons accounted for this great depression, among which the weakness in the banking system, the speculation that prevailed in the stock market and economic imbalances were the main factors. Therefore, the US government set out to regulate the financial market. Its first action was to establish the Securities and Exchange Commission.[46] The SEC was set up in 1932 with a view to protecting investors; maintaining fair, orderly and efficient markets; and to facilitate capital formation. It was the federal agency empowered with broad authority over all aspects of the securities industry, including the power to register, regulate and oversee investment companies, investment advisers and broker-dealers; and securities self-regulatory organisations such as the New York Stock Exchange and the NASDAQ.[47] Second, the Securities Act 1933 was promulgated to govern the securities industry. The aim of this enactment was to guarantee the full and fair disclosure of the character of securities. Therefore, the Securities Act 1933

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[40] Naome R Lamoreaux, 'Entrepreneurship in the US, 1865–1920' in David S Landes, Joel Mokyr and William J Baumol (eds), *The Invention of Enterprise: Entrepreneurship from Ancient Mesopotamia to Modern Times* (Princeton University Press 2010).
[41] Reasons behind the corporate revolution were discussed at section 1.2.1.
[42] Gardiner C. Means, *'The Corporate Revolution in America: Economic Reality vs Economic Theory'* (Crowell-Collier Press 1962); Walter Werner, 'Corporation Law in Search of its Future' (1981) Columbia Law Review 1611.
[43] Berle and Means (n 39).
[44] Gardiner Means, 'The Diffusion of Stock Ownership in the US' (1930) 44 Quarterly Journal of Economics 561.
[45] Robert W Hamilton, 'Corporate Governance in America 1950–2000: Major Changes but Uncertain Benefits' (1999) 25 Journal of Corporation Law 349.
[46] Hereinafter 'SEC'.
[47] Information from the official website of the US Securities and Exchange Committee, <https://www.sec.gov/about/whatwedo.shtml> accessed 23 February 2016.

specified the information that a company had to provide when issuing securities in public markets and prohibited deceitful misrepresentation and other fraud in the sale of securities. The Securities Exchange Act of 1934 addressed all aspects of securities transactions and the aim of this Act was to provide regulation for securities exchange and over-the-counter markets so as to prevent inequitable and unfair practices on exchanges and markets.[48] There are many provisions related to institutional investors: first, s13(a) required all issuers of equity securities subject to registration requirements to file annual and quarterly reports and copies thereof as provided by the applicable SEC rules. The general form for annual reports of issuers subject to the Exchange Act regulation and reporting requirements was Form 10-K.[49]. SEC rule 13a-13 sets out the Exchange Act's quarterly reporting requirements for issuers of registered securities which are generally to be filed on Form 10-Q. Disclosure requirements specific to investment companies included (1) annual and semi-annual reports to the SEC on Form N-SAR and Form N-CSR; and (2) annual and semi-annual reports to shareholders. According to s 13(d), those who acquired more than 5% of the stock of an issuer with securities registered under the 1934 Act had to report to the SEC and disclose their intention of doing so. Furthermore, s 16(a) required that every person who was directly or indirectly the beneficial owner of more than 10% of any class of any equity security (other than an exempted security) which was registered pursuant to s 12 or who was a director or an officer of the issuer of such security, had to file the statements required by this subsection with the Commission.[50] The principal statute that governed investment companies was the Investment Company Act of 1940, which was designed 'to mitigate and, so far as is feasible, to eliminate certain conditions, enumerated in that section, which adversely affected the public interest and interest of investors.'[51] The requirement of full and fair disclosure lay the foundation for the US Securities Laws and it tied together all the specific provisions of the Act.[52] Investment companies were therefore generally subject to substantially similar disclosure and reporting requirements that applied to publicly traded companies.

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[48] Maksymilian Del Mar and William Twining, *Legal Fictions in Theory and Practice* (vol 110 Springer 2015) 387.
[49] Thomas Lee Hazen, *The Law of Securities Regulation* (5th edn West Group) 414.
[50] Securities Exchange Act of 1934, s 16(a).
[51] Investment Company Act of 1940, s l(b).
[52] See official website of the US Securities and Exchange Commission <https://www.sec.gov/news/speech/spch402.htm> accessed 18 October 2016.

According to the political theory forwarded by Roe, US legislators responded to a populist agenda in the 1930s by limiting the power exercised by large financial institutions. Commercial banks were forbidden to participate in investment banking business and invest in stock as a result of the promulgation of the Glass–Steagall Act in 1933. Mutual funds, were prohibited from investing more than 5% of their regulated assets in the securities of any one issuer according to the Investment Company Act of 1940.[53] Insurance companies, as well as pension funds, were limited by the amount of shares they could own.[54] Therefore, institutional investors were prevented from taking a substantial block position in American business during this stage.

With the rise in an ageing population and the decline in birth rate in the 1970s, a sophisticated social security system was needed. Therefore, the Employee Retirement Income Security Act of 1974[55] was enacted with the aim of regulating the operation of pension plans. This marked the beginning of the extraordinary growth of institutional investors in the US.[56] During the 1980s, institutional investors began to rise due to the increased wealth in society, policy changes and its own popularity.[57] The legal barriers that once prevented the development of institutional investors were loosened, and due to scientific and technological progress and financial innovation, funds became a popular investment tool. The possibility of automatic investment or redemption of funds at current market values made 'open-end' mutual funds an attractive investment option. Many new investors lacked sophistication and were attracted to investment companies that offered professional investment services to small investors at a low cost. Mutual funds and hedge funds grew rapidly. Figure 2.3 indicates that the ownership structure showed only small fluctuations during the period from 2004 to 2015. Apart from the shares owned by individuals, mutual funds were the largest owners of

[53] Mark J Roe, 'A Political Theory of American Corporate Finance' (1991) 91(1) Columbia Law Review 20 < http://www.jstor.org/stable/1122856> accessed 08 October 2016.
[54] ibid 21
[55] Hereinafter 'ERISA'.
[56] Ronald Gilson and Jeffrey Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights' (2013) Columbia Law Review < https://www.law.duke.edu/sites/default/files/centers/gfmc/session_3/1_gilson_and_gordon-agency_costs_of_agency_capitalism-2013.pdf > accessed 08 October 2016.
[57] Hamilton (n 45) 353.

corporate equities, followed by federal and state government retirement funds, private pension funds and insurance companies.

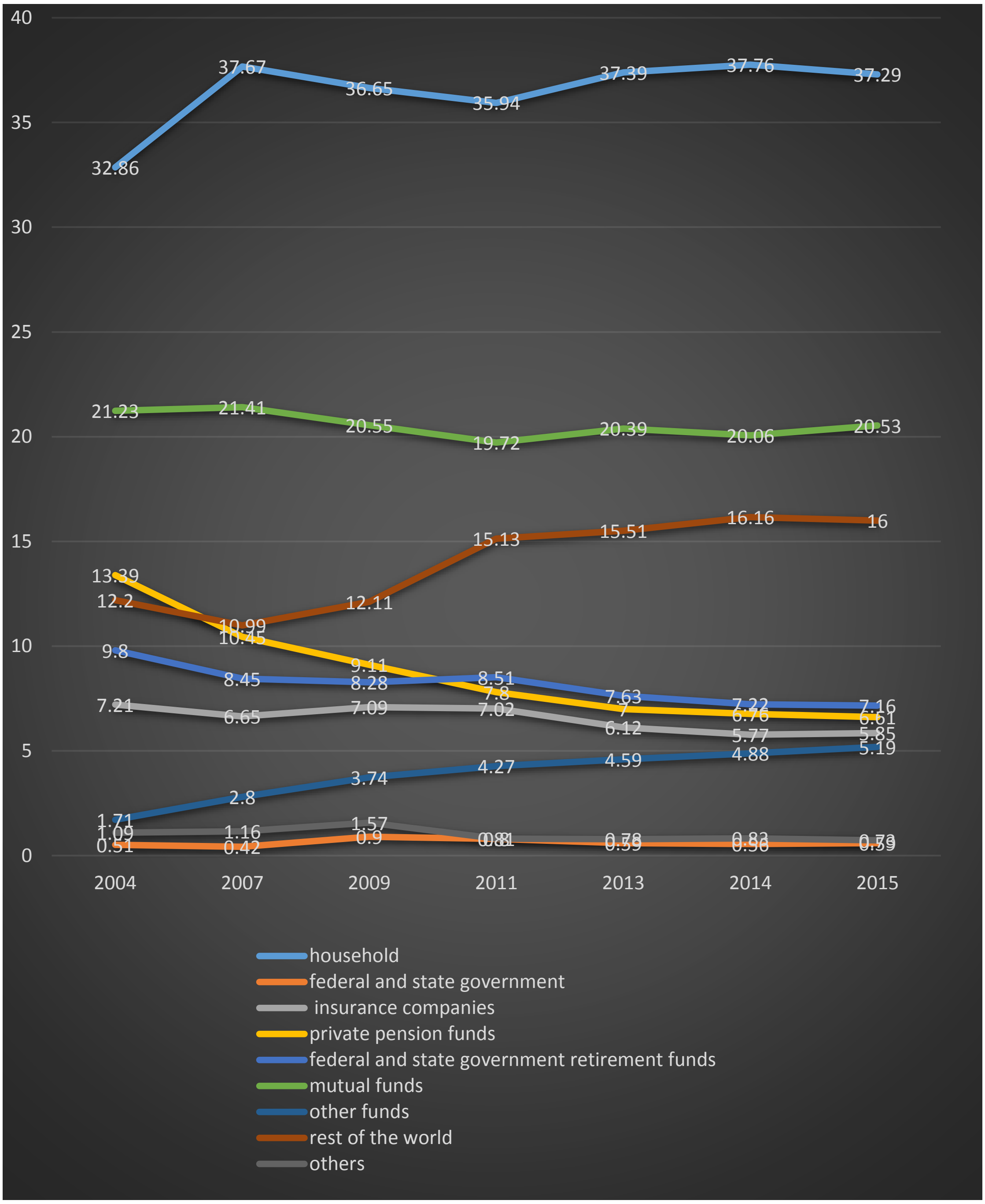

Figure 2.3: Ownership of corporate equities from 2004 to 2015[58]

[58] Data selected from the Financial Accounts of the US Board of Governors of the Federal Reserve System, Washington DC 20551 <https://www.federalreserve.gov/releases/z1/20160310/z1.pdf> accessed on 2 June 2016; analysed by the present author.

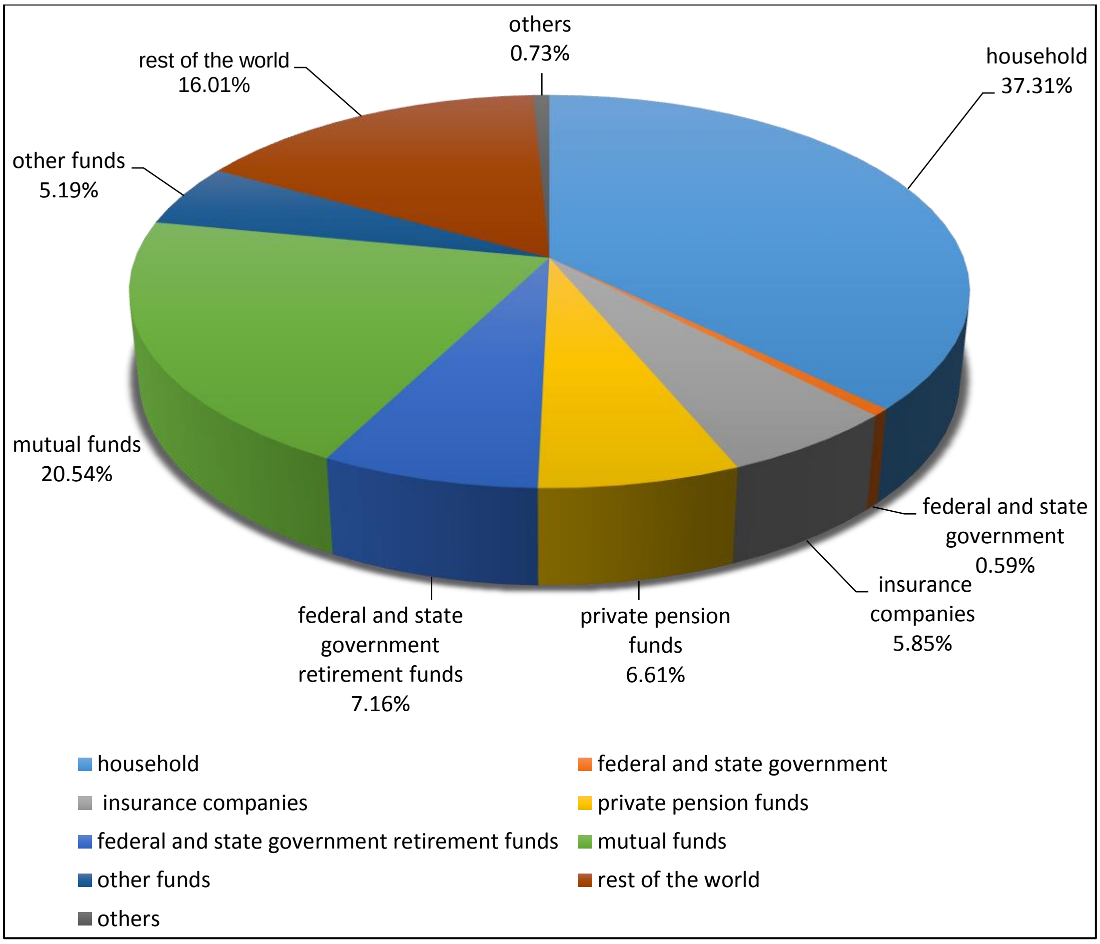

Figure 2.4: Percentage of US stock market owned by value in 2015[59]

2.2 The landscape of institutional investors

2.2.1 Mutual funds

A *mutual fund* is 'a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments'.[60] In the UK, mutual funds offer short-term liquidity on pooled funds and it is either through direct redemption of

[59] Data collected from the Financial Accounts of the US Board of Governors of the Federal Reserve System, Washington DC 20551 <https://www.federalreserve.gov/releases/z1/20160310/z1.pdf> accessed on 2 June 2016; analysed by the present author.

[60] The explanation was quoted from the official website of the US Securities and Exchange Commission, <https://www.sec.gov/investor/tools/mfcc/mutual-fund-help.htm> accessed on 5 June 2016.

holdings, that is, open-end funds, or through the ability to trade shares in the funds on exchanges, that is, closed-end funds.[61]

Closed-end funds in the UK mainly refer to 'investment trusts'. They are public companies rather than real 'trusts' in the legal sense, and are regulated by company law and their shares are traded on the London Stock Exchange.[62] These companies invest in a wide range of assets such as shares, private equity, property and bonds. The directors of the company appoint fund managers who are responsible for the investment decisions and the great majority of investment trusts are managed by external fund management companies.[63]

Open-end funds, can be divided into two categories according to the legal structure under which they fall: (1) unit trusts and (2) open-ended investment companies[64]. They have grown rapidly in the UK and account for more than 9% of the UK stock market. The UK fund industry enjoys the leading position in the number of funds under management, (835 billion pound sterling). It increased by 8.2% compared with 2014.[65] The majority of open-end fund clients are institutional investors, such as insurance companies and pension funds.[66]

A unit trust is a kind of collective investment scheme[67] under which 'the assets are held in trust for the investors, by the trustee, who has legal ownership of the scheme property'.[68] The unit trust is constituted by a trust deed, entered into by the trustee and the manager who are independent of each other, with the manager operating the schemes and the trustee overseeing the activities of the manager. A unit trust is not a

[61] Davis and Steil (n 4).
[62] Geof Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon Press 1996) 23; Paul Myners, 'Institutional Investment in the United Kingdom: A Review' (2001) < http://uksif.org/wp-content/uploads/2012/12/MYNERS-P.-2001.-Institutional-Investment-in-the-United-Kingdom-A-Review.pdf > accessed on 5 June 2016.
[63] Myners (n 62) 73.
[64] Hereinafter 'OEICs'; also known as *investment companies with variable capital* (hereinafter 'ICVCs').
[65] 'Asset Management in the UK 2014–2015: The Investment Association Annual Survey' <http://www.theinvestmentassociation.org/assets/files/research/2015/20150914-ams2014-2015-chapter4.pdf> accessed on 5 June 2016.
[66] 'Asset Management in the UK 2014-2015' (n 65).
[67] Hereinafter 'CIS'.
[68] IMA, 'Authorised Funds: A Regulatory Guide' <http://www.hearthstone.co.uk/getattachment/d1488598-3ff7-4347-ac94-7cc83b77dd89/> accessed on 5 June 2016.

separate legal entity and the investors hold units representing their undivided shares of the trust assets. An OEIC is different from a unit trust from the perspective of its legal structure. It operates under the company structure and cannot exist in unauthorised form.[69] Both unit trust and OEICs are open-ended, which means that units could be issued whenever investors buy certain portions and investors are also free to dispose of their units whenever they want to sell them.

In the US it is usually called an investment company, legally known as an 'open-ended company'. According to the classification of SEC,[70] a mutual fund is one of three basic types of investment companies; the other two are close-end funds[71] and unit investment trusts[72]. Therefore, the mutual fund in the US is basically the same as OEICs in the UK. A mutual fund is the most popular investment choice in the US due to its professional management, diversification and liquidity.

There are basically three main types of mutual funds in the US:

1. *Money market funds:* This is a type of mutual fund with relatively low risks compared with other kinds of mutual funds. They are required by law to invest in certain high-quality, short-term and low-risk investments issued by the US state and local government and corporations.[73]
2. *Bonds fund:* This is another type of mutual fund with higher risks compared with money market funds, mainly because of the high yield strategies they pursue. Unlike money market funds, bond funds are not limited to certain

[69] The formation of OEICs is governed by prt II of the OEIC Regulations, which state that an OEIC is incorporated upon the coming into effect of an authorisation order from the FCA. Since the only method of incorporating an OEIC is through this FCA authorisation procedure, it is not possible to have an unauthorised OEIC in the UK (unlike a unit trust, which may be either authorised or unauthorised).
[70] This classification is quoted from the official website of the US Securities and Exchange Commission, <https://www.sec.gov/investor/pubs/inwsmf.htm> accessed on 15 June 2016,
[71] Closed-end funds, which sell a fixed number of shares at one time that are later traded on a secondary market.
[72] Hereinafter 'UITs'; UITs make a one-time public offering of only a specific, fixed number of redeemable securities called 'units' and which will terminate and dissolve on a date specified at its creation.
[73] For more information, see the official website of the US Securities and Exchange Commission, <https://www.sec.gov/answers/mfmmkt.htm> accessed on 15 June 2016.

investments under the SEC rules and they could vary dramatically in their risks and rewards.[74]

3. *Stock funds:* These funds can be contrasted with money market funds and bonds funds as they are invested in stocks. They aim to provide long-term growth even though their value is likely to experience more ups and downs over the short term.

2.2.2 Insurance companies

The second type of institutional shareholder which is important is insurance companies. As the third largest insurance and long term savings industry in the world, they are second largest domestic equity holders in the UK, collectively holding 9% of investment in the UK stock market in 2014 (see Figure 2.5). Although it has experienced some decreases, insurance companies still play an essential part in the UK's economic strength.[75] Meanwhile, the US is the world's largest insurance market by premium volume.[76]

[74] Office of Investor Education and Advocacy, SEC 'Mutual Funds: A Guide for Investors' <https://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf> accessed on 15 June 2016.

[75] ABI, 'UK Insurance and Long Term Savings Key Facts 2015' <https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2015/Statistics/Key%20Facts%202015.pdf> accessed 15 June 2016.

[76] Federal Insurance Office, US Department of the Treasury, 'Annual Report on the Insurance Industry', 2016 45 <https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2016_Annual_Report.pdf> accessed 15 June 2016.

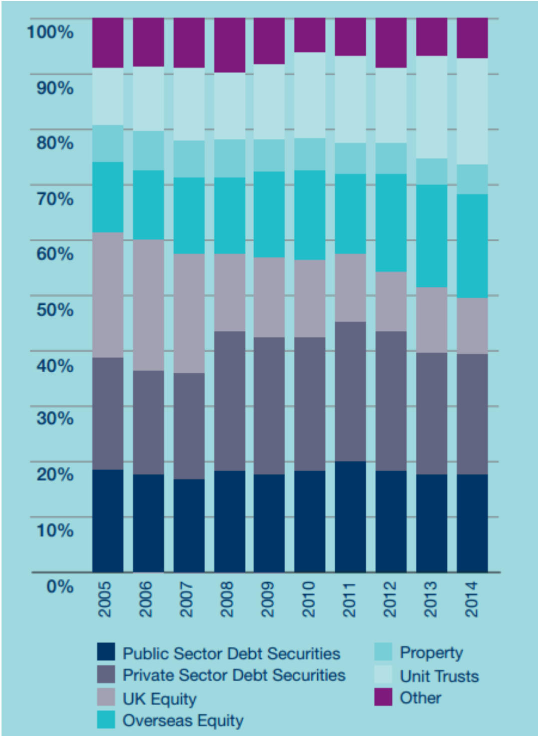

Figure 2.5: Funds managed by insurance and long-term savings providers, by asset class in the UK[77]

The UK insurance industry is mainly constituted of life business and other kinds of long-term insurance contracts, with 90% of the total assets held by them, whereas other forms of insurance, such as household, casualty and health, hold a relatively small percentage.[78] Like insurance in the UK, insurance in the US also consists of life, health, property and casualty. No matter what kind of insurance contract, an individual pays certain amounts of money to insurance companies according to contract and gets back a promissory sum when an insured event happens or upon the termination of the insurance contract.[79] To ensure that the needs of the clients can be met, insurance companies invest in stocks, bonds, real estate or property and other investment goods at maximum return. A large percentage of insurance assets are managed in-house by asset management subsidiaries on behalf of the parent groups' insurance companies or

[77] Figure taken from the UK Insurance and Long Term Savings Key Facts 2015 (n 75).
[78] Ibid.
[79] Davis and Steil (n 4).

have a large insurance component with the group.[80] Insurance companies often act as external fund managers for pension funds.[81]

2.2.3 Pension funds

Since the mid-1990s, UK pension funds have been cutting their holdings of UK equities and have been looking for safer asset classes instead, such as bonds and Sovereign Wealth Funds,[82] but they still occupy a large portion of shares. Pension funds are those who 'collect, pool, and invest assets contributed to provide for the future pension entitlements of beneficiaries'.[83] It could be an unfunded, or funded pension scheme. Unfunded pension schemes are known as 'pay-as-you-go', which are financed 'from the current contributions of the employers and of existing employees or from other revenues on a year-to-year basis'.[84] Beneficiaries have the power to choose from various investment options which vary from higher returns with risky funds to safer funds with low risk. Funded pension schemes are those financed from 'a reserve or fund which has been built up over a period of years by investing accumulated contributions in earning asset'.[85] Unfunded schemes are not discussed in this thesis because they are funded pension schemes that buy shares in listed companies.

Funded pension schemes can be either 'defined benefits'[86] or 'defined contributions'[87]. For those with DB schemes, a defined proportion of their final or career average salary on retirement[88] is provided to them. Both employer and employee make contributions to the scheme which are then invested to generate benefits. Those with DC schemes, unlike DB schemes, have no entitlement to a fixed level of income on retirement and their income is determined by 'the performance of investments brought with the contributions they have made to the scheme'.[89] In the past, most pension funds were set

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80 UK Insurance and Long Term Savings Key Facts 2015 (n 75).
81 Ibid.
82 Hereinafter 'SWF'; Law Commission, 'Fiduciary Duties of Investment Intermediaries (2014) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/325509/41342_HC_368_LC350_Print_Ready.pdf> accessed on 15 June 2016.
83 Davis Steil (n 4) 15.
84 Blake (n 24).
85 *Ibid*.
86 Hereinafter 'DB'.
87 Hereinafter 'DC'.
88 Law Commission (note 82).
89 *Ibid*.

up as DB schemes. However, because of the increasing cost of providing DB schemes,[90] DC schemes have taken their place and are expected to make further gains. At present, under the Pension Act 2008, every employer in the UK must register certain employees in a pension scheme and contribute towards it. This auto-enrolment brings many new employers and employees into DC workplace pensions. DB schemes can be divided into public sector and private sector schemes. Public sector DB schemes are established under statute and private sector DB schemes are set up under trust. DC schemes are also trust-based or contract-based. Where pension schemes are set up under trust, the trustees owe fiduciary duties to their beneficiaries and are regulated largely by the Pensions Regulator (TPR). Duties under trust law do not apply to contract-based pensions and it is the extensive regulations made by the FCA[91] that regulate them.[92]

In the US pension funds can also be divided into public sector and private sector funds. Public sector pensions are offered by federal, state and local levels of government. They are available to public sector employees. These plans may be DB or DC pension plans. The public sector pension plan that operates at federal level is the Federal Employees Retirement System. In every state there is at least one retirement system for its employees, such as the California Public Employees' Retirement System[93] and the New York State Teachers' Retirement System[94]. Regulations governing public funds exist at both the state and federal levels. In the private sector, employers could offer their employees different pension schemes and the most common forms are DB, DC or a hybrid. Traditional DB plans were historically the main types of pension plans until they were surpassed by DC plans, among which, the 401(k) plan is the most important.[95]

2.2.4 Hedge funds

Hedge funds, which are different from the traditional institutional shareholders given their unique organizational structure and investment strategies, have witnessed rapid

[90] Myners (n 62) 109.
[91] They are also subject to supervision by the Prudential Regulation Authority, which considers issues of financial safety and capital liquidity.
[92] Law Commission (n 82).
[93] Hereinafter 'CalPERS'.
[94] Hereinafter 'NYSTRS'.
[95] See Organisation for Economic Development (hereinafter 'OECD') *Private Pension Outlook* (OECD 2008) <http://www.oecd.org/pensions/private-pensions/42169565.pdf> accessed on 6 June 2016.

development in recent years. Most hedge funds are based in the US. In the early 1950s, the hedge fund industry was still an insignificant market participant. After decades of development, it is now a major industry operating in international financial markets. As discussed by Davis, MacNeil, Amour and Cheffins, hedge funds have the potential to play an increasingly more important role in their investee companies.[96] There is no universally accepted definition of a *hedge fund*. According to the definition given by the US Securities and Exchange Commission, a 'hedge fund is principally no more than a marketing tool, intending to group absolute return strategies so as to distinguish them from other types of funds'.[97]

As mentioned earlier, hedge funds are differentiated from traditional institutional shareholders by their unique organizational structure and investment strategies. From the perspective of organizational structure, hedge funds are typically organized as limited partnerships with the founder and managers being the general partner and the investors as the limited partners or members.[98] The investment funds threshold is very high which makes it an option only to wealthy, high net-worth institutions or individuals.[99] From the perspective of investment strategies, like mutual funds, hedge funds invest the money from investors in multiple products with the aim of gaining positive returns. However, hedge funds have more flexible investment strategies compared with mutual funds. Hedge funds use leverage, short-selling and other speculative investment practices.[100] They often utilize sophisticated computer models to determine whether particular assets are over- or under-priced. The hedge fund will buy the under-priced asset and/or sell the over-priced asset until the traditional pricing relationship is restored.[101] Therefore, hedge funds are generally said to pursue

[96] Davis and Steil (n 4); Iain G MacNeil, 'Activism and Collaboration among Shareholders in UK Listed Companies' (2010) 4 *Capital Markets Law Journal* 419-438; John Armour and Brian Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' (2012) 14(3) The Journal of Alternative Investments 27.
[97] Ashley Kovas, 'Hedge Funds and UK Regulation' (2004) 10 Journal of Financial Transformation 51.
[98] Jonathan R Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2010) 242.
[99] Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (2008) 4 The Journal of Finance.
[100] Official website of the US Securities and Exchange Commission <https://www.sec.gov/fast-answers/answershedgehtm.html> accessed on 7 June 2016.
[101] Macey (n 98) 245.

investment strategies of identifying ‘pre-existing value inherent in market inefficiencies and pricing anomalies’.[102]

Historically, hedge funds were privately held, privately managed investment funds and had been exempt from registration under the so-called private adviser exemption in the US. With a increasing level of investor demand and its significant development, regulation has gradually been applied to them. Hedge funds are currently subject to many restrictions on their investment.[103]

2.2.5 Others

As shown in Figure 2.1, the rest of the world constitutes 54% of the UK stock market. Among the rest of the world group, are institutions mentioned above, such as pension funds, insurance companies and mutual funds. In addition, a distinct type of fund are the SWFs. According to the definition given by the US Treasury, SWFs are ‘government vehicles funded by foreign exchange but managed separately from foreign reserves.’[104] The main financial sources of SWFs come from reserves, natural resource payments and the like.[105]

Typically, SWFs are established with the 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), and future generations (create a reserve of funds for future) and domestic industries (to restructure and encourage domestic industries)’.[106] To reach those aims, the vast majority of SWFs invest heavily in safe products, such as US Treasury and other national government bonds.[107] Recent years

[102] Franci J Blassberg, *The Private Equity Primer: The Best of the Debevoise and Plimpton Private Equity Report* (Debevoise & Plimpton 2006).
[103] Such as the anti-fraud and anti-manipulation requirements; insider trading prohibitions, both in the funds’ investment and portfolio trading activities and in the funds’ offers and sales of units to their own investors, and so forth.
[104] Lowery Clay, ‘Sovereign Wealth Funds and the International Financial System’, (US Department of the Treasury, 21 June 2007) < https://www.treasury.gov/press-center/press-releases/Pages/hp471.aspx> access 30 may 2016.
[105] Hong Kong ‘The World's Most Expensive Club’ (*The Economist*, 24 May 2008) <http://www.economist.com/node/9230598?story_id=9230598> accessed 30 may 2016
[106] Bryan J Balin, ‘Sovereign Wealth Funds: A Critical Analysis’ (2009) < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1477725> accessed 30 may 2016.
[107] Ronald J Gilson and Curtis J Milhaupt, ‘Sovereign Wealth Funds And Corporate Governance: A Minimalist Response To The New Mercantilism’ (2007) 60(5) Stanford Law Review 1354.

have witnessed a shift taken by SWFs from conservative investment to some higher-risk/higher-return investments in equities or corporate acquisitions.[108]

Until now, there has been no comprehensive and complete study to show the influence of SWFs on their investee companies and some evidence even shows that they have no or little interest in engaging in the corporate governance of their portfolio companies.[109] Owing to its growing shareholding percentage, a brief introduction to SWFs is discussed here. Considering its limited influence on corporate governance, they will not be included in the detailed analysis of institutional shareholder activism in the following chapters.

Country	Sovereign Wealth Fund Name	Assets USD-Bil	Inception	Origin	*Linaburg-Maduell Transparency Index*
Norway	Government Pension Fund – Global	847.6	1990	Oil	10
UAE – Abu Dhabi	Abu Dhabi Investment Authority	792	1976	Oil	6
China	China Investment Corporation	746.7	2007	Non-Commodity	8
Saudi Arabia	SAMA Foreign Holdings	598.4	n/a	Oil	4
Kuwait	Kuwait Investment Authority	592	1953	Oil	6
China	SAFE Investment Company	474**	1997	Non-Commodity	4
China – Hong Kong	Hong Kong Monetary Authority Investment Portfolio	442.4	1993	Non-Commodity	8
Singapore	Government of Singapore Investment Corporation	344	1981	Non-Commodity	6
Qatar	Qatar Investment Authority	256	2005	Oil & Gas	5
China	National Social Security Fund	236	2000	Non-Commodity	5
Singapore	Temasek Holdings	193.6	1974	Non-Commodity	10
UAE – Dubai	Investment Corporation of Dubai	183	2006	Non-Commodity	5
Saudi Arabia	Public Investment Fund	160	2008	Oil	4
UAE – Abu Dhabi	Abu Dhabi Investment Council	110	2007	Oil	n/a
Australia	Australian Future Fund	95	2006	Non-Commodity	10
South Korea	Korea Investment Corporation	91.8	2005	Non-Commodity	9
Kazakhstan	Samruk-Kazyna JSC	85.1	2008	Non-Commodity	n/a
Kazakhstan	Kazakhstan National Fund	77	2000	Oil	2
Russia	National Welfare Fund	73.5	2008	Oil	5
UAE – Abu Dhabi	International Petroleum Investment Company	66.3	1984	Oil	9

Figure 2.6: Sovereign Wealth Fund rankings[110]

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108 *Ibid*.
109 Balin (n 106).
110 Figure taken from Sovereign Wealth Fund Rankings, Sovereign Wealth Fund Institute, <http://www.swfinstitute.org/sovereign-wealth-fund-rankings/>, accessed 30 May 2016.

2.3 The development of institutional investors in China

Compared with their UK and US counterparts, Chinese institutional investors experienced a late start. Pension funds and insurance companies were the earliest institutional investors in China. On the eve of the founding of the People's Republic, 'labour insurance' (former pension funds) was introduced as a pilot programme in certain provinces under the influence of the Soviet Union. The pension scheme established at that time covered only urban areas. The first insurance companies, People's Insurance Company of China was established in 1949 and it dominated the insurance industry. However, owing to the political influence of the 'Cultural Revolution,[111] all industries were reduced to ruins, and pension scheme and insurance companies were not spared. The economic reforms in 1979 marked the new beginning of the institutional industry. In the late 1980s, the establishment of China Pacific Insurance Company and Ping An Insurance broke the monopolistic position of the People's Insurance Company of China. In addition, at the same time, some reforms took place in the pension schemes. The establishment of stock exchanges in the early 1990s was the necessary prerequisite for the Chinese fund industry. In 1991, the first two security investment funds, the Shenzhen Nanshan Risk Investment Fund and the Wuhan Securities Investment Fund, were founded in China, which indicates the start of the development of the fund industry in China. These 'old funds'[112] were regulated and supervised by the People's Bank of China[113]. The relatively late beginning, however, did not impede the rapid growth of the fund industry and it emerged as a significant investment tool for investors in the stock market. However, the rapid growth of Chinese securities funds resulted in many problems due to the lack of standardized national regulation and their own incapacity. Therefore, national legislation was urgently needed and the Provisional Measures for the Administration of Securities

[111] This was a socio-political movement that took place in China from 1966 to 1976. Set into motion by Mao Zedong, then Chairman of the Communist Party of China, its stated goal was to preserve 'true' Communist ideology in the country by purging remnants of capitalist and traditional elements from Chinese society, and to re-impose Maoist thought as the dominant ideology within the Party. To eliminate his rivals within the Communist Party of China, Mao insisted that these 'revisionists' be removed through violent class struggle. It resulted in widespread factional struggles in all walks of life.
[112] 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 Provisional Measures for the Administration of Securities Investment Funds were promulgated.
[113] Hereinafter 'PBOC'.

Investment Funds[114] were issued by the China Securities Regulatory Commission[115] in 1997.[116] Shortly after that, old funds were restructured into standardized new Securitas Investment Funds[117] and the government adopted a series of measures to nurture their development. For example, it allocated 20% of all newly issued SOEs' shares to fund management companies.[118] In 1998, the Hua'an Fund Management Company, which was based in Shanghai, launched the first open-ended fund, which indicated the arrival of a new era of the development of the SIFs industry.[119]

In 1999, the CSRC claimed to 'promote the development of institutional investors in an extraordinary way' and in the following years, several related policies and legislation were published. In the same year, the China Insurance Regulatory Commission[120] promulgated the 'Interim Measures for Insurance Companies that Invest in Securities Investment Funds', which means that insurance companies could invest in equities in an indirect way and the threshold for indirect investment was no more than 5% of the company's total assets. In 2000, the CSRC released the 'Measures of the Pilot Programme for Open-ended Investment Funds' and, at the same time, the upper limit of investing in securities for insurance companies was increased to 10% of its total assets. Owing to the inadequate social security system in poor areas and the ageing population, the government set up the National Social Security Fund[121] in 2000, which worked as a back-up reserve fund, or 'fund of last resort' to support the social security system in China.[122] In 2001, NSSF was allowed to invest in equities indirectly with no more than 40% of its total asset according to the 'Interim Measures for the Regulation of the National Social Security Fund'. In 2002, open-ended investment funds were adopted nation-wide. The promulgation of the 'Insurance Law of the People's Republic of China' greatly promoted the development of insurance companies by allowing their direct investment in equities In addition, the government launched the Qualified

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114 Hereinafter 'Provisional Measures'.
115 Hereinafter 'CSRC'.
116 Provisional Measures issued by the CSRC on November 1997 and abolished on October 2004.
117 Hereinafter 'SIFs'.
118 Child, John. *Management in China during the age of reform* (Cambridge University Press, 1996) Xiaoxing He, '*A Discussion About the History of Chinese Securities Investment Funds'* [中国证券投资基金发展论] (Tsinghua University Press 2003).
119 *Ibid*.
120 Hereinafter 'CIRC'.
121 Hereinafter 'NSSF'.
122 Official website of National Social Security Fund, <http://www.ssf.gov.cn/Eng_Introduction/201206/t20120620_5603.html> accessed 14 February 2017.

Foreign Institutional Investors[123] programme to open up its domestic market to large overseas investors and published the 'Interim Provisions on the Administration of Foreign Exchange in Domestic Securities Investments of Qualified Foreign Institutional Investors'. As we will see in figure 6, all these policies and legislations greatly promoted the rise in the number of institutional investors in the Chinese stock market and this period could be regarded as a golden age for institutional investors. In the years that followed, this trend continued, the major institutional investors became well developed in China.

Year	Institutional accounts newly opened	Related policies, laws and regulations
1996	15,000	– None
1997	24,900	– Provisional Measures for the Administration of Securities Investment Funds are published
1998	17,300	– None
1999	51,600	– The CSRC claims to 'promote the development of institutional investors in an extraordinary way' – CIRC promulgates the Interim Measures for Insurance Companies that Invest in Securities Investment Funds, which permit insurance companies to invest in equities in an indirect way with no more than 5% of the company's total assets
2000	96,000	– The CSRC releases the Measures of the Pilot Programme for Open-ended Investment Funds – The threshold for insurance companies is increased to 10% – The NSSF is set up
2001	55,300	– The NSSF is allowed to invest in equities indirectly with no more than 40% of its total assets according to the Interim Measures for the Regulation of the NSSF.
2002	50,800	– Open-ended investment funds are rolled out nation-wide

123 Hereinafter 'QFIIs'.

Year	Institutional accounts newly opened	Related policies, laws and regulations
		– The Insurance Law of the People's Republic of China is promulgated which permits insurance companies to invest directly in equities – The Qualified Foreign Institutional Investors Programme is launched and the government published the 'Interim Provisions on the Administration of Foreign Exchange in Domestic Securities Investments of Qualified Foreign Institutional Investors'
2003	15,200	– Corporate pension funds are allowed to invest in equities. – The Law of the People's Republic of China on Securities Investment Fund is promulgated
2004	16,400	– The Interim Measures for the Administration of Stock Investments of Insurance Institutional Investors are promulgated
2005	13,000	– Notice of the China Securities Regulatory Commission on Piloting the Share-trading Reform of Listed Companies is published – Guidance Notes on the Split Share Structure Reform of Listed Companies are issued – Measures on the Administration of Split Share Structure Reform of Listed Companies are promulgated
2006	33,800	– Split Share Structural Reforms are issued aimed at lowering the state shareholding by converting non-tradable shares to tradable shares

Figure 2.7: The number of newly opened institutional accounts the related policies, laws and regulations[124]

[124] The data were collected from the statistics book 1996–2006 (restricted translation) by China Securities Depository and Clearing Corporation Limited (hereinafter 'CSDC') and the related policies and regulations were sorted by the present author.

Figure 2.7 shows that the number of newly opened institutional accounts are closely related to the policies and regulations promulgated. From 1999 to 2002, there was a sharp increase in the number of institutional investors that traded on the stock exchange with an average of 63,425 per year. The reason behind this growth is the CSRC's appeal to 'promote the development of institutional investors in an extraordinary way'. This appeal was implemented by promulgating a series of regulations in these years. Therefore, the development of institutional investors was encouraged, and the limitation and thresholds faced by some of the institutions were gradually loosened. The increase in the number of newly opened institutional accounts in 2006 is mainly due to the split share structure reform. This reform broke the tight control of blockholders in SOEs by transferring a certain percentage of non-tradable shares into tradable shares. Therefore, on the one hand, there are more shares available for institutional shareholders to invest in; on the other hand, the promising market prospect attracts institutional investors investment.

Figure 2.7 shows that from 2004 to 2014 insurance companies (0% to 3.87%), pension funds (1.07% to 1.31) and QFIIs (0.64% to 1.38%) are all growing rapidly. At the same time, tradable A shares held by individuals fell sharply, from 77.65% to 25.03%. Figure 2.8 shows that the majority of shares are in the hands of general institutions, that is, controlling shareholders and legal person enterprises. The key professional institutional shareholders in China are securities investment funds, insurance companies, pension funds and qualified foreign institutional investors.

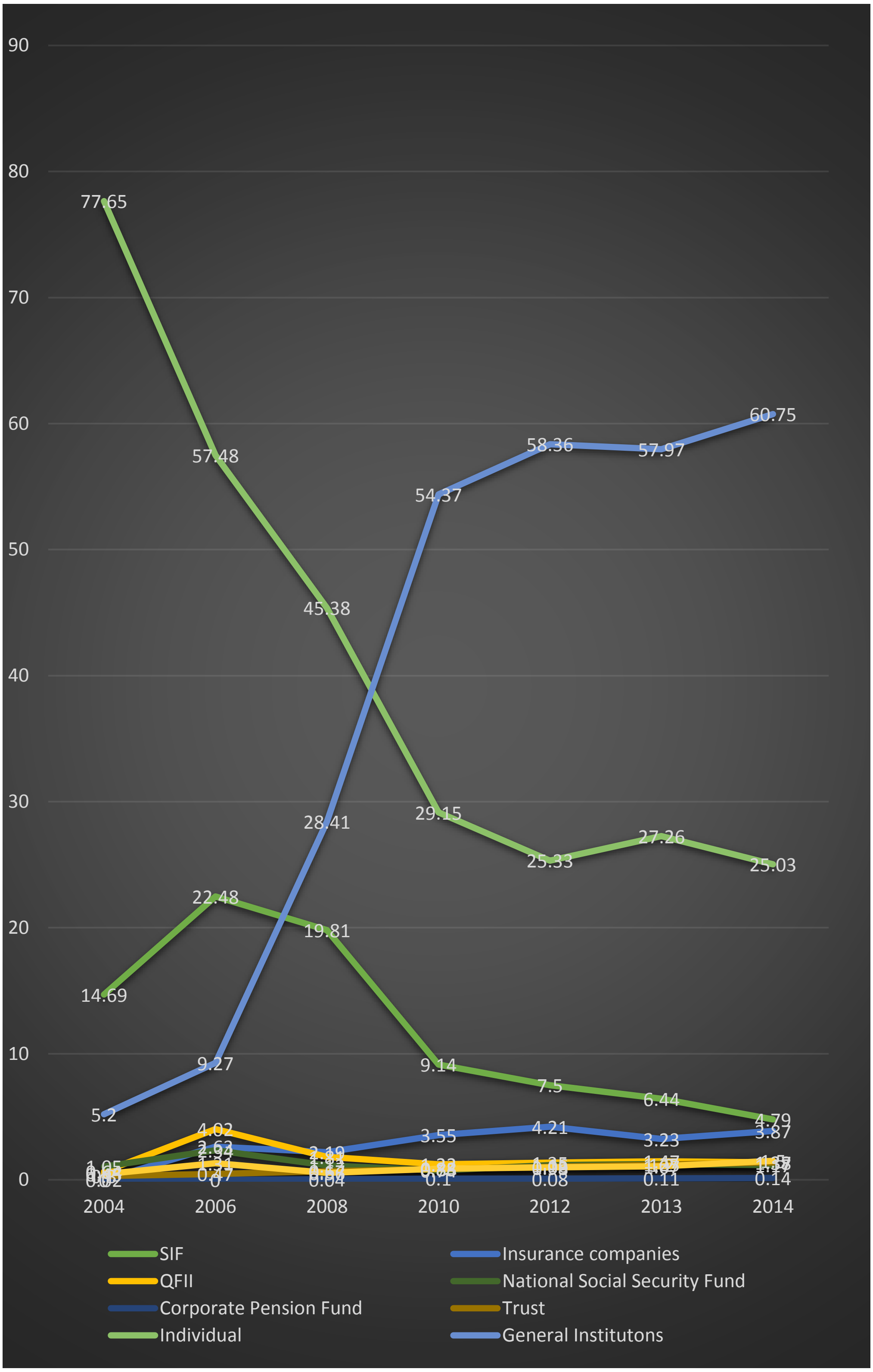

Figure 2.8: Percentage of tradable A shares owned by value from 2004 to 2014

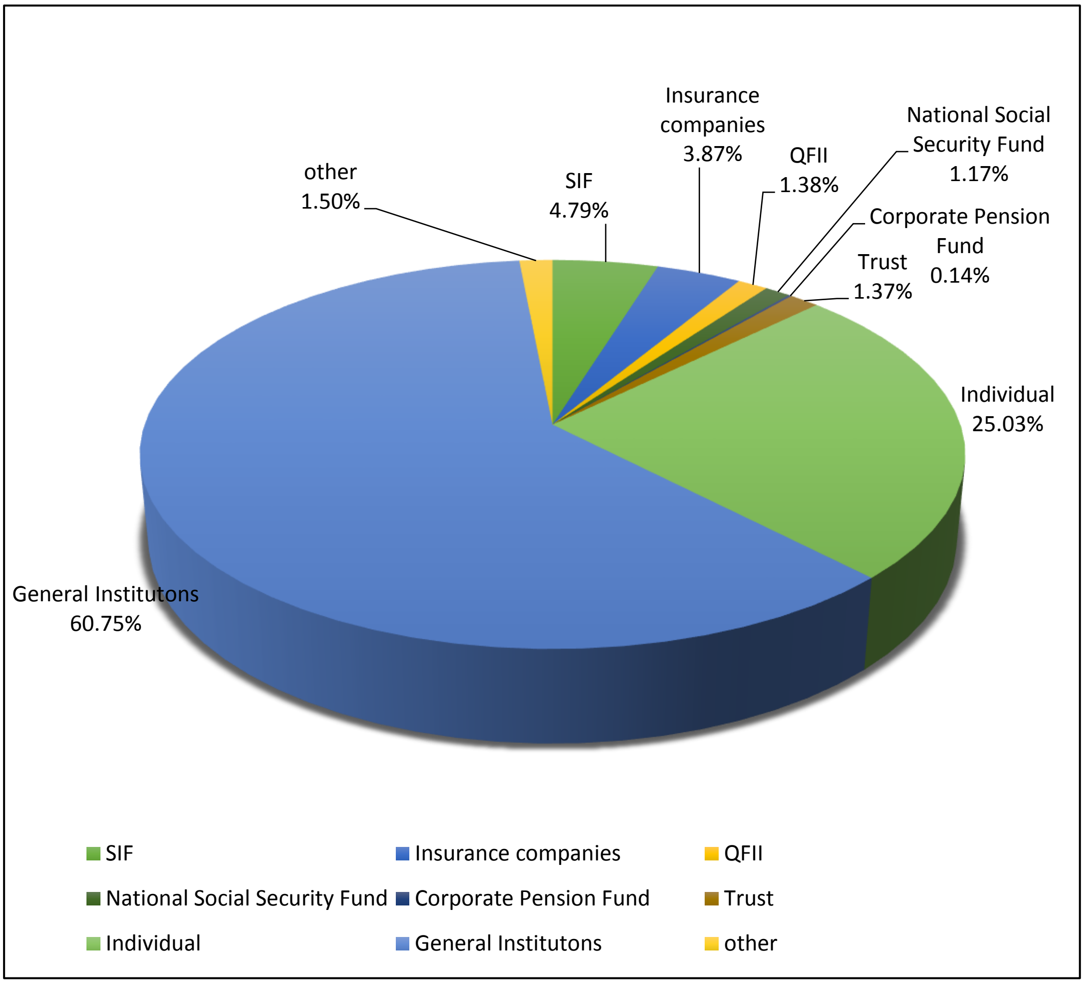

Figure 2.9: Percentage of tradable A shares owned by value in 2014[125]

2.4 The landscape of institutional investors

2.4.1 Securities Investment Funds

Mutual funds or so-called securities investment funds (SIFs) are the largest group of institutional investors in China.[126] Although they witnessed a continued decline during the past ten years, they still held 4.79% tradable A shares in 2014. Having been in

[125] Data collected from the Annual Report for Chinese Securities Investment Funds for the Year 2014 [中国证券投资基金业年报] <http://www.amac.org.cn/tjsj/cbw/390448.shtml> accessed on 16 June 2016. The analysis was done by the present author.

[126] Hua Yang and Jun Zhou, *Reforms in Need: Exploring the Roads for Marketization Reform of the Chinese Capital Market* [变革与突破：中国资本市场发展研究] (China Financial and Economic Publishing House 2014).

existence for less than two decades, securities investment funds are relatively young compared with their UK and US counterparts. According to research conducted by a leading securities research centre, there were 621 securities investment funds in 2009, with assets of 2,676 billion yuan in total.[127] As shown in Figure 2.8, SIFs hold 4.79% of the tradable A shares and it is the largest institutional investors in the Chinese A share market.

At present, the Securities Investment Fund Law is at the centre of China's legal framework for the regulation of SIFs.[128] 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.'[129] The securities law stipulates that only fund management companies approved by the CSRC can establish an SIF and a strict threshold is established to set the entry restriction. Article 13 of the fund law requires that 'the company must have a registered capital of at least RMB 100 million and 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'.[130] The principal shareholder could be a securities company, a securities investment consultant, a trust management company or other financial institution approved by the CSRC.

Fund managers, fund custodians and fund unit holders are three of the most important players involved in SIFs. Fund managers are required to pass the qualification examinations before engaging in the fund industry and they are responsible for raising the fund, offering, subscription and redemption of fund shares, and fund investment strategies.[131] Fund custodians are commercial banks who are licensed by the CSRC.

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[127] China Galaxy Securities Research, 'Report on China's Securities Investment Funds in 2009', <http://www.Chinastock.com.cn/research/ResearchHYYJ.shtml> accessed on 16 June 2017. China Galaxy Securities Research, founded in 2000, is a leading securities research institute in China.

[128] The latest amendment of the Securities Investment Fund Law was in 2015. The CSRC also issued many regulations and rules to supplement and clarify the fund law, which include (1) the Circular on Issues Concerning Warrant Investment by Securities Investment Funds in the Split Share Structure Reform (issued in 2005); (2) the Provisional Code of Corporate Governance for Securities Investment Fund Management Company (issued in 2006); (3) Measures for the Administration of Securities Investment Fund Management Companies (2012); (4) Measures for the Administration of Securities Investment Fund Custody Business (2013); and (5) Measures for the Administration of the Operation of Publicly Offered Securities Investment Funds (2014).

[129] Bo Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (Routledge 2013).

[130] Securities Investment Fund Law s 13(2)(3).

[131] Securities Investment Fund Law s 19.

They 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 fund contracts.'[132] In addition, they are also responsible for the supervision of fund managers' investment behaviours and report any illegal activities to the CSRC. The unit holders are the ultimate owners of the fund and they are given special protection under the fund law. For example, unit holders who have more than 10% of the fund's shares separately or aggregately, could convene a general unit holders' meeting to discuss and decide related matters.

2.4.2 Insurance companies

Insurance companies are the second largest kind of institutional shareholders in the Chinese securities market with 3.87% holding in tradable A shares. There are approximately 120 insurance companies in China. However, most of the market shares are occupied by a few insurance companies,[133] for example, the China Life Insurance, the largest life insurance company in China, who own 35% of the life insurance market.

The economic reforms of in the late 1970s marks the beginning of the insurance industry. With a steadily increasing demand, the insurance companies witnessed significant development. Furthermore, the Chinese government was required to lower the entry threshold to foreign insurers under the Word Trade Organization framework. Therefore, joint venture insurance firms were being established in China which further promotes its development. At an early stage, insurance companies were required to invest only in 'safe investment instruments, such as bank deposits, government and financial bonds, and other assets approved by the State Council'[134] and investment in equities are prohibited. The Interim Measure on the Administration of Insurance Company's Investment in Securities Investment Funds promulgated in 1999 allowed insurance companies to invest in equities up to 15% of their assets indirectly through SIFs.[135] Given the high level of profits generated from investing in equities, many

[132] Securities Investment Fund Law s26.
[133] Dingfu Wu, The Development of Insurance Industry in the Past 60 Years [保险业发展波澜壮阔六十年] (China Insurance News, 23 September 2009) <http://business.sohu.com/20090923/n266934430.shtml> accessed 23 December 2015.
[134] The Insurance Law of 1995 s 104.
[135] According to the Interim Measures on the Administration of Insurance Company's Investment in Securities Investment Funds, the upper limit of each insurance company has to be approved by the China

insurance companies became large clients of SIFs. As a result of the rapid asset expansion and increasing demand for access to securities market, the Provisional Measures for the Administration of Stock Investment by Insurance Institutional Investors enacted in 2004 allowed insurance companies to manage their own investment portfolios and invest in equities directly with a maximum threshold of 10% of the total assets.[136] More recently, the Provisional Measures on the Administration of the Operation of Insurance Capital issued by the CIRC on 2010 raised the threshold to 20%.[137]

However, compared with their UK and US counterparts, whose assets are allocated to stocks in large proportions, Chinese insurance companies still rely heavily on safe investment vehicles such as government bonds.[138] With further relaxing on investment, as well as the increasing demands from the market, insurance companies may become major investors in equities.

According to the policy on 'separate business, separate regulation', the regulator of the insurance industry is CIRC. Chinese insurance companies are regulated by the 1995 insurance law, which was revised in 2009. The insurance law covers many aspects, such as insurance contracts, incorporation, investment and supervision of insurance companies, and it stipulates the regulatory principles and operating framework of insurance companies. Article 68 of the insurance law stipulates that the registered capital requirement for establishing insurance companies is RMB 200 million, which is twice as much as the amount required for fund management companies.[139] Article 106 also states 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'.[140] In addition, the law

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Insurance Regulatory Committee. Generally, the investment is subject to 5% to 15% of the total assets of the insurance company. See Zhimin dai, *On the Normal Development of Institutional Investors in China's Securities Market* [证券市场机构投资者规范化发展研究] (Zhejiang University Press 2008).

[136] Interim Measures for the Administration of Stock Investments of Insurance Institutional Investors [保险机构投资者股票投资管理暂行办法] promulgated by CSRC and CIRC in 2004.

[137] Provisional Measures, s 16(4).

[138] Gong (n 129) 231.

[139] Insurance Law s 68.

[140] Insurance Law s106.

empowers CIRC with a number of regulatory powers, such as the right to supervise the insurance market, to issue qualification requirements for the senior managers of insurance companies and to grant approval for insurance agencies.[141]

2.4.3 Pension funds

Pension funds are the third largest institutional shareholders in China, apart from securities investment funds and insurance companies. The ‘Decision on Developing a Unified Basic Old Age Pension System for Enterprise Employees’[142] built a new framework based on the recommendations of the World Bank.[143] The system is composed of several ‘pillars’ and different subsystems.[144] ‘Pillars’ means that the government, employers and employees all participate in contributing to the pension pool. Subsystems, including the rural residents system, urban employee system and public service employee system coexist. The newly published ‘Decision of the State Council on the Reform of the Pension Insurance System for Employees of State Organs and Public Institutions’[145] reformed the dual track of urban employee system and public service employee system, where currently corporate employees contributed 8% of their salary to the system and government employees contributed no part of their salary. From then on, government employees needed to contribute part of their salary in the same way as their corporate counterparts.

On the recommendation of the World Bank, China now has a three-pillar pension system. The first pillar is the ‘basic old-age insurance system’ which comprises the contribution made by employers and employees. The second pillar is a supplementary

141 Insurance Law s 120.
142 Stuart Leckie and Ning Pan, ‘A Review of the National Social Security Fund in China’ (2007) 12(2) Pensions: An International Journal 90.
143 *Ibid* 92.
144 The multi-pillar pension system only provides funding for urban workers. Rural residents are covered by a separate rural pension system, or the Minimum Life Security System. They are unfunded program and thus, will not be discussed in the thesis.
145 Decision of the State Council on the Reform of the Pension Insurance System for Employees of State Organs and Public Institutions [国务院关于机关事业单位工作人员养老保险制度改革的决定], promulgated by State Council, <http://www.lawinfochina.com/display.aspx?id=18699&lib=law&SearchKeyword=&SearchCKeyword=%b9%fa%ce%f1%d4%ba%b9%d8%d3%da%bb%fa%b9%d8%ca%c2%d2%b5%b5%a5%ce%bb%b9%a4%d7%f7%c8%cb%d4%b1%d1%f8%c0%cf%b1%a3%cf%d5%d6%c6%b6%c8%b8%c4%b8%ef%b5%c4%be%f6%b6%a8>, accessed on 17 June 2016.

or voluntary system called 'enterprise annuities' or corporate pension funds.[146] This pension contribution is set up by eligible employers who can afford to contribute financially and the company has the autonomy to decide on the percentage of this voluntary occupational pensions under the instruction of local government. The third pillar are the voluntary schemes which are managed by private companies or insurance companies, by means of which employees could contribute as much as they can afford in order to provide a better life for themselves when they are old.[147]

Although this multi-pillar pension system has been established in China, it is far from enough given the wealth gap between less-developed provinces and developed provinces. Apart from the inadequate social security system in poor areas, the ageing population also makes the situation worse. Therefore, the government set up the National Social Security Fund[148] in 2000. The NSSF does not from part of the three pillars mentioned above. Instead, it is a complementary vehicle that works as a back-up reserve fund or 'fund of last resort' to support the social security system in China. 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.[149]

Not all pension pillars can make investments as they like. The operation of pillar one, the basic old-age insurance system and pillar three, voluntary schemes, is limited to conservative investment tools, such as government bonds. Only pillar two systems, the CPFs and the NSSF, are permitted to invest their assets on the stock market and these two are the subjects that this thesis addresses.

a. Pillar two: Corporate pension fund

When the reform of the old pension system began in the 1990s, the CPF was introduced as a step forward to the multi-pillar model.[150] It was not until 2004, when the Ministry

[146] Hereinafter 'CPF'.
[147] Yongbeom Kim, Irene SM Ho, and Mark St Giles, 'Developing Institutional Investors in People's Republic of China' (2003) World Bank Country Study Paper < http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.197.4266&rep=rep1&type=pdf> accessed 12 December 2015.
[148] Hereinafter 'NSSF'.
[149] The official website of NSSF, <http://www.nssf.gov.cn/zyjh/ldjhhbg/> accessed 12 December 2015.
[150] For a discussion on the reform, see Bingwen Zheng, 'Reforming Complementary Enterprise Pensions: Overview, Assessment and Prospect' in Dasong Deng and Changping Liu (eds), *China's Economic*

of Labour and Social Security[151] released Interim Measures for Enterprise Annuities and Interim Measure for the Management of Enterprise Annuities Fund[152] with a view to consolidating the Chinese CPF markets and enhancing supervision [153] that the CPF was formally endorsed in regulation.

Under these regulations, the CPF has to operate under a trust model, which is similar to the 401(k) scheme in the US.[154] The IMMEA also establishes quantitative thresholds on the investment of CPFs. Article 47 of IMMEA requires that 'investment in government bonds alone shall not drop below 20% of net assets'[155] and 'the maximum investment in stocks is limited to no more than 20% of net assets'.[156] According to limited information and data regarding the investment activities of CPFs, CPF asset managers are more inclined to invest in conservative products such as government bonds and bank deposits.[157]

The total assets of CPFs were approximately RMB 230 billion by the end of 2009[158] and it has great potential for future growth given its currently low coverage.[159] It is estimated that the CPF market will grow to RMB 14.4 trillion by 2030[160] and the market is confident that CPFs will become an important category of institutional investor in the Chinese securities market.

b. National Social Security Fund

Reform in the Past 30 Year: Overview, Assessment and Prospect (China Social Science Publishing House, Beijing 2009).

[151] Hereinafter 'MoLSS'.

[152] Hereinafter 'IMMEA'.

[153] Ministry of Labour and Social Security, Interim Measures for the Management of Enterprise Annuities Fund (Order No. 23) jointly issued by the MLSS, the China Banking Regulatory Commission (hereinafter 'CBRC'), the China Securities Regulatory Commission (hereinafter 'CSRC'), and the China Insurance Regulatory Commission (CIRC) in 2004.

[154] IMEA s 15.

[155] IMMEA s 47.

[156] IMMEA s 47.

[157] Yu-Wei Hu, Gregorio Impavido and Xiaohong Li, *Governance and Fund Management in the Chinese Pension System*, (IMF Working Paper No. 9-246) <https://www.imf.org/external/pubs/ft/wp/2009/wp09246.pdf> accessed 16 December 2015.

[158] No author 'The Assets of Chinese Enterprises Pension Funds are Estimated to Reach 230 Billion in 2009' [2009 年中国企业年计规模预计 2300 亿元] (Caijin, 21 January 2010) <http://www.caijing.com.cn/2010-01-21/110363001.html> accessed 27 January 2015.

[159] Hu, Impavido and Li (n 157).

[160] Yu-Wei Hu, Fiona Stewart and Juan Yermo, 'Pension Fund Investment And Regulation: An International Perspective and Implications for China's Pension System' in *Private Pension System: Developments and Issues* (OECD published 2007)

A ministerial level organization under the management of the State Council, the NSSF Council, is responsible for the operation of the NSSF. 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'.[161]

The investment behaviours of the NSSF are governed by the Interim Measures on the Administration of the Investment of National Social Security Fund issued by the MoLSS and Ministry of Finance[162] in 2001[163]. The NSSF Measures established investment thresholds for its in-house and outsourcing asset allocation. The in-house asset management is confined to government bonds and bank deposits. The asset outsourcing to external fund managers could be invested in stocks and funds.[164] From the moment the NSSF was established, safety has been regarded as the supreme goal of fund investment and this makes the investment strategy adopted by the NSSP quite conservative. Before 2002, most of the fund assets were managed by in-house experts and these assets were invested in low-yielding instruments such as cash and government bonds, and the returns on these investments were relatively low given China's low interest environment.[165] When lack of money became severe, the NSSF varied its investment channel by developing new investment instruments that generated a high return based on the low-risk premise. Since 2003, the NSSF has delegated its investment to six best domestic fund managers to invest fund assets in the securities market.[166] Within years, the NSSF has increased its assets which are allocated to external fund managers. The investment channels of the NSSF have been expanded to overseas markets as well.[167] Even though the NSSF accounts for a small portion of the

[161] NSSF, 'About the National Council for Social Security Fund', website <http://www.ssf.gov.cn/Eng_Introduction/ >Accessed 24 June 2015
[162] Hereinafter 'MOF'.
[163] Hereinafter 'NSSF Measures'.
[164] Interim Provisions on Administration of NSSF Investment, issued by the MoLSS in 2003, s 25.
[165] Hu, Impavido and Li (n 157).
[166] The six fund management companies are Boseri, Changsheng, Huaxia, Harvest, Penghua and Southern.
[167] In 2006, The National Council of the NSSF issued the Interim Provisions Concerning the Administration of Overseas Investment, allowing fund managers to invest in foreign financial tools subject to limits.

securities market in China, with the expected SOE reforms, the NSSF will receive a substantial contribution.

2.4.4 Qualified foreign institutional investors

Qualified foreign institutional investors are 'foreign institutions who meet certain conditions and may therefore invest directly in the Chinese A share market under the quota granted by the Government.'[168] It is a relatively new phenomenon in China given the fact that foreign investors were prohibited from investing in the Chinese A share market before 2002. Qualified foreign institutional investors not only boost the Chinese securities economy, but they also vest the power of control over the securities market in the hands of the government. The QFII system is widely welcomed by many newly developing market economy countries as it opens its market without the complete opening-up of capital investment.[169]

The CSRC is responsible for the regulation and supervision of QFII activities. At present, the primary legal regulations within the legal framework for QFIIs the Provisional Measures and Measures for the Pilot Programme of Securities Investment in China by RMB Qualified Foreign Institutional Investors, which was jointly issued by the CSRC, People's Bank of China and State Administration of Foreign Exchange on 2006 and 2013 respectively, supplemented by a series of rules.

2.5 Conclusion

In this chapter the development of institutional investors in the UK, US and China was analysed. Data was presented to show the components of share ownership and the percentage of different institutional investors. Finally, the major institutional investors in each country were discussed.

With the benefit of hindsight, one could isolate four principal factors that led to the growth of institutional investors in the UK and US from the discussion on the development of institutional investors above. First, from the perspective of the supply

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[168] Gong (n 129) 92.

[169] Steven Yeo, 'The PRC Qualified Foreign Institutional Investors Market' (2003) 14 China Economic Review 445.

side, there are several factors that contributed to the rise of institutional investors. On the one hand, the development of institutional investors, along with the evolution of dispersed ownership, made many shares available for institutional investors to invest in. In addition, tax rules at certain stages became unfriendly to individual investors and compelled them to exit. Therefore, institutional investors filled the gap when blockholders and individual shareholders all exited the stage. Second, the development of institutional investors can be analysed from the perspective of the demand side. Notable demographic developments and growing wealth called for a more sophisticated social security system and, therefore, pension funds and insurance companies became those institutional investors that enjoyed rapid growth at an early stage. The convenient and flexible open-ended mutual funds attracted those small investors who lack professional knowledge in investment.[170] The explosive growth of institutional shareholders happened at a time when there was a shift from banking through markets to a securities phase. Institutional investors took advantage of technological developments, fulfilling part of the role that used to be played by the bank and met the various demands of the financial system. Third, according to Roe, major US financial institutions were prevented from taking substantial block positions at several points in the twentieth century, given the popular mistrust of concentrated financial power, populist fears, interest group manoeuvring and American political structure.[171] However, this situation was derailed by the policy support and deregulation and, therefore, a friendlier environment had come into being for the development of institutional investors. Fourth, several pieces of legislation and regulations were enacted with the evolution of institutional investors, which not only set boundaries for proper investment behaviour, but also provided a fairer and clearer market by requiring strict information disclosure.

However, in China, the emergence and growth of institutional investors was driven by governmental need. In order to solve the obstacles faced by SOEs, the government established a stock exchange and institutional investors were needed for their huge amount of capital. Given the fact that institutional shareholders fit in well with the stock markets in the Western world, the Chinese government learnt from this and expected

[170] Hamilton (n 45) 353.
[171] Mark J Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*. (Princeton University Press 1996), preface x.

Chinese institutional investors to perform as well as their UK and US counterparts to promote the development of the securities market. The 'Provisional' prescribed that one of the aims of the SIFs was to 'promote the healthy and stable development of securities markets'.[172] In 1999, the CSRC claimed to 'promote the development of institutional investors in an extraordinary way' and SIFs have been given priority in several aspects. Figure 2.7 shows that SIFs are by far the most important institutional investors under this policy bias. Figure 2.7 also shows that there is a positive correlation between the number of newly opened institutional accounts, and policies and regulations promulgated. The rapid development of institutional investors from 1999 to 2002 was a result of the CSRC policy in 1999. Moreover, some factors, such as demographic developments, growing wealth, promulgation of related legislation and deregulation, also promoted the development of institutional shareholders.

Therefore, the emergence and development of institutional investors in the UK and US were driven by the demand from the market and it is, to some extent, self-motivated in nature. Numerous pieces of legislation and regulation were put in place within this process to ensure institutional investor activities took place within certain boundaries. Further deregulation and policy support served as accelerators to boost the growth of institutional investors. Different types of institutional investors developed in a balanced way. However, in China the evolution of institutional investors was largely a governmental action with the aim of fulfilling certain of its own needs and this led to the uneven growth of different institutional investors. The SIF-led institutional investors' landscape will have a further impact on the institutional shareholder activism. In the next chapter, institutional shareholder activism will be examined from a theoretical perspective.

[172] Interim Measures for the Administration of Securities Investment Funds [证券投资基金管理暂行办法] promulgated by CSRC, art 1.<http://www.asianlii.org/cn/legis/cen/laws/imftaosif719/> accessed 12 June 2017.

Chapter 3: Institutional Shareholder Activism: Theoretical Perspective

In Chapter 2 the emergence and development of institutional investors in the UK, US and China was examined, and followed by an analysis of the different types of institutional investors. Chapter 3 aims to provide an overview of institutional shareholder activism from a theoretical perspective, which could help to provide a better understanding of their behaviour. This chapter begins with a brief overview of shareholder activism, that is, its meaning and objectives. This is followed by the theoretical foundations of shareholder activism. The theoretical arguments that both support and oppose shareholder activism are presented. Related researches on the effects of institutional shareholder activism are collected. The section that follows deals with institutional shareholder passivity, which lays the foundation for the discussion in the Chapters 4 and 5. Given the fact that institutional shareholder activism has never been a subject of consensus and there are various deterrents to their engagement, why has institutional shareholder activism grown so rapidly in the last few decades? This chapter answers this question in two ways: one aspect is the internal driving force, that is, the internal elements that push institutional shareholders to engage rather than stand by; the other is the external driving force, namely the wider economic and political environment. Chapter 3 ends with a conclusion.

3.1 Overview of shareholder activism

Shareholder activism, as described by the European Corporate Governance Institute, is 'the way in which shareholders can assert their power as owners of the company to influence its behaviour.'[1] Some scholars define *shareholder activism* as 'actions taken by shareholders with the explicit intention of influencing corporations' policies and practices, rather than as latent intentions implicit in ownership stakes or trading behaviour.'[2] It is used to describe an approach or a set of measures taken by a shareholder or shareholder group to seek effective change within a company. One or more aims may be considered, such as to 'address management issues, including

[1] The definition of shareholder activism is taken from the official website of the European Corporate Governance Institute <http://www.ecgi.org/activism/> accessed 06 March 2016.

[2] Maria L Goranova and Lori Verstegen Ryan. 'Shareholder Activism: A Multidisciplinary Review' (2014) 40 Journal of Management 1231.

remuneration and other corporate governance issues; to improve business performance; to change the company's strategy; to seek to unlock value through returns of capital, spin-offs and other divestments; to influence corporate activity, in particular the outcome of takeover situations; or to remove one or more directors or appoint new directors'.[3] It is not a novel phenomenon given the fact that shareholders were permitted to submit shareholder resolutions as early as 1942.[4] The major forms of shareholder engagement, such as communication with companies, which pose challenges for companies' strategies, could all be regarded as early forms of shareholder activism.[5] The last decades have witnessed an increased presence of large institutional investors, which fostered a group of well-resourced and highly skilled shareholders. They are expected to make informed use of their rights to trigger good corporate governance changes in their investee companies with a greater willingness. According to Filatotchev and Dotsenko: 'More proactive activist approach of traditional institutional shareholders and growing role of hedge funds and international investors facilitate and reshape the development of shareholder activism.'[6]

As shareholder activism is a means of 'defence' against managerial deviations,[7] shareholders are entitled to express their dissatisfaction and usually they have three choices: (1) 'vote with their feet', that is, sell their shares and avoid exposure to the dissatisfaction; (2) keep their shareholding while voicing their dissatisfaction; or (3) keep their shareholding but do nothing. Hirschman has characterized these alternatives as: exit, voice and loyalty.[8] Jansson further develops shareholder activism as the use of voice into two categories: (1) defensive and (2) offensive shareholder

[3] Credit Suisse, 'The Activism Agenda: What Are Activist Investors Looking for?' <https://www.credit-suisse.com/media/assets/microsite/docs/corporate-insights/credit-suisse-corporate-insights-q3-2016.pdf> 2016 accessed 06 March 2017. Credit Suisse Group is a leading global financial services company headquartered in Zurich.

[4] Kevin W Waite, 'The Ordinary Business Operations Exception to the Shareholder Return to Predictability' (1995) 64 Fordham Law Review 1254.

[5] Talner, Lauren, 'The Origins of Shareholder Activism' (Investor Responsibility Research Centre 1993), now out of print, cited in R Franklin Balotti, Jesse A Finkelstein and Gregory P Williams, *Meetings of Stockholders* (Aspen Publishers Online 1995) par 5.4; see also Iris HY Chiu, *The Foundations and Anatomy of Shareholder Activism* (Bloomsbury Publishing 2010) 2.

[6] Igor Filatotchev and Oksana Dotsenko. 'Shareholder Activism in the UK: Types of Activists, Forms of Activism, and Their Impact on a Target's Performance' (2015) 19 Journal of Management & Governance 5.

[7] Chiu (n 5) 7.

[8] Albert O Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations and States* (Harvard University Press 1972).

activism.[9] Defensive activism happens when dissatisfaction arises among investors regarding a management decision or corporate performance and, as a result, the investors lobby for relevant changes. Jansson is of the view that where share prices do not dramatically increase as a result of shareholder activism, the activism could be explained as a defensive type, where shareholders see the need to safeguard their investment in the company, but are not prepared to sell.[10] Defensive activism could be public or private: it could be a private discussion among related parties or the shareholders at the general meeting. This type is defensive in the sense that activists seek to protect pre-existing investments. Offensive activism is usually taken when investors who currently hold a small portion of shares, build up their holdings offensively with the expectation that some substantial changes will take place and, thus, return them with huge profits. Jansson believes that where abnormal returns on share price are generated, such activism could be regarded as offensive activism. This type of activism is ex ante in nature, characterised by hedge funds and different from defensive activism which seeks to rectify a concern within the dissatisfied company. In short, the former kind of activism seeks to defend the value of an existing position and the latter form of activism is made explicitly on the basis that intervention will follow.[11] While there are fundamental differences between defensive and offensive activism from the perspective of their approach and techniques, MacNeil maintains that the objective is the same, namely ‘an improvement in the returns to shareholders’.[12] However, Judge et al. think that the motivation behind shareholder activism could be driven by financial or social factors.[13] Goranova and Ryan completed a multidisciplinary review of shareholder activism[14] which shows that the literature on

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[9] Andreas Jansson, Collective Action among Shareholder Activist (Växjö University Press 2007) <http://www.diva-portal.org/smash/get/diva2:205504/FULLTEXT01.pdf> accessed 03 August 2016; See also John Armour and Brian Cheffins, ‘The Rise and Fall (?) of Shareholder Activism by Hedge Funds’ (2012) 14(3) The Journal of Alternative Investments 27.

[10] Jansson *ibid.* See also Chiu (note 5) 8.

[11] Jansson’s typology draws the distinction between defensive and offensive shareholder activism too starkly. There are circumstances where shareholder activism is driven by defensive concerns, which makes offensive gains at the same time. Contemporary shareholder activism features both defensive and offensive elements.

[12] Iain G MacNeil, ‘Activism and Collaboration among Shareholders in UK Listed Companies’ (2010) 5(4) Capital Markets Law Journal 420. However, it does not necessarily mean that shareholder activism, regardless of its forms, is positive in its effect. This point will be discussed further in section 3.2 of this thesis.

[13] William Q Judge, Ajai Gaur and Maureen I Muller-Kahle, ‘Antecedents of Shareholder Activism in Target Firms: Evidence from a Multi-Country Study’ (2010) 18 Corporate Governance: An International Review 261.

[14] Goranova and Ryan (n 2) 1241.

activism has tended to emerge as two streams, with one stream being in the majority which focuses on financial activism, that is, activism which deals with shareholder value or governance issues,[15] and the other stream exploring the consequences of activism on broader corporate outcomes and stakeholder issues, namely firms' environmental impact[16], corporate social performance[17] and political activity[18]. Therefore, the objectives of shareholder activism may be mixed. This thesis, however, will mainly focus on the financial objectives, owing to constraints of space and availability of data. It contributes an interesting topic for the future research to explore institutional shareholders activism from the perspective of broader corporate outcomes.

3.2 Theoretical foundation of shareholder activism

Shareholder activism is often perceived as a legitimate exercise of ownership rights.[19] As shareholder activism is an incidence of shareholder ownership,[20] it could be

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[15] See generally, Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (2008) 63(4) The Journal of Finance 1749; Robin Greenwood and Michael Schor, 'Investor Activism and Takeovers' (2009) 92(3) Journal of Financial Economics 368.

[16] See generally, Min-Dong Paul Lee and Michael Lounsbury, 'Domesticating Radical Rant and Rage: An Exploration of the Consequences of Environmental Shareholder Resolutions on Corporate Environmental Performance' (2011) 50 Business & Society; Erin M Reid and Michael W Toffel, 'Responding to Public and Private Politics: Corporate Disclosure of Climate Change Strategies' (2009) 30(11) Strategic Management Journal.

[17] See generally, Parthiban David, Matt Bloom and Amy J Hillman 'Investor Activism, Managerial Responsiveness, and Corporate Social Performance' (2007) 28 Strategic Management Journal; Kathleen Rehbein, Sandra Waddock and Samuel B. Graves, 'Understanding Shareholder Activism: Which Corporations are Targeted?' (2004) 43 Business & Society.

[18] See generally, Cynthia E Clark and Elise Perrault Crawford. 'Influencing Climate Change Policy: The Effect of Shareholder Pressure and Firm Environmental Performance' (2012) 51 Business & Society.

[19] The UK government even considered shareholders as possibly owing a fiduciary duty to engage in appropriate activism in their investee companies. See Department of Work and Pensions, Encouraging Shareholder Activism Consultation Paper (2002) <https://www.abi.org.uk/~/media/Files/Documents/Consultation%20papers/2002/05/DWPHMTESACTIVISM_240505111007.pdf> accessed 03 August 2016.

[20] The question of whether shareholders own the company is one of the key debates in company law. Lorraine Talbot claimed that shareholders were not the owners of the company because what they owned was not the company. The case *Bligh v Brent* [Bligh v Brent (1837) 2 Y & C Ex 268] established that whatever it was that shareholders did own, it was not the company asset. In deciding the case in this way, the court was faithfully following the principles laid down in *Salomon v Salmon* [Salomon v A Salomon & Co Ltd [1896] UKHL 1, [1897] AC 22] that the company was a separate legal being which required its own insurance and the company owned itself; the rights granted to shareholders did not add up to the ownership of the company. Others argue that shareholders are the owners of the company because of the legal rights they hold in the company, the law gives shareholders the power one would attribute to owners. For more discussions, see Lorraine Talbot, *Great Debates in Company Law* (Palgrave Macmillan 2014); Lynn A Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2001) Cornell Law Faculty Publication <http://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=1833&context=facpub> accessed 03 August 2016.

legitimated in the name of protecting shareholders' residual interests.[21] Therefore, the starting point to illustrate the rationale behind shareholder activism lies in the 'agency problem' of managerial control proposed by Jensen and Meckling.[22] As discussed in Chapter 1, the separation of ownership and control could result in the divergence between managers' self-serving interests and shareholders' interest in the maximization of corporate wealth[23] and, therefore, corporate governance frameworks are established to ensure that managers are effectively monitored or controlled. Shareholder activism is seen as a 'necessary monitoring force to combat management deviation and shirking'.[24] The agency problem places shareholder activism within the internal governance framework of a corporation and shareholder activism could be characterised as a 'form of market-based discipline' that is intended to monitor management. The fundamental rationale for shareholder activism is arguably a means of 'defence' against managerial deviations.[25] Shareholder activism is, to some extent, beneficial theoretically insofar as it reduces agency costs by monitoring the agent's actions to ensure its proper behaviour. Therefore, those in favour of shareholder activism claim that it results in improved corporate governance and that it has positive externalities because the monitoring benefits all shareholders.[26]

In the aftermath of the financial crisis, the belief that shareholders have a positive role to play in corporate governance was revitalized and some scholars, such as Bebchuk, call for greater managerial accountability to shareholders with the aim to improve firm performance.[27] However, shareholder activism is a topic mired in controversy. Others claim that shareholder activism is detrimental to corporate value[28] and Lorraine Talbot

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[21] Lucian A Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 Harvard Law Review; see also Chiu (note 5).
[22] Michael C Jensen and William H Meckling. 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure.' (1976) 3 Journal of Financial Economics.
[23] *ibid.*
[24] Chiu (note 5) 20.
[25] *Ibid* 7.
[26] See generally, Lucian A Bebchuk, 'The Myth of the Shareholder Franchise.' (2007) 93 Virginia Law Review; Bebchuk (n 21).
[27] See generally, Bebchuk (n 21); Bebchuk (n 26); Dimitrov, Valentin and Prem C Jain, 'It's Showtime: Do Managers Report Better News Before Annual Shareholder Meetings?' (2011) 49 Journal of Accounting Research.
[28] See generally, Lynn A Stout, 'The Mythical Benefits of Shareholder Control.' (2007) Virginia Law Review; Lynn A Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (Berrett-Koehler Publishers 2012); Stephen M Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2005) 119 Harvard Law Review; William W Bratton and Michael L. Wachter. 'The Case Against Shareholder Empowerment.' (2010) University of Pennsylvania

once claimed that shareholders were uniquely unsuited to exercise powers within the company and the existing powers possessed by shareholders should be removed.[29] The following paragraph sets out the objections to shareholder activism.

The first objection comes from Bainbridge, who followed Arrow's theory and argued in favour of the necessity of a centre of power that could exercise fiat within the corporation.[30] Arrow stressed that the importance of a central authority is that it is often the only possible way to make decisions and process information within a large organization that employs many thousands of people.[31] Therefore, Bainbridge argues that the board should be the single and central organ to exercise decision-making authority.[32] He views shareholder activism as something that could be detrimental to the board's authority and, therefore, shareholders should not play a role in corporate governance. He also expressed his concerns that the power of shareholders may be misused by self-interested investors.[33] Lipton and Roseblum also held the view that whether shareholders would act in the best interests of the company was doubtful.[34] Their objection also focuses on the information asymmetry and lack of expertise. Their opponents claim that shareholders lack either time and channels to gather information needed when engaging with a company[35] and therefore shareholders are unable to make 'sound decisions on either operational or policy questions'.[36]

In addition, shareholders are also criticised for their preference for short-termism and liquidity, especially institutional shareholders. The *European Commission Green Paper* on the corporate governance and remuneration policy of financial institutions [37]

Law Review; Leo E Strine, 'Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America.' (2006) 119 Harvard Law Review.

[29] Talbot (n 20) 50.

[30] Kenneth J Arrow, *The Limits of Organization* (W. W. Norton & Company 1974).

[31] Ibid 68-69.

[32] Stephen M Bainbridge, 'Shareholder Activism and Institutional Investors' (2015) UCLA School of Law, Law-Econ Research Paper No. 05-20 <http://ssrn.com/paper=796227> accessed 13 December 2016.

[33] Bainbridge (n 28); Stephen M Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press 2008).

[34] Martin Lipton and Steven A. Rosenblum, 'Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come' (2003) The Business Lawyer 72.

[35] Martin Lipton and Steven A. Rosenblum, 'A new system of corporate governance: The quinquennial election of directors' (1991) 1 The University of Chicago Law Review 195.

[36] Bainbridge (n 32) 621.

[37] European Commission, Green Paper on the Corporate Governance and Remuneration Policies (2010) <http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf> accessed 13 December 2016.

criticises shareholders for their pursuit of short-term profits. The Green Paper also noted that shareholders 'may even be responsible for encouraging excessive risk-taking in view of their relatively short, or even very short (quarterly or half-yearly) investment horizon'.[38] Talbot argues further that what institutional shareholders want is liquidity and the company is a means of extracting value in the eyes of institutional shareholders. They would therefore spread their investment as wide as possible and may leave the company when the maximum value extraction has been achieved, which may undermine the company's long-term sustainability.[39] Bainbridge says that 'institutional shareholder[s] will prefer liquidity to activism. For fully diversified institutions even the total failure of a particular firm will not have a significant effect on their portfolio, and may indeed benefit them to the extent that they also hold stock in competing firms.'[40] Wong argues that it is excessive portfolio diversification that makes monitoring more difficult. 'Large portfolios . . . give rise to difficulties in monitoring – particularly the resource-intensive engagements between institutional investors and boards of directors contemplated by stewardship codes in the UK and other markets – and weaken an "ownership" mindset.'[41]

Finally, shareholder activism also faces some competition from stakeholder activism. Recent literature in the realm of corporate governance increasingly directs its attention to the firm's stake-holding consideration and institutions' social performance. While corporate governance broadly addresses the needs of shareholders and investors, the 'stakeholder' view of the corporation has gained ground in the past decades, which is driven by the position that the modern corporation needs to be better governed for the whole of society as well.[42] Being regarded as one of the most important and radical changes in the Companies Act 2006, the enlightened shareholder value (ESV) approach enshrined in section 172 requires that it is the duty of the directors to 'promote the success of the company for the benefit of its members as a whole.'[43] Moreover,

[38] *Ibid*.
[39] Talbot (n 22) 55.
[40] Stephen M Bainbridge, 'The Case for Limited Shareholder Voting Rights' (2010) 53 UCLA Law Review 622.
[41] Simon CY Wong, 'Why Stewardship is Proving Elusive for Institutional Investors' (2010) 25 Butterworths Journal of International Banking and Financial Law 408.
[42] Millicent Danker, 'Understanding Stakeholder Activism, Managing Transparency Risk' in David Crowther, Güler Aras (eds) *The Governance of Risk (Developments in Corporate Governance and Responsibility, Volume 5) (*Emerald Group Publishing Limited 2013) 33.
[43] CA 2006, s172(1)

according to section 414 of the CA 2006, the directors of a company must prepare a strategic report for each financial year of the company,[44] with the aim of providing details on how section 172 has been applied. Apart from the CA 2006, Directive 2014/95/EU introduces more changes to non-financial reporting.[45]

Apart from these theoretical debates, empirical research aimed at revealing the results of shareholder activism also shows mixed results. For the purposes of the present research, empirical data was collected from the period 1993–2016 (Figure 3.1) which focus on the effect of institutional shareholder activism. The activism behaviour taken by shareholder might targeted various aspects, such as improve financial performance, realize social and environmental appeal. Among which, the financial target is the most common one. One of the main aims of this thesis is to reveal the effects of institutional shareholder activism in improving corporate performance, therefore, researches targeted at social and environmental outcomes are excluded from our research and only those researches focuses on the financial aspects are included.

[44] CA 2006, s414A(1)
[45] Katarzyna Chalaczkiewicz-Ladna, Irene-Marie Esser, and Iain G MacNeil, ‘Engaging stakeholders in the UK in corporate decision-making through strategic reporting: An empirical study’ (2017) draft working paper <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3049203> accessed 28 Novermber 2017

Authors	Activism measure	Period	Result	Main findings
Gordon and Pound (1993)	Governance proposals	1989–1992	I	Shareholder approval varies with the type of activist, proposal, ownership, governance and performance.
Karpoff, Malatesta and Walkling (1996)	Governance proposals	1986–1990	N	Weak negative market reaction on proxy mailing date. Target firms' sales grow slower than peers one to three years after activism.
Smith (1996)	CalPERS proposals	1987–1993	P	Positive market reactions to adoption and for firms that settle with CalPERS; negative for firms that do not.
Strickland, Wiles and Zenner (1996)	United Shareholder Association proposals	1986–1993	I	Insignificant market reaction, but positive for negotiated settlements. Shareholder approval is negatively related to firm performance and positively related to institutional ownership.
Wahal (1996)	Pension fund proposals	1987–1993	I	Insignificant market reaction and lack of long-term improvement in firm operational and financial performance.
Bizjak and Marquette (1998)	Poison pill proposals	1987–1993	N	Negative market reaction to proposals to rescind pills.
Carleton, Nelson and Weisbach (1998)	TIAA-CREF proposals	1992–1996	M	Insignificant market reaction overall; positive for some proposals.
Del Guercio and Hawkins (1999)	Pension fund proposals	1987–1993	I	Insignificant market reaction and long-term effect, positively related to subsequent market for corporate control.
Rao and Sivakumar (1999)	Shareholder resolutions	1984–1995	P	Shareholder resolutions are positively related to establishment of investor relation officers.
Gillan and Starks (2000)	Governance proposals	1987–1994	M	Insignificant market reaction to institutional activism, positive to individual activism.

Authors	Activism measure	Period	Result	Main findings
David, Hitt and Gimeno (2001)	Institutional activism	1987–1993	P	Activism positively related to research and development input.
Song and Szewczyk (2003)	Focus list of Council of Institutional Investors	1991–1996	I	Insignificant differences in returns, mergers, stock repurchases, institutional holdings and analysts' forecast revisions.
Stevens, Steensma, Harrison and Cochran (2005)	Pressure from shareholders	2002	P	Financial executives are more likely to integrate the company's ethics code into their decision-making process if they perceive pressure from market stakeholders, including shareholders.
Christoffersen, Geczy, Musto and Reed (2007)	Governance proposals	1998–1999	P	Governance-related activism is positively related to stock borrowing.
David, Bloom and Hillman (2007)	Shareholder proposals	1992–1998	P	Proposals by shareholders with power and legitimacy are more likely to be settled by the company.
Davis and Kim (2007)	Governance proposals	2001	N	Mutual funds' business ties with targeted companies have a negative impact on their votes for shareholder proposals.
Brav, Jiang, Partnoy and Thomas (2008)	Hedge fund activism	2001–2006	P	Positive market reaction to hedge fund activism; positive impact on Chief Executive Officer turnover and pay for performance.
Del Guercio, Seery and Woidtke (2008)	'Vote no' campaigns	1990–2003	P	Improved post-campaign performance. 'Vote no' campaigns are positively related to forced CEO turnover.
Westphal and Bednar (2008)	Activism threat	2002	P	Higher institutional ownership is positively related to CEO ingratiation behaviour and persuasion attempts.
Becht, Franks, Mayer and Rossi (2009)	Hermes UK focus fund activism	1998–2004	M	Private engagement by the activist fund leads to superior performance of the fund. Insignificant market reaction, but positive effect for restructuring and board changes.

Authors	Activism measure	Period	Result	Main findings
Chowdhury and Wang (2009)	Institutional activism	1996–2002	P	Shareholder activism is positively related to CEO compensation.
Ferri and Sandino (2009)	Shareholder proposals	2003–2004	M	Activism is negatively related to CEO compensation. Activism at peer firms is positively related to voluntary expensing of options.
Green-Wood and Schor (2009)	Hedge fund activism	1993–2006	P	Targeted firms are more likely to be acquired. Positive returns to activism are largely due to subsequent acquisitions.
Klein and Zur (2009)	Hedge fund activism	1995–2005	P	Positive market reaction to shareholder activism, particularly when the objective is board representation, buyout or merger.
Alexander, Chen, Seppi and Spatt (2010)	Proxy contests	1992–2005	P	Positive market reaction to Institutional Shareholder Services recommendations.
Cai and Walkling (2011)	Say-on-pay proposals	2006–2007	I	Insignificant market reaction to say-on-pay proposals
Dimitrov and Jain (2011)	Governance proposals	1996–2005	P	Activism interacts positively with underperformance.
Ertimur, Ferri and Muslu (2011)	‘Vote no campaigns, proposals	1997–2007	M	Pay, entrenchment, and institutional proponents are positively related to shareholder approval, while board independence is negatively related.
Agrawal (2012)	American Federation of Labour and Congress of Industrial Organizations ‘vote no’ campaigns	2003–2006	I	AFL-CIO activism is associated with reductions in labour-union/management disputes. (insignificant)
Butler and Gurun (2012)	Mutual fund voting	2004–2007	P	Mutual funds in the same educational network as the more likely to vote against proposals on executive compensation.

Authors	Activism measure	Period	Result	Main findings
Cunat, Gine and Guadalupe (2012)	Governance proposals	1997–2007	P	Positive market reaction to proposals that pass.
Gantchev (2013)	Hedge fund activism	2000–2007	M	Escalation of activism campaign is positively related to expected benefits for the activist fund, and negatively related to the activist investment in the target and the number of ongoing campaigns.
Gow, Shin and Srinivasan (2014)	Shareholder activist campaigns	2004–2011	P	Directors are almost twice as likely to leave over a two-year period if the firm is the subject of a shareholder activist campaign
Sunder, Sunder and Wongsunwai (2014)	Hedge fund activism	1995–2009	I	Shareholder activism does not always exacerbate bondholder–shareholder conflicts of interest.
Kima, Byuna and Leea (2015)	'Vote no' campaigns by the National Pension Service of Korea	2006–2009	N	Market does not react in the short run.
Prevost, Wongchoti and Marshall (2016)	Shareholder proposals	1988–2010	P	Trading volume increases in the period immediately following the proxy mailing date.

I = insignificant; M = meaningful; N = negative; P = positive

Figure 3.1: Empirical research of shareholder activism, 1993–2016[46]

[46] Part of Figure 3.1 was adapted from Goranova and Ryan (n 2). Rest of the figure was collected and analysed by the present author.

An analysis of the empirical research (Figure 3.1) shows that the results exhibit significant variance. Some results are positive[47], some negative[48], some show that there is an insignificant[49] relationship between shareholder activism and certain market

[47] See generally: Michael P Smith, 'Shareholder Activism by Institutional Investors: Evidence from CalPERS'(1996) 51 The Journal of Finance; Hayagreeva Rao and Kumar Sivakumar 'Institutional Sources of Boundary-spanning Structures: The Establishment of Investor Relations Departments in the Fortune 500 Industrials' (1999) Organization Science; John M Stevens, H Kevin Steensma, David A Harrison and Philip L Cochran 'Symbolic or Substantive Document? The Influence of Ethics Codes on Financial Executives' Decisions' (2005) 26 Strategic Management Journal; Susan EK Christoffersen Christopher C Geczy, David K Musto and Adam V Reed 'Vote Trading and Information Aggregation' (2007) 62 The Journal of Finance; Parthiban David, Matt Bloom and Amy J Hillman 'Investor Activism, Managerial Responsiveness, and Corporate Social Performance' (2007) 28 Strategic Management Journal; Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas 'Hedge Fund Activism, Corporate Governance and Firm Performance' (2008) The Journal of Finance;, Diane Del Guercio, Laura Seery and Tracie Woidtke 'Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?' (2008) Journal of Financial Economics ; James D Westphal and Michael K Bednar 'The Pacification of Institutional Investors' (2008) Administrative Science Quarterly; Shamsud D Chowdhury, and Eric Zengxiang Wang 'Institutional Activism Types and CEO Compensation: A Time-Series Analysis of Large Canadian Corporations' (2009) Journal of Management; April Klein and Emanuel Zur 'Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors' (2009) The Journal of Finance; Cindy R Alexander, Mark A Chen, Duane J Seppi and Chester S Spatt 'Interim News And The Role Of Proxy Voting Advice' (2010) 23 The Review of Financial Studies; Valentin Dimitrov and Prem C Jain 'It's Showtime: Do Managers Report Better News Before Annual Shareholder Meetings?' (2011) Journal of Accounting Research; Alexander W Butler and Umit G Gurun 'Educational Networks, Mutual Fund Voting Patterns and CEO Compensation' (2012) The Review of Financial Studies; Vicente Cuñat, Mireia Gine and Maria Guadalupe 'The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value' (2012) The Journal of Finance; Ian D Gow Sa-Pyung Sean Shin and Suraj Srinivasan, 'Consequences to Directors of Shareholder Activism', Harvard Business School, Working paper 14-071; Andrew K Prevost, Udomsak Wongchoti and Ben R Marshell, 'Does Institutional Shareholder Activism Stimulate Corproate Information Flow? Evidence form Labour Union Proxy Activism' (2016) Journal of Banking and Finance.

[48] See generally, Jonathan M Karpoff, Paul H Malatesta and Ralph A Walkling 'Corporate Governance and Shareholder Initiatives: Empirical Evidence' (1996) Journal of Financial Economics; John M Bizjak and Christopher J Marquette 'Are Shareholder Proposals All Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills' (1998) Journal of Financial and Quantitative Analysis; Gerald F Davis and E Han Kim 'Business Ties and Proxy Voting by Mutual Funds' (2007) 2 Journal of Financial Economics.

[49] See generally, Lilli A Gordon and John Pound 'Information, Ownership Structure and Shareholder Voting: Evidence From Shareholder-sponsored Corporate Governance Proposals' (1993) The Journal of Finance; Deon Strickland, Kenneth W Wiles and Marc Zenner 'A Requiem for the USA Is Small Shareholder Monitoring Effective?' (1996) 2 Journal of Financial Economics; Sunil Wahal, 'Pension fund activism and firm performance' (1996) 31 Journal of Financial and quantitative analysis; Del Guercio, Diane and Jennifer Hawkins 'The Motivation and Impact of Pension Fund Activism' (1999) 52 Journal of Financial Economics; Wei-Ling Song and Samuel H Szewczyk 'Does Coordinated Institutional Investor Activism Reverse The Fortunes Of Underperforming Firms?' (2003) 38 Journal of Financial and Quantitative Analysis; John M Stevens , H Kevin Steensma, David A Harrison and Philip L Cochran 'Symbolic or Substantive Document? The Influence of Ethics Codes on Financial Executives' (2005) 26 Decisions' Strategic Management Journal; Jie Cai and Ralph A Walkling 'Shareholders' Say on Pay: Does It Create Value?' (2011) 46 Journal of Financial and Quantitative Analysis; Ashwini K Agrawal, 'Corporate Governance Objectives of Labor Union Shareholders: Evidence From Proxy Voting' (2011) 25 The Review of Financial Studies; Jayanthi Sunder and Wongsunwai, Wan, 'Debtholder Responses to Shareholder Activism: Evidence from Hedge Fund Interventions' (2014) 27 Review of Financial Studies.

reactions[50], and some results are a mixture of positive, negative and insignificant[51]. In this research 50% of the results are positive and negative results only account for 17% (Figure 3.2). There are two factors that could account for the equivocal results. First, as observed by one researcher, many shareholder proposals are well negotiated by the related parties and, hence, might be withdrawn before their appearance as an actual proposal.[52] Proposals at general meetings may be the result of the lack of responsiveness to activists' private efforts or failure to reach a consensus.[53] Second, the majority of shareholder proposals investigated in the above research is advisory in nature and may, therefore, not bring changes to corporate performance.[54] The type of shareholder activist, the type of activism demands and the degree to which managers are willing to negotiate with shareholder activists also contributes to differences in the empirical results.

The research focuses on different types of shareholders, including pension funds, mutual funds and hedge funds; different activism targets, such as rescind pills, research and development input, CEO compensation, underperformance governance-related topics; and on different jurisdictions (mainly US). There are thus many variables that have an influence on the research results apart from shareholder activism, and it is impossible to exclude their influence and only account for the consequences of shareholder activism. Many research papers focus on the relationship between shareholder proposal and company performance. However, as will be shown in the next

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[50] *Market reaction* means the changes in the market components, such as the share price change following shareholder activism events, corporate operating performance and changes in governance.

[51] See generally, Willard T Carleton, James M Nelson and Michael S Weisbach 'The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence From TIA–CREF' (1998) 53 The Journal of Finance; Stuart L Gillan and Laura T Starks 'Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors' (2000) 57 Journal of Financial Economics; Marco Becht, Julian Franks, Colin Mayer and Stefano Rossi 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2008) 22The Review of Financial Studies;, Fabrizio Ferri and Tatiana Sandino 'The Impact of Shareholder Activism on Financial Reporting and Compensation: The Case of Employee Stock Options Expensing' (2009) 84 The Accounting Review; Yonca Ertimur, Fabrizio Ferri and Stephen R Stubben 'Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals' (2010) 16 Journal of Corporate; Nickolay Gantchev, 'The Costs of Shareholder Activism: Evidence from a Sequential Decision Model' (2013) 107 Journal of Financial Economics.

[52] Goranova and Ryan (n 2) 1245.

[53] Shamsud D Chowdhury and Eric Zengxiang Wang 'Institutional Activism Types and CEO Compensation: A Time-Series Analysis of Large Canadian Corporations' (2009) 35 Journal of Management; Diane Del Guercio and Jennifer Hawkins 'The Motivation and Impact of Pension Fund Activism' (1999) Journal of Financial Economics 312.

[54] Goranova and Ryan (n 2) 1245.

chapter, this kind of activism is most frequently used by US shareholders, whereas their UK and Chinese counterparts often do not use it. As these forms of activism take place on an informal level, there is generally a lack of publicly available information on the effectiveness of private dialogue, and that makes it difficult to evaluate the effectiveness of informal engagement.[55]

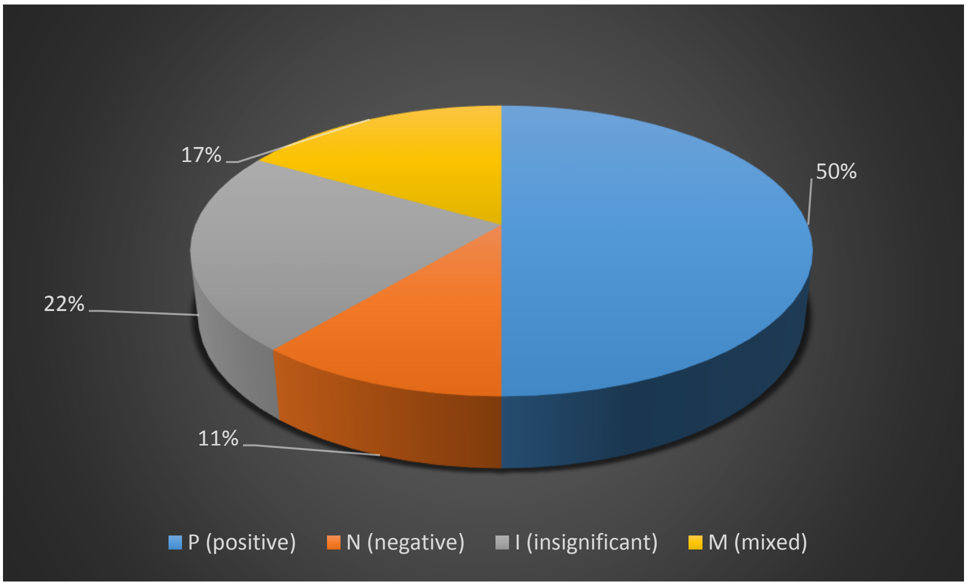

Figure 3.2: Percentage of different results in empirical research[56]

In China, institutional shareholder activism is still in its infancy. Considering the difficulty in collecting relevant data, there are only a few empirical research works that focus on the influence of institutional shareholder activism. In 2002 Luo Wei revealed that there is a positive correlation between the percentage of shares held by SIFs and corporate performance. Therefore, the author made an assumption that it is the engagement by SIFs that promoted corporate performance. The first research study to target institutional shareholder activism was by Wei'an Li and Bin Li in 2008.[57] They analysed the relevance between institutional shareholder intervention and the China Corporate Governance Index.[58] The results of their research show that there is a positive correlation between institutional shareholder engagement and the CCGINK, which

[55] John C Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor' (1999) 91 Columbia Law Review.
[56] Figure 3.2 is an analysis and summary of Figure 3.1.
[57] Wei'an Li and Bin Li, 'Empirical Research About Engagement Of Institutional Shareholders In Corporate Governance' [机构投资者介入公司治理效果的实证研究] (2008) Nankai Business Review.
[58] Hereinafter 'CCGINK'. It is the official data published by the Research Centre of Corporate Governance at Nankai University.

means that the market value of certain companies is promoted when institutional shareholder engagement takes place. More research, in the form of a PhD thesis written in 2010, looked at institutional investor's intervention in the corporate governance of Chinese listed companies from the perspective of management.[59] This research shows that although the positive coefficients indicate the relevance between institutional shareholder activism and corporate performance, it did not pass the significant testing, which means 'Chinese institutional shareholders are no more than 'traders' and show indifference to the long-term investment value of their investee companies.' Therefore, institutional shareholder activism did not improve corporate performance in this research.[60] Other research focuses on institutional shareholder activism, but from a theoretical perspective and with the expectation that institutional shareholder activism will contribute to corporate governance and, therefore, exclude these works.

3.3 Institutional shareholder passivity

There are various deterrents to the likelihood that shareholder engagement will play a substantive role in corporate governance. These factors could be divided into two categories: (1) from shareholders themselves and (2) from outside policy and the legal environment.

3.3.1 Internal factors

When considering shareholder passivity, the primary constraint is cost. On the one hand, the Berle and Means paradigm (i.e., the separation of ownership and control) makes shareholder passivity an inevitable result due to the small fraction of shares held by each shareholder compared with the large scale of modern industrial enterprise.[61] An OECD Working Paper on institutional shareholders identified five main features, or components, of an institutional shareholder' business model that influence the degree of their engagement, one of which is the number of companies that the institution has

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[59] Peitao Gao, 'Theoretical and Empirical Research About the Role of Institutional Shareholders in Corporate Governance' 2010, PhD thesis submitted to Shandong University, <http://gb.oversea.cnki.net/KCMS/detail/detail.aspx?filename=2010102638.nh&dbcode=CDFD&dbname=CDFD2010> accessed 23 June 2016.
[60] *Ibid.*
[61] Bernard S Black and John C Coffee 'Hail Britannia?: Institutional Investor Behavior Under Limited Regulation.' (1994) Michigan Law Review.

to look after.[62] The costs of exercising the same quality of engagement is obviously much higher in 1,000 companies compared with only a handful. This may account for the reason why institutions with highly diversified equity portfolios abstain from ownership engagement. On the other hand, as the chairperson of the National Association of Pension Funds said: 'When you are dealing with a company where you've got a problem, it is unbelievably difficult and time-consuming.'[63] One has to contribute a certain amount of time, money and effort to engage and given that this process is costly, shareholders with a small fraction of shareholding are unlikely to engage unless the potential benefits are much larger than the cost of the effort. To make matters worse, Black and Coffee examined the factors that hindered the formation of institutional coalitions and pointed out that the direct and indirect costs of coordination could influence shareholder activism. The classic free-rider problem and the difficulty in seeking agreement on cost sharing impede the formation of institutional coalitions, besides, even the coalition between institutional shareholders are formed, maintaining this coalition takes a substantial amount of time. Some of the costs are borne by clients while their rivals could free ride on these efforts. As the Walker Report observed, 'shareholders who do not exercise such governance oversight are effectively free-riding on the governance efforts of those that do.'[64]

Although institutional investors are empowered to monitor management, not all institutions are willing to use this power. Institutions that have a close relationship with their investee companies, are less likely to intervene when considering conflict of interests. Given the fact that their activism may lead to the loss of their business – either of the specific firm whose management they have opposed or of the corporate community generally – institutional shareholders are unwilling to oppose corporate management. In addition, as argued by Coffee, for some 'friendly' securities analysts and institutions, the managers of certain companies may provide them with soft information. The unfriendly intervention might block this soft information channel. [65]

[62] Serdar Çelik and Mats Isaksson , 'Institutional Investors as Owners: Who Are They and What Do They Do?', (2013) OECD Corporate Governance Working Papers, No 11, <http://dx.doi.org/10.1787/5k3v1dvmfk42-en> accessed 23 June 2016.
[63] Sullivan Ruth, 'Collective Engagement Picking up Steam' (Financial Times, 9 November 2009) <https://www.ft.com/content/0231ac18-cb07-11de-97e0-00144feabdc0> accessed 23 June 2016.
[64] Sir David Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations (hereinafter 'Walker Report' 2009) 78 <http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 23 June 2016.
[65] Coffee (n 55) 1324

This kind of conflict of interest between investment managers and portfolio companies also prevents shareholders from exercising a more active role, as pointed out by Black: 'they face conflicts of interest if they monitor corporate managers as many institutional investors depend on corporate managers for businesses.[66] Brickley, Lease and Smith found that further evidence shows that 'firms with greater holdings by institutions with potential business relations have more proxy votes in line with management's recommendations, while firms with greater holdings by shareholders without such potential relations experience more proxy votes against management's recommendations'.[67] Andres, Hartzell and Stark's research presents a model of institutional monitoring and the results are consistent with Brickley et al.'s research. The business relations between corporations and their institutional shareholders make a difference to their incentive to put pressure on their investee firms.[68]

Concerns about insufficient expertise prove to be another obstacle. Many shareholders are not confident about pointing out the mistakes of the board of directors and provide well-informed solutions using their own expertise.[69] Inappropriate performance metrics prove to be another reason. Given the fact that the quarterly monitoring process is usually the norm in the investment industry, the evaluation of the asset managers' performance is based on this quarterly report. Therefore, under intense pressure from colleagues and clients, asset managers inevitably focus on the maximization of short-term profits, rather than engaging with their investee companies. Because their remuneration is usually based on their quarterly performance, unsurprisingly, the financial incentive will exacerbate this situation. Another constraint that influences shareholders' willingness to have a greater voice in corporate governance is their preference for liquidity, especially for some institutions, such as mutual funds and insurance companies.[70] Take open-ended mutual funds as an example: on the one hand,

[66] Bernard S Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 UCLA Law Review 845.
[67] James Brickley, Ronald Lease and Clifford Smith, 'Ownership Structure and Voting on Antitakeover Amendments' (1998) 20 Journal of Financial Economics 277.
[68] Almazan Andres, Jay C Hartzell and Laura T Starks 'Conflicts of Interest and Monitoring Costs of Institutional Investors: Evidence from Executive Compensation' (2004) < http://www.haas.berkeley.edu/groups/finance/almazanhartzellstarks%20may%2004.pdf> accessed 28 June 2017.
[69] Pauline Skypala, 'Heads Lock on Shareholder Oversight' (Financial Times, 12 March 2009) <https://www.ft.com/content/d16fe0bc-113a-11de-87b1-0000779fd2ac> accessed 15 June 2017.
[70] Coffee (n 55).

they have to stand ready on a daily basis to repay or redeem the shares of customers who wish to sell and, therefore, most of them are active traders and prefer liquidation over control. On the other hand, mutual funds are compared with their competitors from the perspective of their ability to outperform and the result is a focus on shorter-term performance which makes liquidity a preferable option.[71] 'Locking in' by engaging in the operation of their investee companies could make liquidity much more difficult.[72]

3.3.2 Legal and political environment

3.3.2.1 United Kingdom

In the UK, there are several layers of regulation that discipline the behaviour of institutional shareholders. The first layer is company law which regulates the institutional investors' role as shareholders in their investee companies. The second layer is financial regulations that regulate the role of institutional investors as a player in the financial markets. The third layer are the various codes.[73] Before analysing them in detail, a brief introduction on the new regulatory regime is needed.[74]

In the UK, a Financial Policy Committee[75] has been established within the Bank of England with responsibility for financial stability. It oversees the activities of the two new regulators, the Prudential Regulation Authority[76] and the Financial Conduct Authority. The PRA was established as a subsidiary of the Bank of England and

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[71] *Ibid*.

[72] Andrew Hill, 'Preacher Myners is Right to Raise Hell with Investors' (Financial Times, 22 April 2009) <https://www.ft.com/content/83ae9bf2-2ea9-11de-b7d3-00144feabdc0> accessed 28 June 2016.

[73] In the area of ensuring sound corporate governance, policymakers do not see themselves as being the only ones responsible for the prescription of top-down rules. Therefore, the available regulatory choices are not just between either mandating legal rules on how to run and organize the company or doing nothing at all and allowing the parties to sort it out by themselves. A third option is to provide regulatory assumption or guidance: rules that are applicable unless a company elects for the rule not to apply. While the UK's formal body of legal rules and regulations is important, much of governance relies heavily on codes, which are derived from consultation with the industry itself and work as a benchmark for best practice. The role of the code is to provide more information disclosure to shareholders, and to provide mechanisms and a blue-print for shareholder engagement with companies. 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.

[74] The passage of the Financial Service Act 2012 signifies the abolition of the Financial Services Authority and the creation of three new regulatory bodies: the Financial Conduct Authority, the Prudential Regulation Authority and the Financial Policy Committee. This new regime came into being on 1 April 2013.

[75] Hereinafter 'FPC'.

[76] Hereinafter 'PRA'.

supervision of deposit-taking institutions, insurers and systematic significant investment firms.[77] The FCA conducts business regulation for all authorised firms for the purpose of 'ensur[ing] that the relevant markets function well', protecting consumers, enhancing integrity and promoting effective competition.[78]

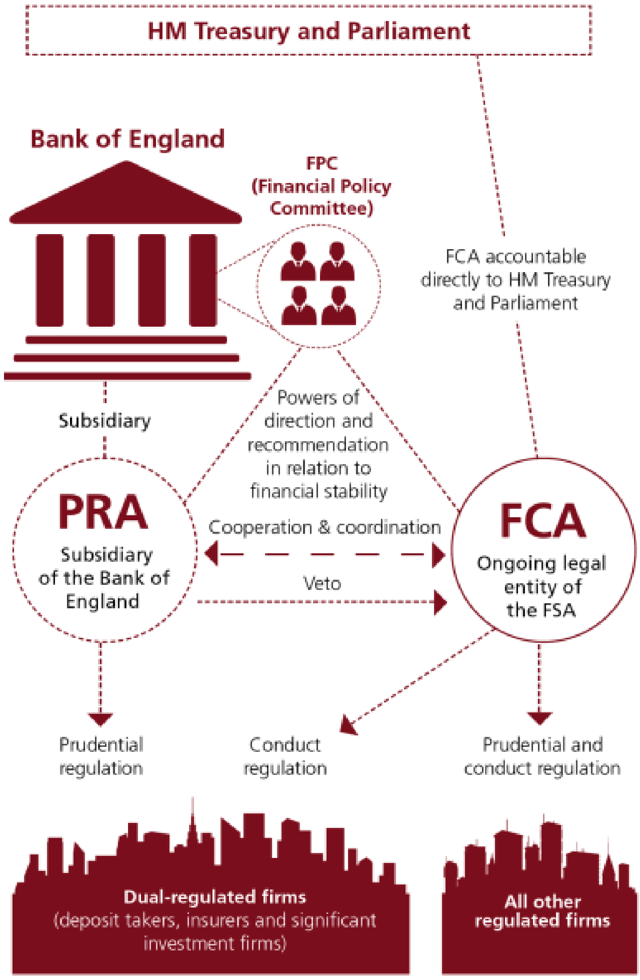

Figure 3.3: United Kingdom regulatory structure [79]

In the UK the main constraint on shareholder engagement would be the market abuse regime under FSMA 2000,[80] even though its primary aim is to ensure market integrity. Afraid of being regarded as an 'insider' when exercising intervention, shareholders are

[77] Iain G MacNeil, *An introduction to the law on financial investment* (Bloomsbury Publishing 2012) 76.
[78] Financial Conduct Authority, 'Our Strategy' <https://www.fca.org.uk/publication/corporate/fca-our-strategy-december-2014.pdf> accessed 28 June 2016.
79 This figure is taken from 'FCA Business Plan: 2013/14', FCA 58 <https://www.fca.org.uk/publication/business-plans/bp-2013-14.pdf> accessed 28 June 2016.
[80] Frank Curtiss, Ida Levine and James Browning, 'The Institutional Investor's Role in "Responsible Ownership" ' in Iain G MacNeil and Justin O'Brien (eds), *The Future of Financial Regulation* (Hart 2010) 309.

cautious about their behaviour when dealing in shares. However, the former Financial Services Authority (now FCA) clarified the extent to which the market abuse regime has operated as a constraint in limiting institutional engagement and ways to break this constraint.[81] On the first issue, it is noted that 'the firms that we have met do not consider that the market abuse regime is an impediment to their activist strategies'. On the second point, the FSA made it clear that 'a firm would not be committing market abuse if it carried out trading on the basis of its own intentions or knowledge of its own strategy'.[82] Thus, it would not be interpreted as market abuse if the purpose of buying shares in one company is intervention or re-structuring.[83]

In addition, the Stewardship Code also provides a hurdle to the activism by creating a sequence that engagement should be escalated.[84] If a shareholder would like to intervene, the first step is to have a confidential discussion with the company. Only once this step has failed, will the further four steps (1. holding additional meetings with management specifically to discuss concerns; 2. expressing concerns through the company's advisers; 3. meeting with the chairperson, senior independent director or with all independent directors; and 4. intervening jointly with other institutions on particular issues.[85]) be allowed before the issue goes public.

3.3.2.2 United States

The regulatory framework in the US works differently compared with its UK counterpart. Each state in the US has its own company law and, therefore, US corporate law is a matter of state rather than federal regulation. From the perspective of the securities industry, the legislation at the federal level exerts great influence. Securities market is regulated at both the federal level and state level ('Blue Sky Laws'), which

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[81] See Financial Services Authority, the letter from the FSA to the Chairperson of the Institutional Shareholders Committee, 2009 <http://www.fsa.gov.uk/pubs/other/shareholder_engagement.pdf> accessed 13 August 2016.

[82] Iain G MacNeil, 'Activism Among Shareholders in UK Listed Companies' (2010) Capital Markets Law Journal 425.

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

[84] MacNeil (n 12) 477.

[85] Financial Reporting Council, The Stewardship Code, Principle 4 <https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx> accessed 13 August 2016.

are aimed at protecting investors from fraudulent practices and activities.[86] While the specific provisions of these Blue Sky Laws vary from state to state and there is little uniformity among them, most of them require the registration of the sold securities and broker-dealers and their representatives, unless it is exempt from registration. It is a complicated web of regulations from 50 different jurisdictions that supplement the SEC rules and regulations.

US institutional shareholders are hobbled by a complex web of legal obstacles that make activism an undesirable option. The most obvious and direct restriction on shareholder power are the extremely limited voting rights. Pound[87] and Black[88] have separately examined the legal rules and regulatory policies governing shareholder voting and have reported that this body of law, which was long thought to protect the shareholder's franchise, often operates to frustrate its effective exercise. According to the Delaware Corporation Law, the election of directors, approval of the charter, amendments of bylaw, mergers, sales of substantially or all the corporation's assets and voluntary dissolution[89] are all included in the shareholders' voting rights. The election of directors and amending the bylaws are rights that do not require board approval. However, the proxy regulatory regime discourages large shareholders from seeking to replace incumbent directors with their own nominees[90] and also discourages shareholders from communicating with one another[91]. Therefore, the election of directors is predetermined by the existing board nominating the next year's board[92] and to exacerbate matters, shareholder resolutions are precatory in most cases and lack binding power[93]. Disclosure requirements pertaining to large holders also exert

[86] See information on official website of U.S. Securities and Exchange Commission <https://www.sec.gov/answers/bluesky.htm> accessed 13 August 2016.
[87] John Pound, 'Proxy Voting and the SEC: Democratic Ideals Versus Market Efficiency', (1990) paper presented at the Structure and Governance of Enterprise Conference, Kennedy School of Government, Harvard University.
[88] Bernard S Black, 'Shareholder Passivity Reexamined.' (1990) 3 Michigan Law Review 576.
[89] Michael P Dooley, *Fundamentals of Corporation Law* (Foundation Press 1995).
[90] Stephen M Bainbridge, 'Redirecting State Takeover Laws at Proxy Contests' (1992) Wisconsin Law Review 1075.
[91] Stephen Choi, 'Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms.'(2000) 16 Journal of Law, Economics and Organization 248.
[92] Bainbridge (n 32).
[93] See generally, Lucian A Bebchuk, 'The Case for Shareholder Access to the Ballot.' (2003) The Business Lawyer; Melvin A Eisenberg, 'Access to the Corporate Proxy Machine' (1970) 83 Harvard Law Review; Brett McDonnell, 'Shareholder Bylaws, Shareholder Nominations and Poison Pills' (2005) Minnesota Legal Studies Research Paper No. 05-06; William K Sjostrim Jr and Young Sang Kim, 'Majority Voting for the Election of Directors' (2007) 40 Connecticut Law Review.

influence in limiting shareholder activism. According to s 13(d) of the Securities Exchange Act and the SEC rules, ‘any person or group acting together to acquire beneficial ownership of more than 5% of the outstanding shares of any class of equity stock in a given issuer are required to make extensive disclosure’.[94] This disclosure requirement impinges substantially on investor privacy and may, therefore, discourage some investors from holding large blocks given the 5% threshold. [95] In addition, insider trading and short swing profit rules also prevent shareholders from exercising significant influence over corporate decision-making. The Securities Exchange Act of 1934 intended to prevent unfair use of inside information and discourage speculative trading by insiders by requiring ‘directors and executive officers of a reporting company to report their beneficial ownership of, and transactions in, the company’s securities to the SEC and the public’[96] and selective disclosure of information to large block shareholders will raise serious insider trading concerns.[97] In addition to s 16(a), s 16(b) also discourages trading on inside information by requiring ‘company insiders to return any profits made from the purchase and sale of company stock if both transactions occur within a six-month period’. This legal rule discourages communication and coordination among shareholders. Last, minority shareholder protection rules may also discourage the formation of institutional shareholders. Under the Delaware corporate law, controlling shareholders owe fiduciary duties to minority shareholders,[98] hence, a majority shareholder ‘who uses its power to force the corporation to enter into contracts with the shareholder or its affiliates on unfair terms can be held liable for the resulting injury to the minority’.[99] Therefore, the formation of large stock blocks are discouraged.[100]

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[94] Securities Exchange Act of 1934 <https://www.sec.gov/about/laws/sea34.pdf> accessed 28 June 2016.
[95] Bernard S Black, ‘Shareholder Activism and Corporate Governance in the United States’ (1998) The New Palgrave Dictionary of Economics and the Law 460.
[96] Securities Exchange Act of 1934, s 16(a)
[97] Stephen M. Bainbridge, ‘The Politics of Corporate Governance’ (1995) 18 Harvard Journal of Law and Public Policy 671. The problem is illustrated by an SEC enforcement proceeding (against the institutional investor group run by money manager Mario Gabelli. The group owned over 25% of the stock of an industrial corporation of which Gabelli was the CEO. Even though there was no evidence of illegal insider trading, the SEC brought an enforcement proceeding alleging that the investment group had inadequate policies to prevent insider trading by the firm based on information learned by Gabelli through his relationship with the corporation.
[98] *See* Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947).
[99] *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).
[100] Black (n 66).

3.3.2.3 China

In China, there are also several layers of regulation that discipline the behaviour of institutional shareholders. The first layer is the company law 2005 and the securities law which was enacted 'for the purpose of regulating the issuing and trading of securities, protecting the lawful rights and interests of investors, safeguarding the economic order and public interests of the society, and promoting the socialist market economy.'[101] It basically applies to the issuance and trading of stocks, corporate bonds and other securities recognized by the State Council lawfully[102] and, therefore, banks, trust and insurance are regulated separately (see second layer discussed below).[103]

The second layer are the regulations published by ministries under the state council. The regulatory boundaries are divided primarily by the broad types of activity which the regulator oversees. Under the state council, there are 'one bank and three commissions' (see Figure 3.4) which represents the Chinese Central Bank, the People's Bank of China[104]; China Banking Regulatory Commission[105]; China Securities Regulatory Commission[106]; China Insurance Regulatory Commission[107]. The PBOC is in charge of the monetary policy aimed at regulating systematic risks and managing financial stability. It also controls the State Administration of Foreign Exchange, which manages the exchange rate. Banks are regulated primarily by the CBRC. Securities and financial markets are regulated by the CSRC in order to maintain an orderly securities and futures market order, and ensure the legal operation of the capital market.[108] Two of the main institutional shareholders are (1) mutual funds and (2) QFII in China which are regulated by CSRC. CIRC is responsible for the regulation of insurance companies and part of the pension funds are regulated by the Ministry of Human Resources and Social Security.

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[101] Securities Law of the People's Republic of China art. 1, <http://www.china.org.cn/english/government/207337.htm> accessed 02 July, 2016.
[102] Securities Law of the People's Republic of China, art. 2.
[103] Securities Law of the People's Republic of China, art. 6.
[104] Hereinafter 'PBOC'.
[105] Hereinafter 'CBRC'.
[106] Hereinafter 'CSRC'.
[107] Hereinafter 'CIRC'.
[108] Douglas J Elliott and Kai Yan, *The Chinese Financial System: An Introduction and Overview* (Brookings Institution 2013).

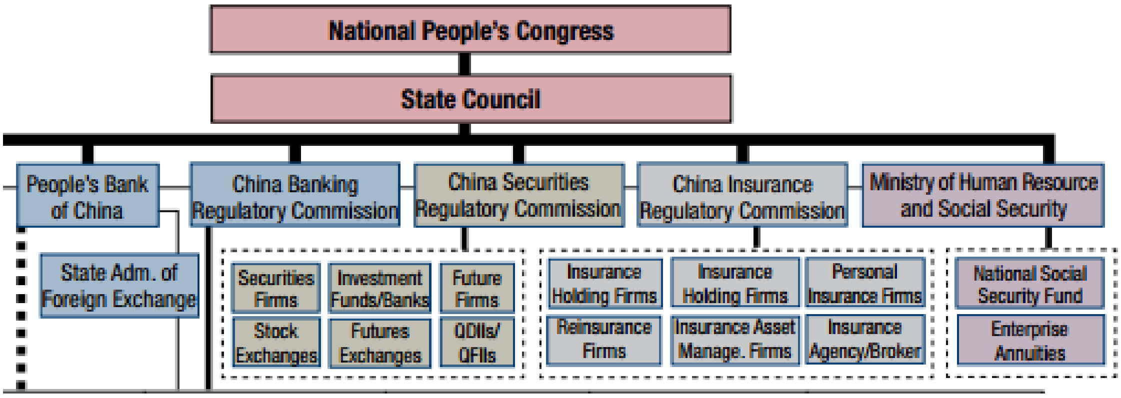

Figure 3.4: Regulatory framework in China [109]

The third layer is the Code of Corporate Governance for Listed Companies, which is aimed at ‘promoting the establishment and improvement of [the] modern enterprise system by listed companies, standardizing the operation of listed companies and bringing forward the healthy development of the securities market’.[110] Unlike the corporate governance code in the UK which is based on the ‘comply or explain’ approach, the Chinese code listed criteria to measure and to judge whether a listed company has a sound corporate governance structure, if not, the CSRC was empowered to order the companies to remedy their major problems according to the code.

Beyond these three layers of regulation, as shown in the dual corporate governance framework,[111] the CPC is another important body that has quasi-regulatory power. The considerable influence of party bodies and party members over personnel appointments, financial decisions and operational strategies makes the CPC decisions influential.[112]

In China, as discussed in Chapter 2, the powers enjoyed by Chinese shareholders is much greater than in the UK and US. The shareholder meeting is an ‘organ of power’ with the absolute decision-making authority in the company. Some rights that belong to directors in the UK, such as deciding a company’s management policy and

[109] This figure is taken from the official CSRC website <http://www.csrc.gov.cn/pub/csrc_en/about/> accessed 02 July 2016.
[110] CSRC, Code of Corporate Governance for Listed Companies <http://www.ecgi.org/codes/documents/code_en.pdf> accessed 02 July 2016
[111] See section 1.3.3 of this thesis.
[112] Elliott and Yan (n 108).

investment plan, require the approval of the shareholders in the Chinese system.[113] The only constraint on shareholder engagement would be to restrict the threshold that limits the amount of the assets that could be invested in stocks.[114] Hence, the legal environment is friendly to shareholders if they want to exercise power.

In conclusion, there are many constraints on shareholder activism from institutional shareholders themselves to a wider environment and shareholder passivity is a product of many barriers. For the most part, no single rule is an impediment; no single cost is prohibitive. However, the accumulation of numerous obstacles and risks imposes a substantial burden on shareholder action.

3.4 Reasons behind the growth of institutional shareholder activism

The literature on the benefits and disadvantages of shareholder activism abounds, and the reasons behind shareholder passivity that make engagement an option need careful consideration. Although the call for increased shareholder activism was never a subject of consensus, institutional shareholder activism has become a growing trend in recent years. This section will point out the driving force behind growing institutional shareholder activism.

3.4.1 Reasons from the perspective of institutional shareholders

The first aspect is the ‘exit’ versus ‘voice’. Albert O. Hirschman once claimed that the options of ‘exit’ and ‘voice’ were available for members of any organization to choose from.[115] The ‘voice’ will be of little attraction if an easy and low-cost ‘exit’ is available for members to exercise. Only if the ‘exit’ is inaccessible, will the members become more interested in exercising a ‘voice’ in governance decisions.[116] Passivity could be combated and shareholders are more likely to engage when they are not happy with corporate performance if using ‘exit’ is not favourable.[117] On the one hand, there are various factors that may make ‘exit’ an unattractive choice: ‘where the exit may involve

[113] Chinese Company Law 2005 , s 38(1).
[114] See section 1.3.3.1 of this thesis.
[115] Hirschman (n 8).
[116] Coffee (n 55).
[117] James P Hawley and Andrew T Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (University of Pennsylvania Press 2000).

a significant stake that may drive market prices lower for the company stock, or where the holding is significant enough such that exit at a loss is not favoured option, or where certain pension funds may be servicing the investee company's pension savings and hence are reluctant to sell the investee companies' shares.'[118] On the other hand, the growth in institutional ownership of securities and the resulting increased capacity for collective action make 'voice' less costly. Institutional shareholders come in different forms with many different characteristics, such as different organizational structures and governance structure, but they share some advantages that are not possessed by individual or non-institutional investors. Institutional investor are known for their specialized knowledge and professional teams of analysts, and access to a host of corporate and market data which could equip them with in-depth analyses and enable them to take wise decisions. Besides, institutional shareholders face lower risks than non-institutional investors due to a broad and diversified investment portfolio. They could play the role of equity market stabilizer, especially in an immature equity market such as China. Finally, institutional shareholders have their own internal governance structure and are supervised by different authorities, which makes them well established and well behaved. All these factors drive shareholders to use 'voice' more often. The second aspect is that shareholders may also gain certain benefits from engagement which was necessarily in line with the cost and, therefore, makes activism an attractive option. Rather than looking at the existing portfolios and trying to engage when certain corporate governance problems arise, many of today's activists select their investee companies based on identified opportunities to exert influence in order to unlock existing value. This type of 'offensive' activism generates great financial returns, and is becoming increasingly popular among institutional shareholders. The third factor relates to the legal protection of shareholders; although the law safeguards investors against management failure, it has limitations. On the one hand, the legal definition of breaches of legal duties may be limited and may not encompass certain errors of judgement which could be fatal to the company. On the other hand, the law provides private shareholder actions to redress defined wrongs but such actions may bring cold comfort to investors as they are ex post and prohibitively costly.[119] Therefore,

[118] Paul Myners, 'Institutional Investment in the United Kingdom: A Review' (2001) para 5.80, 5.85 < http://uksif.org/wp-content/uploads/2012/12/MYNERS-P.-2001.-Institutional-Investment-in-the-United-Kingdom-A-Review.pdf > accessed on 5 June 2016..
[119] Chiu (n 5) 26.

institutional shareholders may adopt activism as an ex ante and efficient tool to solve problems before taking any legal action. In the light of these three factors, institutional shareholders would combat their passivity to some extent and be more likely to engage.

3.4.2 Reasons from a wider context

3.4.2.1 Agency problems and corporate governance deficiencies call for institutional shareholder activism

An effective governance system is one that aligns the interests of managers and shareholders, thereby reducing agency costs and increasing value. Chapter 1 contains a detailed analysis of the corporate governance framework that has been built to address the agency problems that exist in different jurisdictions. However, the governance framework, both internal and external, has not prevented a large number of corporate failures, especially during the most recent global financial crisis. Recent years witnessed a shift to reliance on institutional shareholders with a view to solving those agency problems that have not been successfully resolved by the internal and external corporate governance framework.

The UK and US are usually described as a system of dispersed share ownership, with the lack of controlling shareholders in listed companies.[120] Therefore, an outsider or arm's-length system of corporate governance with both internal and external corporate governance mechanisms is built with the aim of reducing the expected costs and negative impact on the firm's value. For a long time, this set of corporate governance framework was regarded as a 'paragon', copied and transplanted by many other countries. However, the bursting of the high-technology bubble in the late 1990s, the Enron/WorldCom failures in the 2000s and the financial crisis in 2008 reveal the severe shortcomings in this outsider or arm's-length system of corporate governance. An OECD report observed, that the 'financial crisis can be to an important extent attributed to failures and weakness in corporate governance arrangements. When they were put to the test, corporate governance routines did not serve the purpose to safeguard against

[120] Marco Becht, Patrick Bolton and Ailsa Röell, 'Corporate Governance and Control' in George M Constantinides, M. Harris and Rene M Stulz *(eds), Handbook of the Economics of Finance* (North Holland 2003).

excessive risk-taking in a number of financial services companies.'[121] Lang and Jagtiani also claim that the risk control system was a basic failure: 'Financial firms lacked effective internal controls, accurate and timely financial and risk reporting to the right management level, and a corporate-wide view of risk or an enterprise-wide risk management program.'[122] Therefore, the failure of risk management systems is one aspect of corporate governance deficiencies that calls for more shareholder activism. Second, the current remuneration system is frequently criticised for its appetite for excessive risk-taking. Kirkpatrick pointed out that executive salaries were a failure and weakness in corporate governance as the remuneration systems were not in line with companies' risk appetite and long-term sustainability.[123] Another area of concern is board composition and practices. Non-executive directors have been criticised for their lack of time, knowledge and expertise. Finally, the opaque financial reporting and lack of transparency in communication with shareholders are also aspects of corporate governance deficiencies. Sahlman once concluded that 'many organizations suffered from a lethal combination of powerful, sometimes misguided incentives; inadequate control and risk management systems; misleading accounting; and, low quality human capital in terms of integrity and/or competence, all wrapped in a culture that failed to provide a sensible guide for managerial behaviour.'[124] These corporate governance deficiencies act as a concrete reflection of agency problems, sending out the message that the role of institutional shareholders should be encouraged to mitigate these problems. Many scholars argue that large shareholders' engagement could limit agency problems by monitoring and controlling managers' activities.[125] These scholars have further argued that because of the existence of free-riding problems, it was the large shareholders, such as institutional shareholders, that had sufficient incentives to monitor.

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[121] Grant Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis.' (2009) OECD Journal: Financial Market Trends 71.

[122] William W Lang and Julapa A Jagtiani, 'The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance' (2010) 38 Atlantic Economic Journal 132.

[123] Kirkpatrick (n 126)

[124] William A Sahlman, 'Management and the Financial Crisis' (2009) Harvard Business School Working Paper, No 10-033 <http://www.hbs.edu/research/pdf/10-033.pdf> accessed 14 August 2016.

[125]Andrei Shleifer and Robert W Vishny, 'Large Shareholders and Corporate Control' (1986) 94 Journal of Political Economy; Anat R Admati, Paul Pfleiderer and Josef Zechner 'Large Shareholder Activism, Risk Sharing and Financial Market Equilibrium' (1994) 102 Journal of Political Economy; Thomas H Noe 'Investor Activism and Financial Market Structure' (2002) The Review of Financial Studies.

It is beyond argument that the way institutional shareholders approach corporate governance is different from individual investors. The large blocks owned by large institutions enable them to develop specialized expertise and obtain greater access to corporate information which are needed to make informed decisions and for closer monitoring. As Bainbridge has pointed out, institutional investors with large blocks of shares might reunite ownership of the residual claim to seek the ultimate control of the company. Therefore, 'concentrated ownership in the hands of institutional investors might lead to a reduction in shirking and, hence, a reduction in agency costs'.[126]

However, in China, the agency problems is not as simple as in the UK and US, and both vertical and horizontal agency problems are crucial. As discussed in Chapter 1, owing to the dual governance structure, political governance determines that it is the CPC who decides the appointment and promotion of the top executives of SOEs. In Chinese SOEs, the managers and the chairperson of the board are usually the same person, and the overlap of board of directors and management team is a common phenomenon. As a consequence, the managers control the company totally and monitoring mechanisms are basically a failure. In addition, the managers and chairperson in SOEs not only work as business people, they also enjoy administrative positions in the government. The politically orientated bureaucratic system provides few incentives for them to fulfil their duties, but makes them focus on the short-term profits that could result in reward for them in the form of promotion. Therefore, the absolute power of the managers without supervision and their interest in political promotion make the vertical agency problems in China serious. In addition, the horizontal agency cost between majority shareholders and minority shareholders are also severe. Even though several rounds of economic reforms have taken place in the past decades, the state still owns the majority of the shares and this may lead to some adverse consequences. First, the state not only focuses on the financial aspects of SOEs, but also on political, strategic and national defense aspects. Therefore, the misalignment of government interests with minority shareholders' interest generates agency costs. Second, majority shareholding deprives minority shareholders indirectly of their rights. Given the fact that the engagement of minority shareholders exerts no influence over the operation of the companies, those

[126] Stephen M Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press 2008).

minority shareholders are more likely to act as a ‘rubber stamp’. Third, the existence of controlling shareholders invalidates external corporate governance mechanisms such as the market for corporate control and managerial market. As a consequence, the conflicts between majority shareholders and minority shareholders are extremely severe in China. Therefore, in China, institutional shareholders are the only ones who have the capability to engage with the state, and their activism and engagement are welcomed and anticipated.

3.4.2.2 Deregulation and policy support

The external environment could also influence the behaviour of institutional shareholders. Among other factors, the deregulation that breaks down the barrier used to limit shareholder activism and policy support for institutional shareholder engagement is an important factor.

3.4.2.1.1 UK

As argued by Chiu, institutional shareholder activism in the UK is driven not only by investment gains, but also by the policy emphasis on institutional shareholders being part of the governance landscape.[127] Therefore, apart from the factors attributed to institutional shareholders themselves, policy support plays an important role in encouraging institutional shareholder activism.

The thorough examination of existing methods of financial reporting by companies began in 1992 when the management fraud in BCCI and Polly Peck, and the harsh economic climate triggered the establishment of a committee headed by Sir Adrian Cadbury. The Cadbury Report dealt with a model of best practice for listed companies in the UK, including ‘the operation of the main board; the establishment, composition, and operation of key board committees; the importance of, and contribution that can be made by, non-executive directors; the reporting and control mechanisms of a business,

[127] Chiu (note 5) 43.

and the role of shareholders'.[128] This report adopted the 'comply or explain' rule, which meant that companies should explain their reasoning if they could not comply with certain aspects of the code.

As regards the role of institutional shareholders, the report stated that

> [g]iven the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance. Their readiness to do this turns on the degree to which they see it as their responsibility as owners, and in the interest of those whose money they are investing, to bring about changes in companies when necessary, rather than selling their shares.[129]
>
> Because of the importance of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the Code. The widespread adoption of our recommendations will turn in large measure on the support which all shareholders give to them. The obligation on companies to state how far they comply with the Code provides institutional and individual shareholders with a ready-made agenda for their representations to boards. It is up to them to put it to good use.[130]

It is evident that the report encouraged shareholders, especially institutional shareholders, apart from actively voting at the general meeting, to engage actively in dialogue and communication with their investee companies.[131]

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[128] European Corporate Governance Institute, Report of the Committee on the Financial Aspects of Corporate Governance (Burgess Science Press 1992) <http://www.ecgi.org/codes/documents/cadbury.pdf> accessed 4 November 2016.
[129] Ibid, para 6.10.
[130] Ibid, Para 6.16
[131] Ibid, Para 6.8, 6.13.

In 1995, the size of directors' remuneration packages, and their inconsistent and incomplete disclosure in companies' annual reports came into the spotlight and the Greenbury Committee was set up in response to this. A comprehensive set of recommendations – the Greenbury Report – was produced to call for more robust guidelines for the operation of independent remuneration committees and greater shareholder engagement with remuneration issues. The Greenbury Report states that 'shareholders have the option of speaking at the AGM to make their concern known, or putting down their own resolution for the AGM…or voting against remuneration committee members standing for re-election'.[132]

In line with the perception of the role of the shareholders laid down in the Cadbury Report, the Greenbury Report specifically saw a role for shareholder engagement in the issue of executive remuneration which could have governance implications. In order to review the implementation of the Cadbury and Greenbury Committee recommendations, the Hampel Committee was set up. Like the Cadbury Report and the Greenbury Report, the Hampel report also placed great emphasis on the role of institutional shareholders in their investee companies. The report stated that 'the directors as a board are responsible for relations with stakeholders; but they are accountable to the shareholders'.[133] Rather than 'box ticking', institutional shareholders are highly encouraged to engage in dialogue with companies and make full use of their voting rights. Therefore, policy support for shareholder activism by institutions has thus focused on participation in general meetings and the use of voice through the exercise of a vote.

The Myners Report on institutional investment concentrated more on the 'trusteeship aspects of institutional investors and the legal requirements for trustee, with the aim of raising the standards and promoting greater shareholder activism'.[134] The Myners Report on how institutional investment was managed in the UK indicated policy support for shareholder activism involving the private exercise of voice, and strongly encouraged investors to meet privately with executive officers and to register their

[132] Sir Richard Greenbury 'Greenbury Report' Directors' Remuneration: Report of a Study Group' (1995) para 5.28–5.33.
[133] Committee on Corporate Governance, Final Report (1997) <http://www.ecgi.org/codes/documents/hampel.pdf> accessed 4 November 2016.
[134] Myners (n 118) 4.

concerns in a persistent manner with a ‘thick skin’ until their concerns were addressed.[135]

The Higgs Review, which was published in 2003, focused on the role and effectiveness of non-executive directors[136] and the board’s relations with shareholders. The Higgs report set out more explicit avenues of communication and dialogue between shareholders and executive and non-executive directors, and affirmed the rationale for shareholder activism as opined in the Myners Report, namely that shareholder activism may generate value for shareholders and prevent losses in share values.[137] The Higgs Report also recommended that non-executive directors other than the senior independent director should attend a sufficient number of meetings with shareholders to understand shareholder views and concerns.[138] Shareholders should also be given access to non-executive directors through the company secretary at all times.[139] Hence, by 2003, institutional shareholder activism had been given a firm policy endorsement and the policy position on activism had moved from encouragement to vote, to more informal use of dialogue and communication with investee companies.[140]

In 2009, the Walker Review[141] on the corporate governance in banks recommended that shareholders should be encouraged to be more active as ‘stewards’ of the corporations in monitoring management and suggested that principles of engagement that had been formulated under the auspices of the Institutional Shareholders Committee be given greater status as a code in order to facilitate informal engagement. The Walker Review also recommended that collective engagement be permitted in order for institutional shareholders to join efforts in their activism, and that safe harbours be provided for such activism from legal restraints in concert parties and market abuse.[142] Hence,

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135 *Ibid.* para 5.75–5.76.
136 Derek Higgs, ‘Review of the Role and Effectiveness of Non-executive Directors’ (2003) <http://www.ecgi.org/codes/documents/higgsreport.pdf> accessed 4 November 2016
137 *Ibid.* par 15.22.
138 *Ibid.* par 15.16.
139 *Ibid.* par 15.19.
140 Chiu (note 5) 41.
141 David Walker, ‘Review of Corporate Governance in Banks and Financial Institutions’ (2009)<http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 4 November 2016.
142 *Ibid.* par 5.46.

institutional shareholder activism was encouraged not only to be exercised at general meetings, but beyond general meetings.

The UK Stewardship Code, the first of its kind for the Financial Reporting Council[143], tried to promote greater transparency between institutional shareholders and their investee companies by encouraging more communication through dialogue. The code 'aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities'.[144] The tradition of encouraging constructive dialogue between institutional shareholders and companies based on the mutual understanding of objectives was inherited by the Stewardship Code. The FRC set out good practice on engagement with investee companies with the belief that institutional shareholders could be inspired.[145] The FRC hoped that the new Stewardship Code could create a stronger link between governance and the investment process.[146]

The government response to a green paper consultation published in August 2017 was a document setting out the government's response to the green paper consultation and it identified nine proposals for reform which it now intends to take forward.[147] Among the summary of the responses, a majority of respondents who answered the questions were in favour of strengthening shareholders' power to hold companies to account on executive pay.[148] Besides, the government are working on the question of whether more needs to be done to encourage institutional investors to make full use of their existing and any new voting powers on pay. Almost three quarters of the respondents believed more could be done to encourage or enable institutional investors to make greater use of their voting power.[149]

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[143] Hereinafter 'FRC'.
[144] FRC, 'The Stewardship Code', <https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx> accessed 4 November 2016.
[145] Arad Reisberg, 'The Notion of Stewardship from a Company Law Perspective: Re-defined and Re-assessed in Light of the Recent Financial Crisis?' (2011) 18 Journal of Financial Crime.
[146] *Ibid*.
[147] Department for Business, Energy and Industrial Strategy, 'Corporate Governance Reform: The Government Response to the Green Paper Consultation', < https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640631/corporate-governance-reform-government-response.pdf> accessed 24 November 2017.
[148] *Ibid,* 1.4
[149] *Ibid,* 1.11

By analysing the Cadbury Report and the successive corporate governance reports, one can see that UK policymakers place great emphasis on the activism of institutional shareholders with the expectation that they could play an important role as 'owners' rather than merely 'investors' in corporate governance.

3.4.2.1.2 United States

Institutional shareholder activism in the US has a long history which could be traced back to the 1900s when insurance companies, mutual funds and banks were active participants in corporate governance. As introduced in Chapter 2, over the next several decades several laws were passed with the aim of limiting the power of financial intermediaries and, therefore, the active role of institutional shareholders in corporate governance was limited. In 1942, the SEC adopted a rule that was the predecessor of the current rule 14a-8, which stated that management must allow shareholder proposals that constituted a 'proper subject for action by the security holders.'[150] Shareholders began to submit proposals aimed at improving corporate performance and it was not until the mid-1980s that institutional shareholders replaced individual shareholders to play a more active role in corporate governance.

According to Gillan and Starks, the suspension of hostile takeovers and the steady growth in institutional ownership are the most important factors that contributed to the active role of institutional investors at the end of 1980. The formation of the Council of Institutional Investors could be regarded as the beginning of institutional shareholder activism,[151] and public pension funds and union funds soon became the most active investors. The rise of hedge funds in recent decades was changed the picture of institutional shareholder activism. Unlike its UK counterpart, it is difficult to find many rule changes at the SEC level. There have been only a number of provisions aimed at shareholder activists that have been proposed in the context of the larger public and business press discussion of shareholder activism. These provisions include the following:

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[150] U.S. Securities and Exchange Commission, Amendments to Rules on Shareholder Proposals <https://www.sec.gov/rules/final/34-40018.htm> accessed 4 November 2016

[151] Stuart L Gillan and Laura T Starks, 'The Evolution of Shareholder Activism in the United States' (2007) Journal of Applied Corporate Science <http://dx.doi.org/10.2139/ssrn.959670> accessed 4 November 2016.

(1) Changing the 13D filing deadline to lessen the shock of an activist investor (some proposed down to a 1-day timeline after 5% of a company has been purchased);

(2) Altering communication practices to restrict shareholder activists from reaching out to institutional investors.

Unlike the consistent policy encouragement for institutional shareholder activism since the Cadbury report in 1992 and a succession of other reports in the UK, which greatly promote the development of institutional shareholder activism, the US institutional shareholders are under limited policy influence. The lack of overwhelming evidence about policy support for institutional shareholder activism might due to the populist agenda in the 1930s. As mentioned in chapter 2, the pervasion of the distrust about large financial institutions lead to the promulgation of various acts aimed at limiting their power. Although some restrictions are removed afterwards, the government are more likely to follow this cautious attitude towards the development of institutional shareholders and the predominant policy led we saw in the UK is unlikely to happen in the US.

3.4.2.1.3 China

3.4.2.1.3.1 Policy support in the past

Although shareholder activism is not a new phenomenon and it is a prevalent practice and academia in both the UK and US, it is astonishing that shareholder activism has not drawn much attention in China. As discussed earlier in this chapter, directors and top executives chosen by the government, totally control shareholder general meetings on behalf of the majority shareholders, whereas minority shareholders are unable or unwilling to exert their influence. There are some instances where minority shareholders such as institutional shareholders successfully safeguard their interest by engaging actively, but these are rare events. Basically, shareholder activism is in the form of blockholder control in China, which is quite different from the usual form of shareholder activism in the UK and US. However, things are going to change and true shareholder activism could be expected in the very near future. The section that follows takes stock of the policies that encourage institutional shareholder activism and looks at the reforms taking place in China which provides a bright future for institutional shareholder activism.

In 2001, the Code of Corporate Governance for Listed Companies in China[152] was formulated to 'promote the establishment and improvement of a modern enterprise system by listed companies to standardize the operation of listed companies and to bring forward the healthy development of the securities market of our country'.[153] One of the aims of this corporate governance code is to 'establish a corporate governance structure sufficient for ensuring the full exercise of shareholders' rights'.[154] Hence, articles 3, 8 and 9 encourage shareholders actively engaged with companies to protect their interests and rights.

> Article 3: A listed company shall establish efficient channels of communication with its shareholders.
>
> Article 8: [A] listed company shall make every effort, including fully utilizing modern information technology means, to increase the number of shareholders attending the shareholders' meetings.
>
> Article 9: The shareholders can either be present at the shareholders meetings in person or they may appoint a proxy to vote on their behalf, and both means of voting possess the same legal effect.[155]

Furthermore, art. 11 encourages the active engagement of institutional shareholders by requesting that '[i]nstitutional investors . . . play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes.' This is the first time in history that activism by institutional shareholders has been formally prescribed in Chinese company law.

[152] China Securities Regulatory Commission State Economic and Trade Commission, 'Code of Corporate Governance for Listed Companies in China' (2001) <http://www.ecgi.org/codes/documents/code_en.pdf> accessed 4 November 2016.
[153] *Ibid*. preface.
[154] *Ibid*. ch 1, art. 1.
[155] *Ibid* ch 1, arts. 3, 8 and 9.

The new company law, which was adopted in 2005, laid great emphasis on the protection of shareholders' right. Article 38 generously empowered shareholder meetings with great functions and powers, ranging from decision rights on business policy, the election and replacement of directors to the amendment of the articles of association of the company.[156] The company law focused on the protection of minority shareholders particularly. Article 34 expanded the shareholders' right to know.[157] Article 75 prescribed that shareholders could request the purchase of their equity for a reasonable price by the company if certain circumstances occurred.[158] Article 106 brings in accumulative voting system to protect the rights of minority shareholders in the event of an election.[159] Article 152 made the derivative action available in China by stating that '[i]f any director or senior officer is in violation of any provision of laws, administrative regulations or the articles of association of the company, thus causing any losses to the shareholders, the shareholders may initiate legal proceedings against such director or senior officer in the people's court.'[160] All these articles could be seen as the improvement that the government made to provide a better environment for shareholder activism.

The former chairperson of the CSRC Shuqing GUO is a supporter of the growth of institutional shareholders and he has talked about the importance of nurturing institutional shareholders in Chinese capital markets on several public occasions. Under his great influence and the support of the government, the restrictions on institutional shareholders are easing.

In order to promote the sound development of securities investment funds, the newly amended Securities Investment Fund Law of People's Republic of China was published in 2015. In order to promote innovation and competitiveness of publicly-offered mutual funds, this amended law has relaxed requirements for publicly-offered funds in areas

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[156] Company Law 2005, art. 38.
[157] Article 34 prescribes that the shareholders of a company shall have the right to look into, and make copies of, the articles of association of the company, minutes of meetings of the board of directors, resolutions passed at meetings of the board of directors and the board of supervisors, and financial and accounting reports of the company.
[158] Company Law 2005, art. 75.
[159] *Ibid.* art. 106.
[160] *Ibid.* art. 152.

such as market access, investment scope and business operations. The regulation on publicly offered funds are loosened in the following aspects:[161]

- Removal of the need for the CSRC's approvals in respect of (i) the qualification of fund managers and custodians; (ii) establishment of branches of fund managers; (iii) change of shareholders of fund managers with no more than 5% shares; and (iv) amendment of the articles of association of fund managers.
- Fund raising is now only subject to prior registration with the CSRC and prior CSRC approval is no longer required.
- Fund managers can implement share plans for professional persons and set up long-term incentive and restraint schemes.
- Investment scope is expanded to cover derivatives as specified by the CSRC, which will provide the legal basis for investment in the futures market and in stock index futures.
- Restrictions over affiliated and securities trading by the staff of fund managers are relaxed.

The law also introduced a standalone chapter to address the nature, structure and duties of self-regulatory organisations, that is, fund industry association. As self-regulatory organisations in the UK exert great influence on the industry, their Chinese counterparts could be expected to take charge of part of the government's role and exert greater influence on Chinese securities investment funds, given the fact that they are encouraged to play a more active role.

From the perspective of pension funds, the governments has also made some strides. As described in Chapter 2,[162] China set up a multi-pillar pension system and tier one is the basic pension which includes 8% of employees' monthly income and 20% of employer's mandatory distribution. The government also set up the NSSF as a complementary vehicle to support the social security system in China. These two aspects of pension funds are undergoing great reform.

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[161] Tiecheng Yang, The Amended Securities Investment Funds Law: Significant Changes but More Expected (Clifford Chance, 28 January 2013) <https://www.cliffordchance.com/briefings/2013/01/the_amended_securitiesinvestmentfundslaw.html> accessed 4 November 2016.

[162] See section 2.4.2.2.3 of this thesis.

The Measures for the Administration of Investment in Basic Pension Insurance Funds[163] were promulgated in 2015 'for purposes of regulating the administration of investment in basic pension insurance funds, protecting the lawful rights and interests of fund trustors and the relevant parties'.[164] Article 37 stipulates that the allowed proportion of investment in securities and various kinds of funds must be no more than 30% of the net assets of basic pension insurance funds.[165] In 2016, the Regulation on the National Social Security Fund came into force.[166] This regulation is aimed at 'regulating the management and operation of the national social security fund, strengthening the supervision of the national social security fund, and realizing fund maintenance and appreciation under the premise of ensuring safety'.[167] Article 6 prescribes the following:

> The NSSF shall manage and operate the national social security fund in a prudential and steady manner, and invest in and operate the national social security fund on domestic and overseas markets at the ratio approved by the State Council.
>
> The NSSF shall invest in and operate the national social security fund under the principles of safety, profitability and long-term development, and rationally allocate assets among such assets as fixed-income assets, equity assets and unlisted equity assets approved by the State Council within the range of their rates.[168]

It is evident that the Regulation on the National Social Security Fund encourages the development of the NSSF as long-term institutional shareholder and on March 2016, 100 billion RMB of the NSSF's assets was transferred to several domestic funds for the purpose of purchasing tradable A shares on the equities market.[169] With the policy

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[163] The Measures for the Administration of Investment in Basic Pension Insurance Funds [保险公司养老业务管理办法] promulgated by State Council <http://www.circ.gov.cn/web/site45/tab2727/info75546.htm> accessed 4 November 2016.
[164] *Ibid.* art. 1.
[165] *Ibid.* art. 37.
[166] Regulation on the National Social Security Fund [全国社会保障基金条例], promulgated by the State Council <http://en.pkulaw.cn/display.aspx?cgid=267399&lib=law> accessed 4 November 2016.
[167] *Ibid.* art. 1.
[168] *Ibid*. art. 6.
[169] 'Different Interpretation of the Billions in Pension Money That Poured into the Securities Market [百亿社保基金入市引发不同解读] (Sina News, 19 April 2016) <http://news.sina.com.cn/zhiku/zkcg/2016-04-19/doc-ifxriqqv6295840.shtml> accessed 4 November 2016. Sina is the leading news website in China.

support for the development of pension funds in China, there should be sufficient confidence that they will be of greater importance in the capital market.

In terms of insurance companies, the Interim Measures for the Administration of the Utilization of Insurance Funds was revised in 2014170. Article 6 stipulates as follows:

> The utilization of insurance funds shall be limited to the following forms:
>
> (1) Making bank deposits;
> (2) Purchasing and selling negotiable securities including bonds, stocks, shares of securities investment funds, etc.;
> (3) Investing in real estate; and
> (4) Other fund utilization forms as prescribed by the State Council.[171]

Insurance companies are thus allowed to invest in stocks and in 2015, the China Insurance Regulatory Commission published the Notice of the China Insurance Regulatory Commission on Issues concerning the Increased Regulatory Ratio of Insurance Funds Invested in Blue Chip Stocks which expressly states that

> the upper limit of the regulatory ratio of its balance of investment in a single blue-chip stock to its total assets at the end of the previous quarter may change from 5% to 10%; and if its balance of investment in equity assets accounts for 30% or more of its total assets at the end of the previous quarter, it may continue to increase its holding of blue-chip stocks but its balance of investment in equity assets after the increased holding shall not be more than 40% of its total assets at the end of the previous quarter.[172]

This further encourages insurance companies to invest in the stock markets.

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[170] Interim Measures for the Administration of Utilization of Insurance Funds [保险资金运用管理暂行办法] China Insurance Regulatory Commission <http://www.circ.gov.cn/web/site0/tab7758/info3980761.htm> accessed 4 November 2016.
[171] *Ibid.* art. 6.
[172] Notice of the China Insurance Regulatory Commission on Issues Concerning the Increased Regulatory Ratio of Insurance Funds Invested in Blue-Chip Stocks [中国保监会关于提高保险资金投资蓝筹股票监管比例有关事项的通知] China Insurance Regulatory Commission <http://www1.lawinfochina.com/display.aspx?id=19845&lib=law&SearchKeyword=&SearchCKeyword=> accessed 4 November 2016.

As for the role of QFII, the CSRC, PBOC and the State Administration of Foreign Exchange published the Measures for the Administration of Securities Investment Within the Borders of China by Qualified Foreign Institutional Investors in 2006.[173] In these ten years, the policymakers have continually published several notices on the management and supervision of QFII.[174] The management of QFII is becoming increasingly more standardized in China and the 10 billion RMB investment restriction was removed in 2015, which will make QFII an important institutional shareholder in China.

3.4.2.1.3.2 Reform in progress

Once again, China finds itself standing on the crossroads and struggling with bloated SOEs, rising debt and growth-choking overcapacity. Although it has been several decades since the government began to reform SOEs, their actions have only changed the walls and the windows, and the foundation remains untouched. China's SOEs today are different from those in the 1990s. Although SOEs are fewer in numbers, their size

[173] Measures for the Administration of Securities Investment within the Borders of China by Qualified Foreign Institutional Investors [合格境外机构投资者境内证券投资管理办法] China Securities Regulatory Commission, People's Bank of China and State Administration of Foreign Exchange <http://www.lawinfochina.com/display.aspx?lib=law&id=5445&EncodingName=big5> accessed 4 November 2016.

[174] For example: 'Notice of the People's Bank of China on Relevant Matters Concerning Investment in the Interbank Bond Market by Qualified Foreign Institutional Investors' [中国人民银行关于合格境外机构投资者投资银行间债券市场有关事项的通知] (No. 69 [2013] of the People's Bank of China); 'Notice of the Shanghai Stock Exchange on Matters Concerning Strengthening the Management of the Securities Trading Activities of Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors' [上海证券交易所关于加强合格境外机构投资者和人民币合格境外机构投资者证券交易行为管理有关事项的通知] (No. 19 [2014] of the Shanghai Stock Exchange); 'Notice of the Shanghai Stock Exchange on Issuing the Detailed Implementation Rules of the Shanghai Stock Exchange for the Securities Trading of Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors' [上海证券交易所关于发布《上海证券交易所合格境外机构投资者和人民币合格境外机构投资者证券交易实施细则》的通知] (No. 12 [2014] of the Shanghai Stock Exchange); 'Notice of the Shenzhen Stock Exchange on Issuing the Detailed Implementation Rules of the Shenzhen Stock Exchange for the Securities Trading of Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors' [深圳证券交易所关于发布《深圳证券交易所合格境外机构投资者和人民币合格境外机构投资者证券交易实施细则》的通知] (No. 36 [2014] of the Shenzhen Stock Exchange); 'Notice of the General Affairs Department of the State Administration of Foreign Exchange on Issuing the Operating Guidelines for the Administration of Quota for Qualified Foreign Institutional Investors' [国家外汇管理局综合司关于发布《合格境外机构投资者额度管理操作指引》的通知] (No. 88 [2015] of the General Affairs Department of the State Administration of Foreign Exchange).

and overall competitiveness is growing rapidly, especially for those controlled by the central government. Rather than focusing on the competitive manufacturing industry only, SOEs expanded their business in fields of 'strategic importance', such as mining, energy, transportation, telecommunications, banking and public utilities. However, SOEs are often blamed for their inefficiency due to the severe agency problems. In order to keep their handsome profits and continue enjoying their monopoly privileges, a barrier was established to prevent private investment from entering the market. Even when private capital is allowed to enter, it often faces unfair competition. The global financial crisis unveiled the fact that the traditional growth model of SOEs in the decades 1997 to 2017 was not sustainable. However, the fiscal stimulus package announced in 2008, along with the extremely expansionary monetary policy adopted in 2009, made things worse. This made the government bet on painful restructuring and it is looking to replace the foundations of SOEs. Instead of continuing to resort to the old ways of deploying massive stimulus, resulting in overproduction and high debt levels, the party has decided to undertake 'supply-side structural reform',[175] which relies on SOE reform. Breaking down the SOE monopolies is the only way forward.

The clamour for SOE reform grows louder from all parts of China, and the government has taken the first step in a new long march towards a mixed economy. Since the promulgation of the Decision on Major Issues Concerning Comprehensively Deepening Reforms[176] by the Central Committee of the China Communist Party[177] in November 2013, a new wave of marketization reform of China's SOEs has been launched in which the political foundation and legitimacy for specifically mixed ownership reform[178] of SOEs was established. As fundamental guidance for the reform, it is clearly stated that '[d]iversified ownership integrated by State capital, collective capital and private capital is the prime method for materializing the basic economic

[175] Supply-side structural reform is the newest guiding ideology put forwarded by President Xi Jinping in 2015. The supply-side structural reforms aim to deliver five key tasks: (1) reduce overcapacity, (2) reduce inventories, (3) de-leverage, (4) lower costs and (5) shore up weak growth areas. These five tasks are interconnected and mutually reinforcing.
[176] 'The Decision on Major Issues Concerning Comprehensively Deepening Reforms' [中共中央关于全面深化改革若干重大问题的决定], adopted at the close of the Third Plenary Session of the 18th CPC Central Committee on 2013, <http://www.china.org.cn/china/third_plenary_session/2013-11/16/content_30620736.htm> accessed 8 November 2016.
[177] Hereinafter 'Central Committee'.
[178] Mixed ownership reforms aim to promote the integration of state and private capital.

system'[179], '[n]on-State shares will be allowed in State capital investment projects'[180] and '[m]ixed-ownership enterprises will be allowed to utilize employee stock ownership to form a vested community of capital owners and workers',[181] which implies that private capital can invest in publically owned enterprises as the shareholders. Moreover, the Decision also points out the abolition of unreasonable regulations on the non-public economy, eliminating hidden barriers and encouraging non-state enterprises to invest in or play a controlling role in mixed ownership enterprises.[182] From the perspective of legal reform, the above policy has given a signal that specific institutional transformation will be carried out.

In August 2015, the Guidance Opinions on the Deepening of Reform of State-Owned Enterprises[183] were passed at the Central Committee and the State Council, which provides 30 specific guiding points for mixed ownership reform of China's SOEs. It is China's first major policy statement on SOE reform. The Opinions build on the principles of the previous decision, providing the blueprint for China's government ministries to proceed with legislative reform, continue with existing SOE reform initiatives and take new steps to implement further SOE reform. According to the Guidance Opinions, SOEs in China are classified into 'commercial' and 'public interest' according to their different economic and social functions.[184] Commercial SOEs operate on market-based principles in order to create and generate value for their shareholders. In contrast, the role of public interest SOEs is to protect people's livelihood, serve the community, and provide public goods and services. In the context of commercial SOEs that operate on a market basis, private investors are allowed to invest in or even control the SOEs,[185] by which the economic efficiency of SOEs' corporate governance can be improved. As for the 'public interest SOEs, the ownership of such SOEs may still remain state-controlled, while in which the minority investors are allowed to invest'.[186]

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[179] 'The Decision on Major Issues Concerning Comprehensively Deepening Reforms' (n 176) s 6.
[180] *Ibid*.
[181] *Ibid*.
[182] *Ibid*. s8.
[183] Hereinafter 'Guidance Opinions'. Guidance Opinions on the Deepening of Reform of State-Owned Enterprises [中共中央、国务院关于深化国有企业改革的指导意见] <http://www.gov.cn/zhengce/2015-09/13/content_2930440.htm> accessed 8 November 2016.
[184] *Ibid*. s 4.
[185] *Ibid*. s 5.
[186] *Ibid*. s 6.

As regards the capital structure reform of China's SOEs, the Guidance Opinions encourage private capital holders to apply equity subscriptions, convertible bonds and equity swaps to invest in SOEs for the purpose of diversifying the ownership structure of SOEs.[187] Moreover, the preferred share as another legal instrument for diversifying the ownership structure of SOEs has also been accepted by China's top decision-makers[188] and securities regulators,[189] by which the state can still retain control over SOEs in some special fields such as the financial and media industries. In the meantime, private investors can guarantee their financial interests by exercising their preference rights in profit distribution and liquidation.

Given the fact that SOEs are large in size, small companies and individuals are too weak to participate in the mixed ownership reform. Hence, institutional shareholders and some powerful companies are expected to play a major role in the reforms. One of the senior officers responsible for SOE reform once stated at a conference that, institutional investors, like national social security funds, and insurance funds are top priorities when looking for private investors of the mixed ownership reform.[190]

By analysing the policy support for the development of institutional shareholders in China in recent years, the finding is that institutional shareholders are becoming increasingly more important in China and with the further reform of SOEs, they have the potential to become a major force in participating in the reform and, hence, have a further influence on the corporate governance of these companies.

3.5 Conclusion

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[187] *Ibid.* s 17.

[188] According to s 7 of the Guidance Opinion, the state-owned capital may be transferred into preferred shares in SOEs in specific industries, in terms of which the state can remain the managerial power over such SOEs.

[189] As early as March 2014, the CSRC had issued the Measures for the Pilot Administration of Preferred Stock, in which the detailed rules pertaining to the rights of preferred shareholders, the procedure of issuing preferred shares and special restrictions of listed companies were provided.

[190] 'Pension Funds and Chinese Investors Are the Top Priority in SOE Reforms [国企混改优先考虑社保和中国投资者] (Wall Street News, 29 December 2014) <https://wallstreetcn.com/articles/212537> accessed 8 November 2016.

This chapter took a close look at institutional shareholder activism from a theoretical perspective in the UK, US and China. The shareholder activism considered in this chapter is that behaviour displayed by shareholders with the aim of promoting corporate financial performance. Actions with environmental, political and social objectives were not considered. The premise of this chapter is not that shareholder activism is something to be encouraged and celebrated given their beneficial function. Rather, the thesis leaves shareholder activism open to criticism, and illustrates both supporting and opposing theories and empirical evidence. Agency problems form the unified theoretical foundation when talking about shareholder activism and it is the worsening agency problems after the global financial crisis that called for more institutional shareholder activism. However, shareholder activism is also criticised by scholars such as Bainbridge and Talbot for its adverse impact on board authority, lack of information and expertise, and the short-term and liquid orientation of shareholders. Furthermore, the inertia of shareholders and some legal barriers to some extent make them reluctant to exercise their power. The empirical research also showed a mixed result about the influence of institutional shareholder activism. Therefore, shareholder activism is not perfect in every aspect and it cannot prove to be a panacea for the pathologies of corporate governance.

What is interesting is that although shareholder activism is fully debated, there has increasingly been enthusiasm for institutional shareholder activism in recent years in the UK, US and China. This brings about the question of why this phenomenon occurred. The answer lies in institutional shareholders themselves and a wider context. First, their large shareholding and benefits gained from activism make 'voice' more favourable. Second, agency problems and corporate governance deficiencies fuelled the calls for institutional shareholder activism. Deregulation and policy support provide a better environment for institutional shareholders to exercise their power. An interesting point here is that institutional shareholder activism in the UK and China are both driven by the policy emphasis on institutional shareholders being part of the governance landscape or 'regulatory space' and policymakers arguably see institutional shareholder activism as being part of good corporate governance.[191] This could be clearly seen from a succession of reports published in these two countries aimed at encouraging institutional

[191] Chiu (note 5) 18.

shareholder activism. Whereas institutional shareholder activism in the US was under limited governmental policy support as only a limited number of evidence could be found in terms of encouraging institutional shareholder activism. Therefore, unlike the development of institutional shareholder activism in the UK and China is predominantly policy led, their US counterparts is more of a self-help, bottom-up measure with minor support from policy.Therefore, even though the merits of shareholder activism are debateable, the greater role played by institutional shareholders justified its existence. Given the increasing presence of institutional investors in the financial markets, it is not surprising that people expect institutional shareholders to become more active in their role as shareholders, and to exert greater influence on investee companies and capital markets.[192]

[192] Paul A Gompers and Andrew Metrick. 'Institutional Investors and Equity Prices' (2001) 116 The Quarterly Journal of Economics
< http://www.nber.org/papers/w6723> accessed 20 December 2016.

Chapter 4: Institutional Shareholder Activism in the United Kingdom and United States

In Chapter 3 shareholder activism was discussed from a theoretical perspective. Although there are objections to shareholder activism and institutional shareholders face obstacles when engaging in their investee companies, institutional shareholder activism has continued to grow in recent decades and the key role played by them in corporate governance cannot be underestimated. Rather than the 'giant sleeping giants' they used to be, which relied heavily on the active market for corporate control to exert discipline on management or selling out the shares to exit, institutional shareholders nowadays have increasingly engaged in corporate governance activities with the goal of improving corporate governance.

In this chapter, institutional shareholder activism in the UK and US is examined with a view to answering the following questions: (1) What are the factors that influence the behaviour of institutional shareholder?; (2) what are the forms of activism that institutional shareholders use and how do they engage with their investee companies? and (3) what can be learnt from the experience? By answering these three questions, a clear picture of the activist behaviour that institutional shareholder exhibit is drawn. Therefore, in the first part of this chapter prior academic research is examined and the factors that influence the behaviour of institutional shareholders pointed out by scholars are listed, followed by an analysis of four typologies of activism, namely (1) private meetings, (2) proxy voting, (3) submitting proposals and (4) bringing legal actions against the company. The extent to which different types of institutional shareholders engage in corporate governance given the diversity of the institutions is discussed. Detailed analysis unveils these shareholders' behaviour and shows how their activity verifies the proposed factors that influence their activism. This is followed by a conclusion.

4.1 Factors that influence institutional shareholder activism

In Chapter 3 the various deterrents to shareholder activism were analysed. Both internal factors and outside factors lead to shareholder passivity.[1]Internal factors include cost,

[1] See section 3.3 of this thesis.

preference for liquidity, concerns for insufficient expertise and conflict of interest.[2] Legal and political factors have an outside influence on shareholder activism.[3] Coffee pointed out those institutional shareholders who owned large shareholdings were more likely to be active in governance.[4] Black and Coffee pointed out that the 'overweighted' institutions could be expected to take a leading position in engaging in corporate governance, and institutional shareholders who were 'underweighted' were less likely to participate in a shareholder coalition. A larger stake gives them a larger incentive.[5] Therefore, the number of shares held by institutional shareholders is the most fundamental factor that influences the willingness of activism taken by institutional shareholders. Furthermore, Çelik and Isaksson point out other factors that influence the degree of institutions' engagement in their investee companies apart from the portfolio factor mentioned above.[6] The first factor is the purpose of the institution. Whether certain types of institutional shareholders have profit-maximizing obligations distinguishes them from those that do not. The second factor is the kind of products they are offering. Those institutions offering long-term products would behave differently from those offering short-term products. The third factor is the investment strategy. There is no fixed number of investment strategies and, in principle, 'there are as many investment strategies as there are investors'.[7] Main institutional shareholders basically use three strategies, according to an OECD classification. First, there is the 'passive index' strategy, which means funds hold a portfolio that mimics a predefined index of shares so as to reproduce or replicate the behaviour of a market index.[8] Second, a 'passive fundamental' strategy means those investors who make an active choice in selecting the individual companies in which to invest and keep these shares for an extended period. Third, there is the 'active fundamental' strategy, which means the continual buying and selling of company shares that are specifically chosen based on fundamental analysis, such as short-term growth potential. This strategy is often

[2] See section 3.3.1 of the thesis.
[3] See section 3.3.2 of this thesis.
[4] John C Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1999) 91 Columbia Law Review 1285; Bernard S Black and John C Coffee, 'Hail Britannia?: Institutional Investor Behavior Under Limited Regulation' (1994) Michigan Law Review 2011.
[5] *Ibid*, Black and Coffee.
[6] Serdar Çelik and Mats Isaksson , 'Institutional Investors as Owners: Who Are They and What Do They Do?', (2013) OECD Corporate Governance Working Papers, No 11, <http://dx.doi.org/10.1787/5k3v1dvmfk42-en> accessed 23 June 2016.
[7] *Ibid*, 23.
[8] E. Philip Davis and Benn Steil, *Institutional Investors* (MIT Press, 2001) 58.

associated with a high degree of ownership engagement, even though it may be temporary, to generate the results they pursue, such as an increase in dividends. Lastly, institutional investors might deploy an active strategy but based on quantity of information about investee companies, which means the large flow of information processed by sophisticated software is usually used as the basis for their high-frequency trading. This ‘active quantitative’ strategy has extremely short time frames for transactions and this benefits from stock exchanges’ colocation services.[9]

Figure 4.1 outlines the five factors that could influence the degree of institutional shareholder activism, namely (1) shareholding (portfolio structure), (2) cost, (3) conflict of interest, (4) liability structure and (5) investment strategy:

	Factors			
Shareholding (Portfolio)	Concentrated		Diversified	
Cost of engagement	High		Low	
Conflict of interest	Much		Less	
Liability structure	Long term		Short term	
Investment strategy	Passive index	Passive fundamental	Active fundamental	Active quantitative

Figure 4.1: Internal factors that influence institutional shareholder activism

With these factors in mind, insider institutional shareholder activism in the UK and US will be examined to see whether and how these factors play a role in institutions’ engagement activities.

4.2 Unveiling institutional shareholder activism in the United Kingdom and United States

[9] Çelik and Isaksson (note 6) 4.

4.2.1 Typology of institutional shareholder activism

Shareholder activism is not a new phenomenon, as explained in Chapter 3. It is used to describe an approach or a set of measures taken by a shareholder or shareholder group to seek effective change within a company, and it encompasses a broad range of formal and informal activity. There are basically four types of institutional shareholder activism: (1) private meetings, (2) proxy voting, (3) submitting proposals and (4) bringing legal actions. The level of intensity is escalates from private meetings to public legal actions (Figure 4.1).

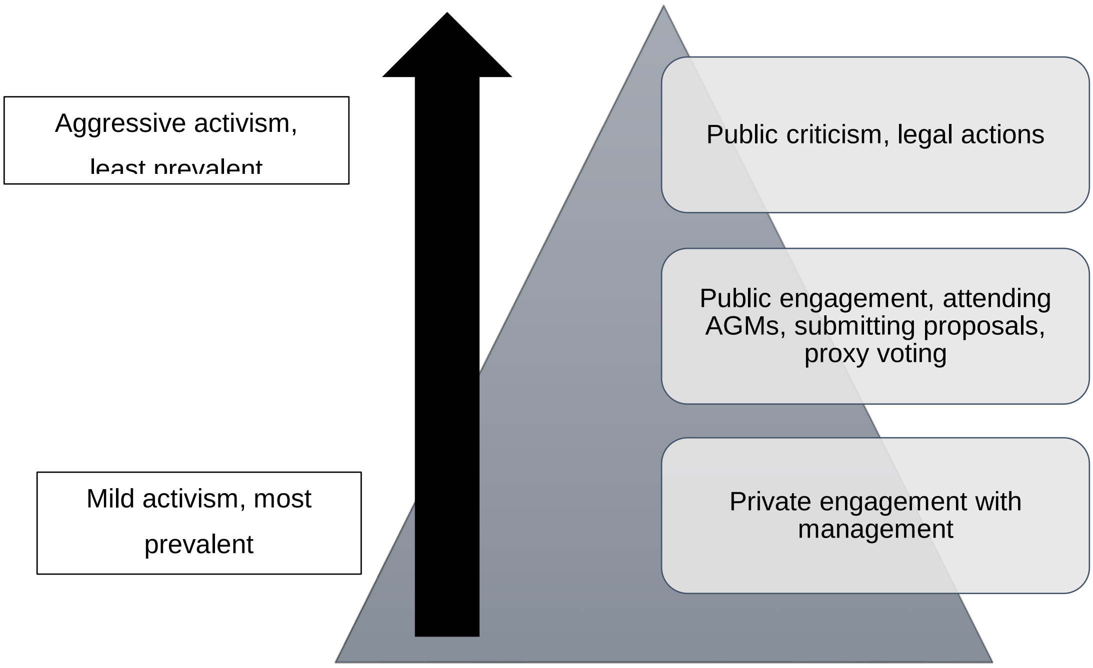

Figure 4.1: Activities taken by institutional investors[10]

In the sections that follow each type of activism will be looked at in turn, starting with an introduction followed by the legal requirements or prescriptions, ending in the empirical data.

4.2.1.1 Private meetings

[10] This figure was adapted from Thomas Clarke, *International Corporate Governance: A Comparative Approach* (Routledge, 2007) 120.

Meetings between institutional investors and companies are important as it is the first approach that is considered by institutional investors when concerns arise over corporate governance. It is one of the most commonly used approaches to shareholder engagement. As an effective way of communication that could avoid public confrontation, private meetings are welcomed by both companies and institutions.

On the one hand, this kind of meeting could be initiated by shareholders. Before institutional shareholders hold a private meeting, they will evaluate problematic matters internally and if these matters can be resolved by way of private meetings,[11] this would be the first step. They will then raise their concerns with the problematic companies in an informal way, such as write a letter or make a telephone call to the managers or officers concerned in the targeted companies. When both parties have a clear idea of each other's concerns, a meeting will be held that is aimed at solving specific governance topics. A company usually arranges these meetings on a one-to-one basis with its large institutional shareholders during the course of the year and the meetings are at the highest level with key members of the board involved.[12] A telephone call is usually followed by meetings to ensure that everything has been discussed. On the other hand, the board could also initiate a dialogue with its shareholders for the purpose of promoting mutual understanding on a variety of issues. As one of the commonly used activism approaches, there are many issues that could be discussed at the private meetings, such as the firm's strategy and objectives, efforts to achieve them, the quality of the management and so forth.

Given the importance of private meetings, regulators, policymakers and trade organizations have to call on more frequent board–shareholder communication. The UK Corporate Governance Code recommends that 'the board as a whole has a responsibility to conduct satisfactory dialogue with institutional shareholders to understand their issues and concerns'.[13] Chairpersons, non-executive directors and senior independent directors are charged with particular responsibility to have sufficient

[11] Joseph W Yockey, 'On the Role and Regulation of Private Negotiations in Governance' (2009) 61 South Carolina Law Review 173.
[12] Chris A Mallin (ed.), *Handbook on International Corporate Governance: Country Analyses* (Edward Elgar Publishing, 2011) 87.
[13] Financial Reporting Council, 'The UK Corporate Governance Code' (2016) E.1 <https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf > accessed 25 August 2017.

contact with major shareholders.[14] The Stewardship Code also regards private meetings between institutional shareholders and the company as the first option of engagement when concerns arise.[15] Guidelines from trade associations all recommend institutional shareholders communicate regularly with their investee companies' board and senior management.[16] Although communication between institutional shareholders and their investee companies is encouraged, there are some restrictions on the information that may be exchanged at the meeting. The FCA Disclosure Rules and Transparency Rule require[17] that if insider information is involved in private meetings, companies should report this insider information to the Regulatory Information Service.[18] There are provisions that serve the same function in the US in order to respond to the concern that certain investors were gaining selective access to privileged firm information, The Regulation Fair Disclosure was passed in 2000. This regulation prohibits managers from privately conveying material information to investors. Although it did not explicitly prohibit private meetings with investors, the contents of any private conversation between investors and management must comply with the Regulation Fair Disclosure.[19]

Although private meetings take place behind closed doors, there is some evidence from institutional reports, academic research and newspapers to lift the veil of private meetings between institutional shareholders and their investee companies.

a. Meetings could take the form of a simple telephone call, letters or meeting in person. A US study found that there are various ways that boards meet

[14] *Ibid.*
[15] Financial Reporting Council, 'The UK Stewardship Code' (2012) Principle 4 <https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf> accessed 25 August 2017.
[16] For example, see Institutional Shareholders Committee, 'A Statement of Principle on the Responsibilities of Institutional Shareholders and Agents' (2007) 4 <https://www.companysecretarialpracticeonline.co.uk/events/isc-code-on-responsibilities-of-institutional-investors/443> accessed 25 August 2017.
[17] Hereinafter 'DTR'.
[18] Financial Conduct Authority, DTR 2.2.1. Companies subject to the DTRs and/or the Listing Rules are required in a range of circumstances to make announcements to investors. The FCA has currently approved eight providers that act as Regulated Information Service providers from which companies making regulatory announcements can choose <http://www.fsa.gov.uk/Pages/doing/ukla/ris/contact/index.shtml> accessed 25 August 2017.
[19] David Solomon and Eugene Soltes, 'What Are We Meeting for? The Consequences of Private Meetings with Investors' (2015) The Journal of Law and Economics.

shareholders.[20] Some companies held meetings with their institutional shareholders on an ad hoc basis and establish a formal, separate shareholder advisory committee to further promote communication. Some companies are positioned as a listening post to hear shareholders' concern. Generally, there is no consistent form for private meetings and it is usually dependent on the aim of the discussion. A survey undertaken in the US suggested that direct discussion with management was the most frequent form of engagement, with 63% of the respondents claiming that they had used it in the past five years.[21]

b. For the participants of the meetings, a survey conducted by the Investment Management Association[22] shows that the participants in private meetings from the perspective of the company are the chairperson, financial directors, and non-executive and senior independent director.[23] According to Stapledon, some large companies set up specialist investor relations executives who are responsible for meetings with institutions.[24] From the perspective of institutional shareholders, a small percentage of institutions (2/33), according to the IMA survey, delegate the responsibility for meetings to their portfolio managers.[25] The majority of institutional investors set up specialist teams on corporate governance who represent institutions at meetings.[26]

c. The frequency of meetings depends on many factors. Offensive institutional shareholders, such as hedge funds, are more likely to have meetings with management than other institutions.[27] When there are specific issues or contentious concerns, the frequency of these meetings would be high. The frequency is reliant on certain types of institutional shareholders and specific

[20] Bo Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (Routledge 2013).
[21] Joseph A McCahery, Zacharias Sautner and Laura T Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' (2016) The Journal of Finance 1.
[22] Hereinafter 'IMA'. This is the trade body that represents UK investment managers and it is now called *The Investment Association*.
[23] Investment Management Association, 'Survey of Fund Managers' Engagement with the Companies for the Year Ended 30 June 2006' (hereinafter 'IMA 2006 Survey') 14 <http://www.theinvestmentassociation.org/assets/files/press/2007/20070704-01.pdf> accessed 26 August 2017.
[24] Geof Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon Press 1996) 103;
[25] 'IMA 2006 Survey' (n 23) 14.
[26] *Ibid*.
[27] See section 4.2.1.1 of this thesis.

time horizons. The IMA survey shows that on average each institution had held 33 meetings with their investee companies by the middle of 2006.[28] In the US a survey showed that on average CEOs and chief financial officers[29] had held meetings with investors on 17 and 26 days out of the year respectively.[30] However, there are several factors that could influence the frequency of these meetings. First, for those hedge funds aimed at underperforming companies, such as Hermes, the frequency of the meetings held with their investee companies could be high. Second, as Martin and Nisar note, some large companies have established their own corporate governance engagement principles which require that the meetings with their investors should be held on a regular basis but less frequently than in the first case.[31] Third, there are circumstances where if the contentious issue cannot be solved at once, the meetings and contact between the company and institutional shareholders will be more frequent. Apart from the routine meetings described above, institutional shareholders could escalate their action by meeting with independent directors or senior independent directors according to the ISC's principles on the responsibilities of institutional shareholders and agents.[32]

d. The topics discussed at the meetings are mainly decided by the aim of the meetings. Stapledon found that the meetings focus on issues of 'the latest financial results, current trading operations, trends in pricing, capital expenditure, cash flow, gearing, etc'.[33] Institutional shareholders are more focused on general issues such as the long-term strategy of the company instead of short-term topics such as current trading.[34]

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28 'IMA 2006 Survey' (n 23) 17.
29 Hereinafter 'CFO'.
30 Solomon and Soltes (n 19) 331.
31 Roderick Martin and Tahir M Nisar, 'Activist Investment: Institutional Investor Monitoring of Portfolio Companies' (2007) 45 Management Decision 832.
32 Hereinafter 'Statement of Principles'. Institutional Shareholders' Committee, 'A Statement of Principles on the Responsibilities of Institutional Shareholders and Agents' (2007) <https://www.companysecretarialpracticeonline.co.uk/events/isc-code-on-responsibilities-of-institutional-investors/443> accessed 25 August 2016.
33 Stapledon (n 24) 104.
34 *Ibid.* 104.

Ayres and Braithwaite stated 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’.[35] By way of analogy, private meetings could be regarded as that modest form of intervention, as shown in Figure 4.1. If companies fail to respond to the issues presented at private meeting, institutional shareholders could consider further actions which will be discussed below.

4.2.1.2 Voting

When an attempt to sort out any contentious issues with a company ‘behind the scenes’ fails, institutional shareholders may use their other rights to have their concerns solved. The findings of McCahery et al.’s research show that only if a behind-the-scenes negotiation as a first option has failed, will public measures, such as shareholder proposals and public criticism, be carried out.[36] As ownership and control are separated in modern companies, shareholders’ residual control rights over companies rest largely on their voting rights. As an obvious form of engagement and an important means to exercise voice, shareholders place great emphasis on the exercise of voting rights to effect corporate governance in their investee companies. Voting is, to some extent, the most basic and important tool that institutional shareholders could utilize. Voting could be used to elect or remove directors, approve or reject directors’ proposals and authorize executive pay packages.[37] Therefore, the form of voting is at the heart of any discussion about shareholder activism.[38]

The voting process begins when institutional shareholders receive a package of information – notice of meeting – by mail or other electronic forms from their investee companies. This package not only states the time and place of the meeting, but also includes various documents that report on the operations of the company, the financial

[35] Ian Ayres and John Braithwaite. *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press on Demand, 1995).
[36] McCahery, Sautner and Starks (n 21) 24 .
[37] Gong (note 12) 168.
[38] However, voting is only one aspect of shareholder rights, there are other rights, such as the right to require the directors to call a general meeting of the company, the right to require a company to circulate a statement in advance of shareholders’ meeting and to circulate a resolution in advance of an annual general meeting. Given the fact that there are too few data to analyse these separately, the focus will be on activism in the form of voting.

performance and vital decisions, such as proposals for changes to the company's share structure or mergers and acquisitions. It is important for institutional shareholders to participate in the voting and make their decisions based on their full understanding of this information. Shareholders are given a certain period within which to consider their decision regarding the issues proposed. They can then attend the meeting in person or else by means of proxy. In many companies, the facility to vote electronically is now available.[39]

In the UK, corporate governance guidelines and government reports call for institutional shareholders to vote actively on a continual basis. The 1992 Cadbury Report stipulated that '[g]iven the weight of their votes, the way in which institutional shareholders use their power . . . is of fundamental importance', and encouraged institutional shareholders to 'make positive use of their voting rights and disclose their policies on voting'.[40] The Hampel Report also states that 'institutional shareholders have a responsibility to make considered use of their votes'.[41] Moreover, the Stewardship Code requires that '[i]nstitutional 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', and requires institutional investors to disclose voting policies and voting records.[42] Apart from these government reports, various institutional investor representative groups also publish their own guidelines to guide the behaviour of their members. As early as 1995, NAPF (now the Pensions and Lifetime Savings Associations) referred to the vote as a powerful measure and 'encourage – as a matter of best practice – the regular exercise of proxy votes by pension funds'.[43] Four years later, NAPF, together with the Association of British Insurers[44],

[39] Since Myners' call for electronic voting in 'Myners Principles for Institutional Investment Decision-making: Review of Progress' in 2004, there has been a substantial increase in the number of companies that facilitate electronic voting and in the number of electronic votes. According to the Shareholder Voting Working Group, 'Review of the Impediments to Voting UK Shares', All FTSE 100 companies and 74% of FTSE 250 companies had introduced electronic voting by 2006.
[40] European Corporate Governance Institute, Report of the Committee on the Financial Aspects of Corporate Governance (Burgess Science Press 1992) <http://www.ecgi.org/codes/documents/cadbury.pdf> accessed 4 November 2016.
[41] Committee on Corporate Governance, Final Report (1997) <http://www.ecgi.org/codes/documents/hampel.pdf> accessed 4 November 2016
[42] The UK Stewardship Code (n 15). Principle 1, 6.
[43] NAPF, Annual Survey of Occupational Pensions of 1995, cited in Christine Mallin *Corporate Governance* (5th edition, Oxford University Press 2013).
[44] Hereinafter 'ABI'.

published a guideline on voting which highlighted the important role of voting and called for voting to be exercised in a considered fashion rather than 'box ticking'.[45] As discussed in Chapter 3, the CA 2006 brought in new rules to enhance investors' information rights.[46] Institutional investors could receive the information about the issues to be addressed at shareholders' meetings directly from the company. Permission to use electronic means to communicate and vote greatly reduces indirect costs.[47] In addition, the CA 2006 widened the rights of proxies that were formerly regulated by CA 1985 in three respects. First, the rule that proxies were not allowed to vote by a show of hands was removed. Second, proxy rights were enhanced by allowing a proxy of a shareholder to speak at the meeting.[48] Third, one or more proxies were allowed to be appointed by shareholders to exercise all or part of the rights.[49] Therefore, by greatly expanding the rights of proxies, the CA 2006 made it possible for institutional shareholders to act as proxies so that registered owners can exercise all the shareholders rights that would otherwise vest in the registered owners alone.

In the US, disclosure of voting is on a mandatory basis for some institutions. Registered management investment companies are required to disclose their proxy voting policies and procedures, and their actual voting records since 2003 under the Securities and Exchange Commission rules.[50] Under the Investment Company Act of 1940 and the Investment Adviser Act of 1940, investment companies and their advisers are also under obligations with respect to proxy voting. A fund's board normally delegates voting responsibility to the fund's adviser, under the supervision of the board, in recognition of the fact that proxy voting is part of the investment advisory process.[51] Rule 206(4)-6 requires advisers to 'describe their proxy voting policies and procedures to clients, and upon request, to provide clients with a copy of those policies and

[45] NAPF/ABI, 'Responsible Voting: A Joint ABI–NAPF Statement' (ABI/NAPF, London 1999) <https://www.ivis.co.uk/media/5896/ABI_NAPF_Joint_Statement_14feb2008_2_v_5.pdf> accessed 22 June 2017.
[46] See section 3.4.2 of this thesis.
[47] CA 2006 s 333.
[48] CA 2006 s 324.
[49] CA 2006 s 324.
[50] Hereinafter 'SEC'. Securities and Exchange Commission Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Companies' (2003) <http://www.sec.gov/rules/final/33-8188.htm> accessed 12 March 2016.
[51] Sean Collins, 'Trends in Proxy Voting by Registered Investment Companies, 2007–2009' (2010) Investment Company Institute Research Perspective.

procedures'.[52] Among other things, these policies and procedures must specify how the interests of fund investors will be protected when a vote presents a conflict between the interests of fund investors and those of a funds' advisers. Funds must disclose all the proxy votes they cast and they do this by filling in Form N-PX with the SEC.[53] Since 1994, private pension funds governed by the Employess Rirement Income Security Act[54] have also been obliged by way of Interpretative Bulletin 94-2 to disclose information regarding voting activities. The SEC guidance, *called Staff Legal Bulletin No. 20* (issued in 2014) may increase pressure on more investment managers to take greater direct responsibility for the vote and to perform due diligence around vote agency services where that duty is delegated under a set of voting policies.

There is empirical evidence regarding institutional shareholder voting:

a. *Voting level:* There is increasingly more evidence on the exercise of voting rights by institutional shareholders given the fact that it is an important indicator of shareholder activism. As early as 1994, a study focusing on UK listed companies found that only 35% of the ordinary shares of the 101 companies were voted at annual general meetings.[55] In 2005, Manifest conducted research and showed that the overall voting level was 61.06%.[56] In 2007, the Pension Funds' Engagement with Companies Survey found that all respondents had used their voting rights or liaised with managers about voting.[57] In 2008, IMA conducted a survey that showed that 32 firms in the study appeared to be voting on around 95% of the resolutions.[58] In the US the 2014 CalPERS report showed that firms cast more than 9,000 votes altogether, with 928 votes being cast in 2013. Among these votes, 58% were voted for

[52] Investment Advisers Act of 1940, 17 CFR 275.206(4)-*6*.
[53] Investment Company Act of 1940, s 30.
[54] Hereinafter 'ERISA'.
[55] Stapledon (n 24) 122.
[56] Manifest's research result was cited in Paul Myners *Review of the Impediments to Voting UK Shares, 2005* (Shareholder Voting Working Group 2005).
<https://www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=press/2005/20051114-01.pdf > accessed 12 March 2017.
[57] NAPF, 'Pension Funds' Engagement with Companies Survey 2007'
<http://www.napf.co.uk/PolicyandResearch/DocumentLibrary.aspx> accessed 12 March 2017.
[58] IMA 2006 Survey (n 23).

and 42% were voted against.[59] Empirical research in the form of interviews with large institutional shareholders in the US show that 53% of the respondents reported voting against management as a shareholder engagement measure.[60]

b. *Voting decision-makers:* According to the IMA survey mentioned above, approximately no more than 5% of beneficial owners retained voting rights themselves. Otherwise, these beneficial owners directed the funds to follow the instruction of a particular agency or to outsource to a third party.[61] The NAPF 2007 survey revealed that 14 of 33 respondents subscribed to one or more voting agencies. Some funds may not delegate their voting right to agencies directly; instead, they rely on the recommendation provided by the fund managers or specialists.[62] The most often subscribed agencies were Research Recommendations Electronic Voting[63], Pension and Investment Research Consultants Ltd[64] and Manifest and Glass Lewis.[65]

c. In terms of voting agendas, a survey conducted by Manifest and Georgeson shows that directors' (re)election, resolutions dealing with share capital or transactions in own shares, and auditors' (re)appointment and remuneration are the most common issues.[66] The Trade Union Congress[67] Fund Manager Voting Survey found that directors' remuneration was the issue that received the most opposing votes from institutional shareholders, followed by board balance or director independence and pre-emption rights.[68] In the US shareholders were asked to vote on a series of corporate issues, including the

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[59] CalPERS, 'Towards Sustainable Investment and Operations, 2014 Report' (2015) <https://www.responsible-investor.com/images/uploads/reports/CalPERS_2015.pdf> accessed 12 March 2017.

[60] McCahery, Sautner and Starks (n 21).

[61] Survey of Fund Managers' Engagement with the Companies for the Year Ended 30 June 2006 (n 58).

[62] Pension Funds' Engagement with Companies Survey (n 57).

[63] Hereinafter 'RREV'.

[64] Hereinafter 'PIRC'.

[65] Pension Funds' Engagement with Companies Survey (n 57).

[66] Eugenia Unanyants-Jackson, *Proxy Voting 2007: A Pan-European Perspective* (Manifest Information Service 2007) 23.

[67] Hereinafter 'TUC'.

[68] TUC, 'TUC Fund Manager Voting Survey 2015' (2015) <https://www.tuc.org.uk/sites/default/files/Fund_Manager_Survey_2015.pdf> accessed 23 August 2017.

management proposals raised by the company, such as the election of directors, ratification of the auditor, approval of equity compensation plans, say on pay, anti-takeover protections, bylaw changes and shareholders proposals sponsored by shareholders. Unlike individual shareholders, institutional investors are responsible for thousands of public companies' interests, with each company holding annual meetings and various other matters to be voted on and, therefore, the voting task is huge. Consequently, most institutional investors establish dedicated proxy voting departments for the purpose of developing voting guidelines and voting proxies, and many institutional investors subscribe to proxy advisory firms, such as the IVIS and PIRC in the UK, and the ISS and Glass Lewis in the US. A survey conducted in the US recently showed that 60% of the survey's respondents used proxy advisers, and about half of these respondents actually used the services of more than one adviser.[69] These third parties become an important part in the voting process. A question that is greatly debated is on outsourced institutional shareholder activism – the role played by proxy advisers. As pointed out above, a large percentage of institutional shareholders rely on proxy advisers, at least for voting platforms in which the investors provide the advisers with instructions on how they want shares voted and the information shared by the proxy advisers on which to exercise their vote. However, the utilization of proxy advisers is not without issue. The current debate focuses on two: (1) their conflict of interest, and (2) the quality of information and advice provided.[70] From the perspective of conflict of interest, proxy firms such as ISS play a dual role in issuing their advice. On the one hand, they serve as a consultant, advising firms on how they can improve their corporate governance. On the other hand, ISS make recommendations on how institutional investors of these companies should vote. Therefore, some scholars argue that this kind of dual role could result in the problem of conflict of interest and, hence, influence the reliability of their advice.[71] However, ISS argued that they have 'structurally separated [their] voting advice from [their] consulting business, reducing the

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[69] McCahery, Sautner and Starks (n 21) 21.
[70] *Ibid*.
[71] See generally, Cindy Alexander, Mark A Chen, Duane J Seppi and Chester S Spatt, 'Interim News and the Role of Proxy Voting Advice' (2010) 23 The Review of Financial Studies; Davi Yermack, 'Shareholder Voting and Corporate Governance' (2010) 2 Annual Review of Finance and Economics.

potential of conflict of interest'.[72] Besides, a Working Paper by ECGI also argues that the industry's structure, which consists of two main players, also reduces the possibility of conflicts of interest.[73] From the perspective of the quality of voting advice, some hold the view that given the fact that proxy advisers are using their expertise and experience to collect information, perform delegated monitoring and, hence, make informed voting recommendations, they are a reliable source of informed voting advice.[74] Therefore, the services of proxy advisers reduce investors' voting costs, leading to better and more informed voting decisions. Others hold the view that the recommendations of proxy advisers are too standardized and ignore firm-specific circumstances.[75] Moreover, considering the opaqueness in proxies' recommendation criteria, it is difficult to assess the quality of the voting recommendations. However, a recent survey indicates that proxy advisers do not just aggregate shareholder preferences or coincide with them, but actually influence voting in a positive way because of the information provided.[76] The respondents of this survey report that proxy advisers could help them make better voting decisions to some extent, but they remain their own decision makers. These results are in line with Aggarwal et al.[77]and Iliev et al.[78], whose respective research shows that proxy voters do not uniformly follow the recommendations of proxy advisers. Therefore, the use of proxy advisers does not necessarily itself represent that institutional shareholders take a passive role in corporate governance.

[72] McCahery, Sautner and Starks (n 21) 18.

[73] Tao Li, 'Outsourcing Corporate Governance: Conflicts of Interest and Competition in the Proxy Advisery Industry (2013) ECGI Finance Working Paper 389/2013 < https://poseidon01.ssrn.com/delivery.php?ID=576121020003020086110099027092078064032043077033024024075122124067084070070080110000011050026016049049112003119102117120093030048026026076017091095003091104091095010095002080020070080031003091127071020081081092065090079096087072069119026073117119083124&EXT=pdf> accessed 23 August 2017.

[74] Yonca Ertimur, Fabrizio Ferri, and David Oesch. 'Shareholder Votes and Proxy Advisors: Evidence from Say on Pay' (2013) 51 Journal of Accounting Research 958.

[75] Jeffrey N Gordon, '"Say on Pay": Cautionary Notes on the UK Experience and the Case for Shareholder Opt-in' (2009). Columbia Law and Economics Working Paper 336/ECGI Law Working Paper 117/2009 <http://dx.doi.org/10.2139/ssrn.1262867> accessed 23 August 2017.

[76] McCahery, Sautner and Starks (n 21) 23.

[77] Reena Aggarwal and Isil Erel and Laura T Starks, 'Influence of Public Opinion on Investor Voting and Proxy Advisors' (2015) Fisher College of Business Working Paper WP 2014-03-12/Georgetown McDonough School of Business Research Paper No. 2447012 <http://dx.doi.org/10.2139/ssrn.2447012> accessed 23 August 2017.

[78] Peter Iliev and Michelle Lowry, 'Are Mutual Funds Active Voters?' (2014) 28 The Review of Financial Studies 451.

4.2.1.3 Submitting proposals

Submitting proposed resolutions for a shareholder meeting is another option for institutional shareholders to engage in corporate governance. It provides an opportunity for institutional shareholders to communicate with both corporate management and other shareholders, and it allows shareholders to raise their own concerns, that is to say, to 'set the agenda'. Unlike proxy voting which is merely for or against the executive agendas, submitting proposals enables institutional shareholders to vote on the issues they want.

In the UK CA 2006 permits shareholders who represent 'at least 5% of the total voting rights of all the members' or 'at least 100 members who have a right to vote on the resolution at the annual general meeting to which the requests relate and hold shares in the company on which there has been paid up an average sum, per member, of at least £100' to put forward a solution to be considered at the next AGM and require the circulation of resolutions for AGMs.[79] In the US, the SEC regards shareholder proposals as a governance mechanism. Section 14 of the Securities and Exchange Act of 1934 prescribes that

> to be eligible to submit a proposal under Rule 14a-8, a shareholder must, among other things, provide documentation evidencing that the shareholder has continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the shareholder meeting for at least one year as of the date the shareholder submits the proposal.

It also permits a shareholder to include a proposal and a 500-word supporting statement in the proxy statement distributed by a company for its annual shareholder meeting.[80] Shareholders could submit proposals outside Rule 14a-8. However, they rarely do so when considering the fact that the use of Rule 14a-8 could save on the expense of preparing their own proxy statement.

[79] CA 2006, s 338.
[80] Securities and Exchange Act of 1934, s 14.

The pattern of institutional shareholder activism in the UK is reactive in nature, that is, institutional shareholders react to actions taken by the company and consider how to use their vote, rather than call extraordinary general meetings or table proposals. According to Stapledon, the resolutions proposed at annual general meetings are by and large initiated by management, rather than by shareholders.[81] PIRC also conducted a study on shareholder proposals among FTSE 350 companies in the early 2000s and the research shows that the number of resolutions proposed by shareholders only accounted for a small percentage of the 6,000 resolutions discussed.[82] One reason for this low proposal rate is the uncertainty of the acceptance of shareholders' proposals. This could frustrate potential institutional investors behaving as activists. On the other hand, the threshold for submitting proposals is high for many institutional investors. Institutions have to bear many costs and devote much time in order to secure co-operation from other shareholders. Therefore, they may use other forms of activities, such as a private meeting and proxy voting discussed above. Another reason is that the uncertainty about whether shareholders' proposals can be adopted increases the uncertainty of potential institutional activists.[83] In the US empirical evidence shows that member's proposals for resolutions are increasingly successful as they attract fellow shareholders' support and although not binding in nature, could practically change the direction that the company has been taking.[84] US public pension funds conducted research into shareholder proposal activism and found that shareholder proposals introduced by the five largest pension funds had grown from 18 in 2010 to 37 in 2015.[85] The subject matter of shareholder proposals ranged from employment rights, proxy access to executive compensation and other corporate governance issues.

[81] Stapledon (n 24) 85.
[82] PIRC, 'Modernising Company Law: PIRC's Response to the White Paper' (2002)[no longer available] cited in Gong (n 20) 121.
[83] The fourth study was conducted by the TUC. Its 'Fund Manager Voting Survey 2009' (n 68) shows that all five shareholder resolutions were defeated, with one achieving a vote in favour of just under 10% at the company's annual general meetings.
[84] Randall S Thomas and James F Cotter, 'Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction' (2007) 13 Journal of Corporate Finance; Sturt Gillan and Laura T Starks, 'The Evolution of Shareholder Activism in the United States' (2007) 19 Jounal of Applied Corporate Finance <http://dx.doi.org/10.2139/ssrn.959670> accessed 23 August 2017.
[85] Harvard Law School Forum on Corporate Governance and Financial Regulation, 'Public Pension Funds' Shareholder-Proposal Activism' (2015) <https://corpgov.law.harvard.edu/2015/07/01/public-pension-funds-shareholder-proposal-activism/> accessed 23 August 2017.

4.2.1.4 Legal action

When an issue of breach of directors' duty arises, shareholders can rely on legal action to place constraints on the activities of directors and to seek redress, including the statutory derivative action shared by the UK and US, and minority shareholders' litigation – unfair prejudice in the UK.

The starting point for understanding the derivative action is the case of *Foss v Harbottle*.[86] Two doctrines were established in this case: (1) the courts will not interfere in the internal management of companies; and (2) the proper claimant is the company itself when wrongs have been done to the company.[87] Given the fact that these rules could often generate injustice, for example, the majority shareholders could vote to divide the company's assets among themselves with nothing left for the minority shareholders, exceptions are developed to optimize the application of the derivative action. [88] Therefore, those legal actions taken by shareholders against directors on behalf of the company within these exceptions could be derivative actions.

Currently, the derivative claims are now on a statutory footing in CA 2006. The key aspects of a derivative claim are set out in section 260. Section 260(1) defines its three elements: '(a) the action is brought by a member of a company; (b) the cause of the action is vested in the company; and (c) relief is sought on the company's behalf'.[89] Section 260(3) specifies the types of breach of duty under which a derivative claim may

[86] *Foss v Harbottle* (1843) 67 ER 189.

[87] This rule is sometimes abbreviated to the 'proper claimant' rule. This rule is the embodiment of several technical ideas. First, it incorporates the rule in *Percival v Wright* that directors' duties are owed to the company and not to the shareholders. Second, it embodies the Salmon doctrine that the company is a separate entity form the shareholders and thus has its own assets and its own rights to sue. The right to sue is thus vested and remains vested in the company, and does not flow through to the shareholders.

[88] See generally, Ben G Pettet, John P Lowry and Arad Reisberg. *Pettet's Company Law: Company Law and Corporate Finance* (Pearson Education, 2012) 240. The four exceptions were: (1) ultra vires and illegal: it has long been held that where the act is ultra vires or illegal by statute, the individual cannot be prevented from litigating the matter merely by an ordinary resolution in a general meeting. (for ultra vires, see *Hutton v West Cork Railway Co. Ltd*; illegal: see *Ooregum Gold Ming Co. v Roper*); (2) special majorities: individual minority shareholders could litigate in the situation where the constitution of the company requires a special resolution to do some act, while the company tries to pass it with an ordinary resolution; (3) personal right: if the articles of association give the shareholders rights that they can enforce against the company; the right cannot be taken away by ordinary resolutions and (4) fraud on minority: this is a general concept, for example, the majority of the shareholders could vote to divide the assets of the company among themselves and leaving the minority with nothing and with no remedy. *See Cook v Deek*.

[89] CA 2006 s 260 (1).

be brought: 'A derivative claim under this Chapter may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company',[90] Therefore, shareholders should first make a prima facie estimate about the entitlement to relief claimed. Section 261 prescribes that 'a member of a company who brings a derivative claim under this Chapter must apply to the court for permission to continue it'.[91] Section 261(2) grants the court the power to determine whether an action for corporate wrong should proceed taking account of the matters in s 263. There are two levels of test to be applied before granting permission. First, permission must be refused if a prima facie case is not disclosed on the evidence filed with the application according to s 261(2). Second, s 263 requires the court to refuse where directors act in accordance with the duty to promote the success of the company.[92] Moreover, where the matter complained of was authorised in advance or ratified, the court must refuse permission.

In the US, under the Delaware law, shareholders also need to meet certain criteria before pursuing derivative litigation. First, a shareholder is eligible to bring a derivative action if the shareholders held the company's stock at the time of the challenged wrongdoing and continues from that time to hold stock throughout the course of litigation. This is the 'continuous ownership' rule which enables a shareholder to bring and maintain a derivative action. Second, in the context of shareholder requests that the company pursue litigation, the decision whether to pursue litigation on behalf of the company generally resides with the board as an exercise of business judgement. A shareholder first has to demand that the board of directors of the company assert the claim. A shareholder lacks standing to bring a suit on the company's behalf unless (1) the shareholder has demanded that the directors pursue the corporate claim and the demand is wrongfully refused or (2) purports to initiate litigation on behalf of the company and alleges with particularity why pre-suit demand is excused as futile.[93]

Part 30 of the CA 2006 grants shareholders who are being treated in an unfairly prejudicial way powers to seek relief from the court.[94] However, the unfair prejudice

[90] CA 2006 s 260 (3).
[91] CA 2006 s 261 (1).
[92] CA 2006 s 263.
[93] Delaware General Corporation Law s 18-1002.
[94] CA 2006, ss 994–999.

petition for minority shareholders under s 994 of the CA 2006 is often more appropriate for smaller private companies where issues of grievance relate to matters outside pure investment, and after *O'Neill v Phillips*[95], it would arguably be rare for investors in public listed companies to find redress in taking an unfair prejudice petition.

Some scholars, such as Cox, Coffee and Reisberg, maintain that some level of deterrence against potential abuses by management could be exercised by those liability rules, such as the 'social stigma' enforced by a successful derivative action, the threats of financial penalties and the loss of reputational capital. This deterrent is not only limited to certain companies to whom liability rules have been applied, but also other companies.[96] To some extent, these kinds of deterrents will affect both ex ante expectations of wrongdoers as well as ex post liability for the total damages they incurred.[97]

However, there are hurdles when applying the legal actions. The first consideration is the cost of bringing a derivative suit.[98] Derivative claimants will be saddled with significant legal costs if they lose the case. Even in the case of successful derivative claims, an empirical research study found that 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'.[99] Therefore, with derivative action potential costs are higher than the received benefits. Second, it is time-consuming and likely to take months to reach a conclusion. Therefore, this type of activism is usually regarded as an action of last resort and is very rare in practice.

[95] *O'Neill v Phillips* [1999] 1 WLR 1092. The case provides that the unfair prejudice petition may be brought only if there is a breach of express provisions in the company's constitution, or where there is a breach of mutual understanding and abuse of rules in an inequitable manner in a 'quasi-partnership', hence limiting the instances where shareholders of public widely dispersed companies may take such an action in court.

[96] James D Cox, 'Compensation Deterrence and the Market as Boundaries for Derivative Suit Procedures' (1983) 52 George Washington Law Review; John C Coffee Jr, 'New Myths and Old Realities: The American Law Institute Faces the Derivative Action' (1993) The Business Lawyer; Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press, 2007).

[97] *Ibid.* 200.

[98] Alan J Dignam and John Lowry, *Company Law* (9th edn, Oxford University Press 2016).

[99] Sanjai Bhagat and Roberta Romano, 'Event Studies and the Law: Part II: Empirical Studies of Corporate Law' (2002) 4 American Law and Economics Review.

4.2.2 Activism by different institutional shareholders

As discussed in Chapter 1, firms have undergone a tremendous shift in the last century, family-controlled companies started unwinding due to several factors, [100] and institutions rose to become the main owners of publicly issued equity and they were largely 'sleeping giants' relying on the market for corporate control to exert discipline on management. From the 1980s in the US and 1990s in the UK, 'systematic forms' of institutional shareholder activism began to emerge.[101] From then on, in the discourse on corporate governance, the role of institutional shareholders as a market force for discipline was frequently put forward. However, the general term *institutional shareholders* itself does not say very much about their nature. A breakdown by types of institutional shareholders in the UK and US is provided here in Chapter 4. Not all institutional shareholders are the same and they may vary in their objectives, driving force, investment strategies and size. These factors influence the degree of institutional shareholder activism which may lead to different results in different institutions. For example, passive institutional investors who focus on index returns may pay less attention to the performance of their investee companies, while active investors might care about individual firms. Long-term investors may be better at tolerating volatility than short-term investors and the latter may prefer to focus on quarterly earnings and stock price. Large institutional shareholders are more likely to dedicate significant resources to governance matters and their small counterparts may lack these resources. Therefore, the answer to the question of what the role of institutional shareholders is in corporate governance may lie in the types of investors and what they actually do in terms of engaging with firms in which they invest. In this part of the chapter, institutional shareholder engagement activity will be looked at more closely. Not all possible types of institutional investors have been included[102] partly because of a lack

[100] Such as tax incentives favouring diversification, the rise of the portfolio theory and the rise of the managerial revolution, See John Armour, Brian R Cheffins, and David A Skeel. *Corporate Ownership Structure and the Evolution of Bankruptcy Law in the US and UK* (ESRC Centre for Business Research, University of Cambridge, 2002).

[101] Iris HY Chiu, *The Foundations and Anatomy of Shareholder Activism* (Bloomsbury Publishing 2010). By referring to 'systematic forms of shareholder activism', Chiu means the perspective taken by some shareholders who regard activism as an inherent part of their investment management; that engaging with their investee companies is part and parcel of ongoing investment, and not as an ad hoc occurrence.

[102] Foreign shareholders are, to a large extent, made up by sovereign wealth funds (hereinafter 'SWFs'), are the largest significant group of shareholders in the UK. The SWF appears to make highly diversified and small investments in different industries worldwide and has a primary concern for investment value. Therefore, it is observed that sovereign wealth funds have engaged in little or no shareholder activism in

of reliable data and partly because they are insignificant given their engagement activities in corporate governance. The main types of institutional shareholders discussed in Chapter 4 are analysed. Besides, there are also differences within the same category of institutional shareholders and it is impossible to consider every individual institution. Therefore, a general picture about activism in one institution will be presented without mentioning specific differences within them.

4.2.2.1 Mutual fund

Mutual funds are the major category of institutional investor in the both UK and US. However, unlike pension funds and insurance companies which are usually regarded as long-term investors, which will be discussed later, mutual funds are institutions that require liquidity more than others.[103] This can be explained from their industry nature and portfolio strategies. On the one hand, unlike pension funds and insurance companies whose pay-out is actuarially predictable, mutual funds shareholders, depositors or policyholders may withdraw their funds at short notice. Therefore, adopting a large control position or long-term investment strategies are unacceptable if such stakes would be illiquid. The problem is made worse when considering open-ended mutual funds that need to stand at the ready to redeem the shares of customers who wish to sell on a daily basis. Therefore, mutual funds are more likely to be active traders. In addition, given the fact that the competition between funds to attract customer's funds is stiff, their ability to report the current market value of their investment to outperform their competitors is important. As a result, mutual funds are more focused on short-term performance than others and liquidity is a high priority for rational mutual fund managers.[104] On the other hand, the investment strategies used by mutual funds makes them less likely to be long-term investors. There are basically two portfolio approaches, active management and passive management. Active management is aimed at identifying undervalued securities. These shares are purchased with the assumption that 'the market is inefficient and that not all relevant information

both the UK and US. Therefore, this thesis will not devote much discussion to SWFs as they lead no significant activist activity. Further, see Chiu (note 101); Richard A Epstein and Amanda M Rose, 'The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow' (2012) University of Chicago Law Review 111 .

[103] Coffee (n 4) 1277.

[104] Coffee (n 4) 1277.

is present in the securities market'.[105] Active management thus attempts to make profit by trading securities. Passive management seeks to reproduce or replicate the behaviour of a market index by tracking a market-weighted index or portfolio.[106] The two firms with the largest amounts of money under their management, BlackRock and State Street, primarily engage in passive management strategies.[107]

The IMA conducted a survey in 2006 aimed at measuring its members' engagement with the companies in which they invested. The survey revealed that the majority of the fund management companies being investigated routinely met with their investee companies or at least once a year.[108] In terms of the numbers of meetings held with their investee companies, there is wide disparity. Among 23 institutions that reported in detail, one had 290 meetings, ten institutions had ten or fewer, and the remaining 11 had between 11 and 88 meetings during 2006.[109] On average, each institution had held 33 meetings with its investee companies. Given the behind-the-scenes nature of private meetings, some meetings were not captured on record.[110] Only a few institutions had annually or regularly met with non-executives. The majority of institutions contacted non-executives when there were issues or at the company's request.[111]

The TUC also published a survey regarding the voting and engagement of fund managers in 2015.[112] The survey shows evidence that some asset managers were more willing to vote against management over remuneration issues that year. There was an overall reduction in the proportion of abstentions and an increase in opposing votes, suggesting a tougher approach is taken by asset managers.[113] According to the survey, four respondents supported management in 75% or more resolutions, while at the other end, six investors supported management in 30% or fewer resolutions. On remuneration,

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[105] Paul Myners, Institutional Investment in the United Kingdom: A Review (2001) 36 <http://uksif.org/wp-content/uploads/2012/12/MYNERS-P.-2001.-Institutional-Investment-in-the-United-Kingdom-A-Review.pdf> accessed 5 June 2017.
[106] Philip and Steil (n 8) 58.
[107] Victor Reklaitis, 'Passive Investing is Now the Mainstream Method, Market Watch' (Market Watch, 7 August 2014) <http://www.marketwatch.com/story/passive-investing-is-now-the-mainstream-method-says-morningstar-researcher-2014-08-07> accessed 12 August 2017.
[108] IMA 2006 Survey (n 23) 1.
[109] Ibid.
[110] Ibid.
[111] Ibid.
[112] TUC (note 69) 2.
[113] *Ibid.*

two respondents supported 80% or more remuneration reports, while three respondents did not support any. Take Aberdeen Asset Management as an example, the firm has votes in 61 of its investee companies' reports of which 24 were opposed. The remuneration policy is the most frequent (13 out of 24) topic being rejected.

4.2.2.2 Pension funds

In the UK and US, pension funds are a large category of institutional investors. There are unfunded and funded pension schemes, and most of the occupational pension operate on a funded basis. As the objective of this kind of pension fund is to 'build up a fund of investment assets from the contributions of both employer and employees, so that the income from, and the capital value of, those assets are available to finance the pension obligations of the employer when employees retire',[114] pension funds' investment environment tend to be characterised in general by 'long-term stability and predictable change, but occasional short-term volatility'.[115] On the one hand, in terms of contribution inflows, the contractual nature of the contribution guarantees the stability of the inflows in a certain period and restrains them from the competition of other forms of savings. From the perspective of outflows, unlike mutual funds, pension funds do not face share redemptions and the normal age of retirement of individual employees is set at the beginning of the contract and the rate of those who need premature retirement because of invalidity or mortality is actuarially predictable.[116] Besides, the long period before the payment of the pension schemes makes pension funds more likely to go through many business cycles and across many periods of boom and slump, which could lead to a more stable long-term average return. Therefore, these factors of stability and predictability gives pension funds a wide choice and investment strategy, and allows them to invest with long-term focus and select portfolios with long maturity profiles. To some extent, the maturity structure of pension fund assets is longer than that of any other type of savings institution, including that of insurance companies which, even in their life business, have to deal with, for example, short-term endowment policies and also have to make allowance for surrenders and policy loans.

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[114] David Blake, *Pension Schemes and Pension Funds in the United Kingdom* (Oxford University Press, 2003) 377.
[115] *Ibid.* 407.
[116] *Ibid.* 407.

There are several ways to manage the investment of a pension fund. For those pension funds that are small in size, their portfolio is usually managed by insurance companies. Large pension funds tend to be self-insured or self-administered, which means the fund trustee is the registered beneficial owner of the fund assets in their investee companies and they are managed by 'in-house staff' or outsource the management to external fund managers.[117] Sometimes, funds are pooled with the contributions from different pensions managed together and invested as a single sum.[118] Pooled funds are usually operated as either unit trusts, which are established under a trust structure[119] or managed pension funds which operate under insurance contracts.[120] Unlike UK pension funds which use a mixture of inside and outside managers, US pension funds tend to allocate the management of their assets among several investment advisers, thereby effectively staging competition among them. Arguably, UK pension funds are more likely to reduce the pressure of short-term performance when compared with their US counterparts, given the use of more internal managers and the absence of fierce competition.

With the belief that 'pension funds as long-term investors and they have a clear interest in promoting the success of their investee companies', the NAPF issued its tenth annual survey of pension funds' engagement with their investee companies.[121] The following is an analysis of the key findings of this engagement survey.

a. *Stewardship responsibility*:[122] The first aspect mentioned in this report is the stewardship responsibilities owed by pension funds. Respondents nearly

[117] Gordon Clark, *Pension Fund Capitalism* (Oxford University Press, 2000).
[118] Gong (note 12) 142.
[119] Unit trusts are discussed separately.
[120] In a managed pension fund, the fund simply purchases units of a diversified investment from insurance companies. The insurance companies that manage the fund are the beneficial owners of the assets and therefor have the right to exercise voting rights. Pension schemes purchasing funds own only their investment policies. For more, see Stapledon (n 24).
[121] NAPF, Engagement Survey: Pension Funds' Engagement with Investee Companies. NAPF Research Report, 2014' (2014) <http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0412_NAPF_engagement_survey_2014.pdf> accessed 23 August 2017.
[122] The NAPF has long believed that a greater number of pension fund signatories to the Code is important to give a clear signal to the market and, in turn, influence behavioural changes that lead to better stewardship by asset managers and companies. Therefore, the number of signatories to the UK Code continues to increase – there are now 82 asset owner signatories, including 63 pension funds, according to the data provided in the NAPF survey.

unanimously (93%) accepted the idea that institutional shareholders had stewardship responsibilities which included voting shares and engaging with companies.[123] However, only 53% of the respondents agreed that institutional investors had played an active enough role as stewards of investee companies in the past 12 months.[124] Besides, two thirds (67%) of respondents had formally committed themselves to the Stewardship Code[125] and more funds review their investment managers' application of the stewardship policy on a more frequent basis, with 38% of them doing so quarterly and more than 80% doing so annually at least. The vast majority (80%) of respondents indicated that they took the stewardship activities and policies of managers into account when selecting managers.

b. *Engagement with investee companies:* The survey showed that the shareholder turnout rate at UK annual general meetings was approximately 69%. Nearly 80% of respondents had an investment policy that included engagement and voting, which was set out in their Statement of Investment Principles.[126] In practice, the main approach of respondents to engagement with their investee companies was via delegation. Of the pension funds 57% delegated to their investment managers and 19% outsourced to a third party, with only 10% engaging directly with investee companies themselves.[127] In terms of the effectiveness of the engagement activities, the majority of respondents reported that there was evidence of influence resulting in positive changes on most issues.[128] In respect of voting, 93% of the respondents exercised their vote rights within the UK and the rate of voting in other jurisdictions was increasing.[129] In the US, although specific data on the pension industry were lacking, CalPERS could be used as an example and will be analysed below.

[123] NAPF (n 121) 9.
[124] *Ibid.* 11.
[125] *Ibid.* 13.
[126] A SIP is a written statement governing decisions about investments for the purposes of an occupational pension scheme. NAPF Engagement Survey: pension funds' engagement with investee companies. NAPF, (n 121) 16.
[127] *Ibid.* 26.
[128] Such as board composition (66% agree), company strategy (54% agree) and executive remuneration (76% agree); NAPF (n 121) 28.
[129] NAPF (n 121) 30.

c. *Long-term investment*: There has been growing acceptance that compared with mutual funds, pension funds are long-term in nature. Therefore, NAPF are encouraging pension funds to be 'more explicit about their investment philosophy and their understanding of their objectives and risks'[130]. More than 60% of the respondents stated that it was important for investment managers to take the long-term sustainability of the company strategy into account when making investment decisions. As shown in this chapter, UK pension funds face surprisingly few regulatory restrictions on their investment behaviour. They are free to invest in virtually any type of asset, financial or real, cash or derivative, at home or abroad.[131] Given the restrictions on both contribution inflows and pension outflows, it seems reasonable that the investment practices of pension funds themselves are largely unrestricted, which makes them more likely to invest in the longer term. In the US the Board of Administration of CalPERS adopted a set of 11 pension beliefs in 2014. These beliefs articulate the pension fund's view on 'public pension design, funding, and administration'. Pension Belief 4 requires that a 'retirement plan should include a defined benefit component, have professionally managed funds with a long-term horizon, and incorporate pooled investments and pooled risks'.[132] The Sub-beliefs under this requirements are that a 'key success measure for the CalPERS investment programme is delivery of the long-term target return for the fund'; '[s]taff can be measured on returns relative to an appropriate benchmark, but staff performance plans should include additional objectives or key performance indicators to align staff with funds' long-term goals', which show that CalPERS places great emphasis on the long-term horizon of its fund.

CalPERS, who plays a leading role in institutional shareholder activism in the US, will be used as a classic case to see how it engaged in its investee companies.

[130] *Ibid.* 16.
[131] Blake (n 114) 401.
[132] CalPERS, 'Our Views Guiding Us into the Future' <https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf> accessed 23 August 2016.

Established in 1932, CalPERS is the United States' largest public pension fund, with US$300 billion in assets managed by it in 2014.[133] Since the mid-1980s, institutional investors have become active in monitoring corporate management and independently voting the shares they controlled. CalPERS has been a leader in this movement. Since 1987, CalPERS has formally been active with its corporate governance activities. In the early days there was no formal announcement of the targeted companies. CalPERS' staff selected companies to target and if approved by the CalPERS board, letters were sent to the targeted companies' CEO.[134] Many of the early reforms were aimed at repealing poison pills and staggered boards.[135] In 1992, CalPERS began publicly announcing its 'focus list' in an effort to apply public pressure on the companies it had in its sight.[136] CalPERS began selecting firms using an elaborate matrix of factors, with less attention paid to a particular governance issue. Instead, it focused on stock return performance and governance in general. The criteria for the focus list have changed over time and it includes companies that CalPERS has 'concerns about stock and financial underperformance, and corporate governance practices'.[137] CalPERS works with these companies to improve their corporate governance and thereby improve their financial performance. However, beginning in 2011, the focus list and the engagements became private given the fact that 'the confidentiality facilitates the development of constructive relationships'.[138] Its engagement with underperforming public stock companies is mainly in the form of private contacts and proxy actions. In its 2014 'Towards Sustainable Investment and Operations Report',[139] CalPERS states that the focus list still played a vital role in its engagement on corporate governance and it selects targeted companies from the top 1,000 domestic public equity holdings that are underperforming on both stock returns and governance factors. Governance factors include 'board quality, staggered boards, lack of director independence, shareowner

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[133] CalPERS, 'Facts at a Glance' (2015) <https://www.calpers.ca.gov/docs/forms-publications/facts-at-a-glance.pdf> accessed 23 August 2016.
[134] Stephen Nesbitt, 'Long-term Rewards from Shareholder Activism: A Study of the "CalPERS Effect"' (1992) 6 Journal of Applied Corporate Finance 75.
[135] Claire E Crutchley, Carl D Hudson and Marlin RH Jensen, 'Shareholder Wealth Effects of CalPERS' Activism' (1998) Financial Services Review 1.
[136] Brad M Barber, 'Monitoring the Monitor: Evaluating CalPERS Activism' (2007) 16 The Journal of Investing 66.
[137] Author unknown, 'CalPERS Targets Five Companies on 2008 Focus List of Underperformers' (San Francisco Business Time, 23 March 2008) <https://www.bizjournals.com/sanfrancisco/stories/2008/03/24/daily14.html> accessed 28 August 2016.
[138] Towards Sustainable Investment and Operations (n 59) 12.
[139] *Ibid*.

rights, poison pills, executive compensation, and risk management of environmental and social issues'.[140]

Apart from the focus list strategy, CalPERS also sees proxy voting as the primary way to influence a company's operation and corporate governance.[141] In 2016, CalPERS launched four proxy voting campaigns[142] and supported shareholder proposals by other organizations on topics such as board diversity, climate reporting and proxy access.[143]

Empirical research on the results of CalPERS' activism is mixed. Smith found that companies that had adopted the changes proposed by CalPERS or that made changes resulting in settlements being reached with CalPERS, shareholders' wealth increased and those companies who did not, shareholders' wealth decreased. [144] Wahal examined all firms targeted by nine major pension funds from 1987 to 1993 and found that only firms targeted by CalPERS experienced a positive stock price reaction.[145] Crutchley, Hudson Jensen's research found that very visible and aggressive activism increased shareholder wealth, but 'a quieter activism practiced by CalPERS after 1994 does not'. For the total sample period, 1992–97, the returns for targeted firms were no different.[146] Two studies published by CalPERS staff in 2003–2004 found that stocks on the CalPERS Focus List experienced 'positive excess stock returns of about 12% over the three months following release of the list'.[147] English et al. concluded that CalPERS' targeting produced a statistically significant improvement in short-term returns but not necessarily in long-term returns.[148] Nelson's research in 2006 found 'no evidence to support the persistence of a "CalPERS"' effect after 1993. [149] Barber found that

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[140] *Ibid 15*.
[141] CalPERS official website, 'Proxy voting' <https://www.calpers.ca.gov/page/investments/governance/proxy-voting> accessed 28 August 2016.
[142] *Ibid*. The four proxy voting campaigns are Anglo American, Glencore Plc, Old Republic International Corp and Rio Tinto Plc.
[143] 'Proxy voting' (note 141).
[144] Michael P Smith 'Shareholder Activism by Institutional Investors: Evidence from CalPERS' (1996) 51 The Journal of Finance 227.
[145] Sunil Wahal, 'Pension Fund Activism and Firm Performance' (1996) Journal of Financial and Quantitative Analysis 12.
[146] Crutchley, Hudson, and Jensen (n 135) 8.
[147] Mark Anson, Ted White and Ho Ho, 'The Shareholder Wealth Effects of CalPERS' Focus List' (2003) 15 Journal of Applied Corporate Finance 102
[148] Philip C English, Thomas I Smythe, and Chris R McNeil, 'The "CalPERS Effect" Revisited' (2004) 10 Journal of Corporate Finance 157.
[149] James M Nelson, 'The "CalPERS effect" Revisited Again' (2006) 12 Journal of Corporate Finance 187.

'CalPERS activism yields small, but reliably positive, market reactions in the short term' and the long-term returns are not guaranteed.[150]

4.2.2.3 Insurance companies

In the UK and US, insurance companies have long been the important types of institutional investors in terms of their equity holdings and have been central to the development of capital markets.[151] Insurance is a contract based on money for a promise. The policy holder's premium is consideration for the insurer's agreement to pay a covered claim that may occur months, years or even decades in the future and where the amount of the claim is likely to be.[152] The UK insurance industry mainly consists of life business and other long-term insurance contracts, with 93% of the total assets controlled by them, as opposed to other insurance contracts, such as household, casualty and health.[153] In the US, according to the data provided by the Insurance Information Institute, the US insurance industry's net premiums amounted to US$1.2 trillion dollar in 2015, with life and health sector contributing 55%.[154] Given the fact that life insurance accounts for a large percentage of the insurance industry, there is plenty of time before a sum needs to be paid out at either death or a specified time in the future. Therefore, in the life insurance business, contracts are mainly long-term in nature and, to some extent, similar to pension funds.[155]

In 2013, ABI issued a report on corporate governance and shareholder engagement, with the aim of promoting good corporate governance and investee company's long-

[150] Barber (n 136).
[151] Black and Coffee (n 4) 1997.
[152] Peter Kochenburger and Patrick Slave 'An Introduction to Insurance Regulation' in Julian M Burling and Kevin Lazarus (eds) *Research Handbook on International Insurance Law and Regulation* (Edward Elgar Publishing, 2012) 221.
[153] ABI, *UK Insurance: Key Facts* (2010) 3 <https://www.abi.org.uk/globalassets/sitecore/files/documents/publications/public/2015/statistics/key-facts-2015.pdf > accessed 05 September 2017.
[154] Insurance Information Institute, 'Facts and Statistics: Industry overview' <http://www.iii.org/fact-statistic/industry-overview> accessed 05 September 2016.
[155] Insurance Companies and Pension Funds as Institutional Investors: Global Investment Patterns, Trusted Sources Research and Networks, Report prepared for the City of London Corporation by Trusted Sources, November (2011) 7 <http://www.cityoflondon.gov.uk/business/support-promotion-and-advice/promoting-the-city-internationally/china/Documents/Insurance%20companies%20and%20pension%20funds%20report.pdf> accessed 05 September 2016.

term sustainable performance.[156] This report covers several aspects[157] and section five reviews current approaches to shareholder engagement. What follows is an analysis of the key findings of the report in terms of engagement:

a. *Attitude towards institutional shareholder activism*: There is a long tradition for ABI members to regard engagement as an important responsibility that should be exercised on behalf of their clients. ABI members see 'effective shareholder engagement as an integral part of the investment process and therefore as a means to generate outperformance over the long term'.[158] Although some members acknowledge that their corporate governance practice may be compliance in nature, rather than part of the investment process at the beginning, the culture of responsible ownership is currently increasingly being integrated into the investment process and a virtuous circle of engagement is being created.[159]

b. *Private meeting with companies*: There is no set formula for engagement. Given the diversity of approaches in evaluating and understanding companies, different shareholders will have different engagement approaches, and likely adopt different voice and exit strategies, depending on the circumstances. All members acknowledge that their approach may vary extensively from case to case when considering the specific circumstances of the company in question. They place great emphasis on the importance of confidentiality in order to ensure an appropriate relationship of trust and, in turn, enhanced dialogue.[160] Therefore, a private meeting is the first recourse of engagement. During the course of 2013, members of the ABI Investment Committee each held, on average, 150 meetings with UK listed companies.[161] The meetings covered a wide range of issues, such as board composition, remuneration, strategy, accounting, audit and poor performance. If insufficient or no progress was

[156] ABI, 'Improving Corporate Governance and Shareholder Engagement' (2013) 3 <https://www.ivis.co.uk/media/5929/ABI-Report-Improving-Corporate-Governance-and-Shareholder-Engagement.pdf> accessed 05 September 2016.
[157] Such as corporate governance overviews, non-executive directors, shareholder engagement, shareholder rights and asset managers.
[158] ABI (n 156) 17.
[159] *Ibid.* 17.
[160] *Ibid.* 20.
[161] *Ibid.* 20.

made after the meetings with the company, collective engagement may be contemplated. Many members believed that most successful collective engagements would tend to involve three to four shareholders and include at least one or two of the largest ten shareholders. Sometimes, they may carry out collective engagement through the ABI executive.[162]

c. *Voting*: ABI members consider it important 'to demonstrate to the market that institutional investors undertake rigorous voting analysis and decision-making' as the voting rate is usually regarded as a critical aspect of responsible ownership.[163] The report shows that all members vote all their UK equity holdings. In order to identify potential issues in their investee companies and, hence, inform their in-house analysis, all members of ABIS have a policy of using proxy adviser research. However, the final voting decision is not solely dependent on their recommendations. Those members with a small shareholding sometimes vote in accordance with proxy adviser recommendations. In addition, as all ABI members are Stewardship Code signatories, they disclose their voting policies, their formal voting process and actual voting decisions.[164] In terms of the proxy voting, only 20% of members assigned proxy voting responsibilities exclusively to portfolio managers[165] and 90% of members' proxy voting decision-making processes include active participation from portfolio managers and investment analysts. Of members' proxy voting decision-making processes 50% require formal approval from the Chief Investment Officer for negative voting decisions or for large equity positions.

[162] ABI collective meetings are initiated by members who are seeking to resolve issues with shareholders or by investors who feel that their concerns have not been addressed. The executive normally arranges a pre-meeting to share concerns and decide on areas of focus for the meeting and any objectives. The meeting are chaired by a senior figure among the ABI members and individual members will raise their own specific concerns. The Director of Investment Affairs will then write a letter to the company following the meeting. This letter will typically outline commitments made by the company, highlight any areas of outstanding concern and convey whether a further meeting would be required.
[163] ABI, Best Practice Principles on Corporate Governance Research http://bppgrp.info/wp-content/uploads/2014/01/ABI-BPP-GRP-Consultation-Response-2013.pdf
[164] ABI (n 156) 23.
[165] *Ibid.* 19.

4.2.2.4 Hedge funds

Hedge funds, as discussed in Chapter 2, are private pools of capital that engage in a variety of trading strategies with the aim of generating excess returns. Hedge funds operate on ‘an agenda of absolute returns’,[166] which means they have to maximise upsides and minimise downsides by using various strategies, such as hedging, leveraging and short selling,[167] in order to generate returns for their investment no matter the market condition. Their investment strategies are ‘designed to squeeze agency costs and other inefficiencies out of underperforming companies’.[168] Hedge funds are known for their high fee structure (2/20), with 20% of the portfolio upside and 2% management fee.[169] In order to justify these fees, hedge funds face great pressure from their clients to generate superior performance. Therefore, unlike the defensive institutional shareholders activism discussed above, hedge funds generally carry out different kinds of activities, that is, offensive activism[170], which means their activism has frequently been exercised out to persuade companies to take certain actions that could result in the generation of cash for hedge funds.[171] McCahery et al. showed that many hedge funds (48% of their sample) were very active in seeking communication with management.[172]

According to empirical research, the hedge fund investment horizon is relatively short-term.[173] The relatively short-term horizon also feeds into hedge funds’ aggression and impatience in extracting the value of their investments and, hence, a similar style in

[166] Chiu (n 101) 73.
[167] Alternative Investment Market Association (AIMA), ‘AIMA’s Roadmap to Hedge Funds’ 101 <https://www.aima.org/uploads/assets/uploaded/1225c1ba-f62b-439a-904d60564a441200.pdf> accessed 07 September 2016.
[168] Robert C Illig, ‘What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight’ (2007) 57 American University Law Review 225.
[169] See generally, John C Coffee, ‘The SEC and The Institutional Investor: A Half-Time Report’ (1994) Cardozo Law Review; Bernard S Black, ‘Shareholder Activism and Corporate Governance in the United States’ (vol 3 *The New Palgrave Dictionary of Economics and the Law*, 1998) <http://dx.doi.org/10.2139/ssrn.45100> accessed 05 September 2016.
[170] *Offensive activism* is described as actions that are taken to seize an opportunity for the purpose of generating abnormal returns on share price. See Brian R Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford Scholarship online 2010) <http://ukcatalogue.oup.com/product/9780199236978.do> 5 accessed 25 January 2016.
[171] Chiu (n 101) 76.
[172] McCahery, Sautner and Starks (n 21) 19.
[173] Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, ‘Hedge Fund Activism, Corporate Governance, and Firm Performance’ (2008) 63 The Journal of Finance 1729.

their activism.[174] Given the fact that hedge funds target companies and engage in their investee companies with a view to generating abnormal returns, the process of activist engagement is quite different from other institutional shareholders. Activism taken by hedge funds generally begins with an informal contact with their target companies for the purpose of generating dialogue with investor relations and executive officers. This initial contact is non-confrontational.[175] In order to put pressure on the targeted company, hedge funds may use various strategies; the most common one being to write letters to management that list deficiencies observed by hedge fund activists, and various changes and concessions sought to be made.[176] The Conference Board reports that this first step is almost universally taken in all cases in the US where some public attention is given to the activism.[177] In nearly a fifth of cases, concessions may be made by the targeted company without any public attention drawn to the activism.[178] If this action does not get the expected results, the hedge fund may take the next action, namely to publicise the contents of the letter in order to draw attention to the activism. Such open letters are frequently published in major newspapers in the jurisdiction of the target company.[179] This public or semi-public communication generally exerts pressure on the board of the targeted company to meet with and try to resolve the activist demands, although such meetings need not necessarily result in concessions being made by the target. In the US failure to obtain concessions from the targeted company after publicising the activism may result in a threat to, or actual carrying out of, a proxy contest by the hedge fund activist. The indication of a hedge fund activists' 'intent to solicit' proxies or actual commencement of the campaign of solicitation of proxies generally results in the targeted company's climb-down from resistance against the hedge fund activist. Settlements could occur based on major concessions or minor concessions agreeable to the activist.[180] However, such steps are rarely taken in the UK. On the whole, compared with other institutional shareholders, hedge funds are more

[174] William W Bratton, 'Hedge Funds and Governance Targets' (2006) 95 Georgetown Law Journal 1375.
[175] Matteo Tonello, 'Hedge Fund Activism: Findings and Recommendations for Corporations and Investors' (17 September 2008). The Conference Board Research Working Group Series, <http://dx.doi.org/10.2139/ssrn.1107027> access 12 September 2016.
[176] Chiu (n 101) 78.
[177] Tonello (n 175).
[178] Brav et al. (n 173).
[179] Chiu (n 101) 79.
[180] *Ibid.*

likely to use confrontational and aggressive tactics against the targeted companies in their escalation of activism if their initial efforts do not generate expected results.

As pointed out by Armour and Cheffins, hedge fund activism remains largely a US phenomenon given the fact that most hedge funds are based in the US.[181] However, Hermes, the fund manager owned by the British Telecoms Pension Scheme, operates a UK Focus Fund that pursues shareholder engagement. Its investment strategy is an appropriate case here to take a close look at the hedge fund activism.

The Hermes approach can be discussed in two stages: (1) investment stage and (2) engagement stage. At the investment stage, Hermes usually focuses on those companies that have been underperforming for a certain period in the market due to structural or strategic governance problems but have the ability to fix these problems through shareholder 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 in its portfolio'.[182] In terms of the engagement process, a meeting with the targeted companies is usually the first step taken, if it receives positive feedback from the board, Hermes will assist the board with implementing the consensus they have reached. If a negative response is received, Hermes will meet with independent board members and the major shareholders to persuade the board to make changes. If the board makes no changes, the fund will escalate its action into public action, such as calling a general meeting.[183] Once the changes have been made, Hermes will hold the shares and wait for 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 process to be successfully completed.

[181] John Armour and Brian Cheffins, 'The Rise And Fall (?) of Shareholder Activism by Hedge Funds' (2012) The Journal of Alternative Investments 17.
[182] Marco Becht, Julian Franks, Colin Mayer and Stefano Rossi, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2008) 22The Review of Financial Studies 3093.
[183] William Bratton and Joseph A McCahery (eds) *Institutional Investor Activism: Hedge Funds and Private Equity, Economics and Regulation* (Oxford University Press, 2015).

Research undertaken by the London Business School focused on the ways in which Hermes caries out activism and its effectiveness on those targeted underperforming companies.[184] From 1998 to 2004, Hermes had targeted 30 of its 41 investee companies by means of private meetings, telephone calls, letters between fund representatives and executive directors, investment relation officers and other board members. Hermes had been successful in using private communication to bring about governance change. More than half of its targeted companies, in some cases as many as 75%, had adopted its proposed changes.[185] Moreover, once the companies had followed up on Hermes's suggestions to make changes, the study found that their share price increased substantially; by as much as 6% immediately after the changes had been disclosed to the public.[186]

4.2.2.5 Industry trade associations

There is another important pillar of institutional shareholder activism, which is of in the UK style, namely industry trade associations. British institutional shareholders tend to act and voice through various institutional investor representative groups when dealing with corporate management. The main types of institutional shareholders all have their own industry association: the PLSA (the former NAPF), the ABI, the Investment Association[187] (the former IMA), and the Association of Investment Companies[188]. The PLSA, the history of which is more than 90 years old, consists of more than 1,300 pension schemes with 20 million members and ￡1 trillion in assets and over 400 supporting businesses.[189] 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.[190] The IA is the representative body for the UK investment management industry. Its members collectively manage over ￡3 trillion of assets in the UK.[191] The AIC was formed in 1932 to represent the closed-ended investment company industry. It has some 300

[184] Becht et al. (n 182) 3093.
[185] *Ibid.* 3111.
[186] *Ibid.* 3097.
[187] Hereinafter 'IA'.
[188] Hereinafter 'AIC'.
[189] See PLSA official website <http://www.plsa.co.uk> accessed 12 September 2017.
[190] See ABI official website <https://www.abi.org.uk/> accessed 12 September 2017.
[191] See IA official website <http://www.theinvestmentassociation.org/> accessed 12 September 2017.

members, which between them account for approximately 77% of the sector by assets.[192] Apart from these individual trade organizations, an umbrella organization, the Institutional Shareholders Committee[193], which collectively represents major financial institutions except commercial banks, was created in 1973 under the agreement of these trade associations.[194] Its role is to allow 'the UK's institutional shareholding community to exchange views and, on occasion, coordinate their activities in support of the interests of UK investors.'[195]

These associations are, though in various degrees, active in encouraging institutional shareholders engaging in corporate governance. Firstly, these industry trade organizations play a traditional lobbying role with the government on behalf of their members.[196] They not only lobby or liaise with governmental institutions[197] on matters such as large transaction and management buy-outs, but are also represented in some of them.[198] Moreover, they have the chance to contribute their opinions and advice to the UK corporate governance framework. For example, they have issued many responses to government-related bodies, such as the FRC, who collects comments on various aspects of corporate governance.[199] Secondly, UK industry associations have produced several statements of, or guidance on, best practice in corporate governance issues, such as the ISC's A Statement of Principle on the Responsibilities of Institutional Shareholders and Agents[200], the ISC's Code on the Responsibilities of Institutional Investors, NAPF's 2009 Corporate Governance and Voting Guidelines Responsible Voting (a Joint ABI–NAPF Statement), and the ABI's Report on Improving Corporate Governance and Shareholder Engagement. All the above guidance is voluntary in nature but those associations call on institutions to state publicly how they apply the principles. Thirdly, industry associations bridge the

[192] See AIC official website <www.theaic.co.uk> accessed 12 September 2017.
[193] Hereinafter 'ISC'.
[194] The creation of the ISC did not replace the roles of its members, PLSA, ABI, IA 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 its members.
[195] Investment Association, 'Investors Form New Top Council, Set Rights Issues Enquiry As First Task' (18 May 2010) <https://www.theinvestmentassociation.org/media-centre/press-releases/2010/press-release-2010-05-18.html> accessed 12 September 2017.
[196] Stapledon (n 24) 133.
[197] Such as the London Stock Exchange, the Institute of Chartered Accountants of England and Wales.
[198] Such as the Takeover Panel and the Stock Exchange's Investors Advisory Group.
[199] For example, NAPF issued its response to the FRC Combined Code Review in 2009.
[200] Hereinafter 'Statement of Principle'.

connection between their institutional members and their investee companies in circumstances where concerns or problems may rise.[201] For example, when corporate governance problems or strategic concerns rise in certain investee companies, a 'case committee' will be established. With the help of associations, members holding large numbers of shares form this 'case committee' to meet with the board and management with the aim of resolving these problems. It was the most important means of forming negotiations between institutional shareholders and corporate managers in the late 1980s and 1990s.[202] As reported by Stapledon, the ABI formed about 200 case committees annually.[203] However, thereafter they were less visible[204] until 2003 when NAPF was reported as reviving its case committee.

Furthermore, industry associations could provide some background research and advice to their members. Associations, such as the NAPF and ABI, help their members to monitor their investee companies through their voting information services. They make voting recommendations on behalf of their members if required to do so by monitoring listed companies' compliance with relevant corporate governance guidance, such as the UK Corporate Governance Code. In addition, industry associations also conduct surveys to examine the extent to which members are complying with good practice and engage with investee companies to act as responsible investors. These surveys are important sources of evidence in the present thesis to investigate the level of shareholder engagement.[205]

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[201] A good example is the institutional shareholders–management row over the CEO's pay in Sainsbury plc in 2004. The NAPF met with the chairperson of Sainsbury plc's Remuneration Committee and recommended its members vote against the management's proposal. See Julia Finch, 'Sainsbury's Facing Pay Defeat' The Guardian (10 July 2004) <http://www.guardian.co.uk/business/2004/jul/10/executivesalaries.executivepay> accessed 12 September 2016.

[202] Paul Davies, *Institutional Investors in the United Kingdom*: A Review <http://uksif.org/wp-content/uploads/2012/12/MYNERS-P.-2001.-Institutional-Investment-in-the-United-Kingdom-A-Review.pdf> accessed 12 September 2016.

[203] Stapledon (n 24) 137.

[204] Typically, case committees were viewed as 'unwieldly', having too many members to act quickly or decisively. Today, a firm's largest shareholders, when they intervene, are more likely to form a loose coalition on their own than to set up a case committee through the ABI or the NAPF. Furthermore, some institutions might not want to join a case committee as this would restrict their ability to sell. Finally, a committee of only insurance companies or pension funds cannot speak for all institutional investors, yet a pan-institutional committee would be even more unwieldy.

[205] See above surveys conducted by the NAPF, ABI and IMA.

Therefore, it is beyond argument that UK industry trade associations play a vital role in providing better corporate governance standards, and promoting good communication between institutional shareholders and their investee companies. The increase in institutional shareholder activism in recent years in the UK is, to some extent, driven by these associations. The ABI will be used as an example to see how the associations play a role in making their members more active.

The ABI has a long history of taking its shareholder engagement responsibilities seriously, which could be traced back to 1991, when the ABI published a discussion paper on the responsibilities of institutional shareholders.[206] The document outlined nine principles of good practice for institutional investors; one of which described the impotence of engagement. The first principle is that '[i]nstitutional investors should encourage regular, systematic contact at senior executive level for the purposes of an exchange of views and information on strategy, performance, board membership and quality of management.'[207] Over time, the ABI's role in facilitating dialogue between investors and companies has led to a strong understanding of different approaches to engagement.[208]

As discussed above, UK industry associations have produced and promoted statements of, and guidance on, best practice in corporate governance in various areas and the ABI is no exception in this respect. As early as 1999 the ABI, together with NAPF, issued a statement regarding responsible voting. In 2008, the 'Joint Statement on Executive Contracts and Severance by the ABI and NAPF' was published for the purpose of 'assisting Boards and their Remuneration Committees with the design and application of contractual obligations for senior executives.'[209] Following on from this, the 'Board Effectiveness: Highlighting Best Practice: Encouraging Progress'[210], 'Comply or

[206] ABI, 'The Responsibilities of Institutional Shareholders' (1991) <http://www.ivis.co.uk/PDF/3.3_The_Responsibilities_of_Institutional_Shareholders.pdf> accessed 12 September 2016.
[207] ABI (n 156) 17.
[208] *Ibid.*.
[209] ABI and NAPF, Joint Statement on Executive Contracts and Severance by the Association of British Insurer (ABI) and the National Association of Pension Funds (NAPF) (2009) 2 https://www.ivis.co.uk/media/5896/ABI_NAPF_Joint_Statement_14feb2008_2_v_5.pdf accessed 12 September 2016.
[210] ABI, "Report on Board Effectiveness' (2011) <https://www.ivis.co.uk/media/5917/ABI-Board-Effectiveness-Report-2011-Final.pdf> accessed 13 September 2016.

Explain: Investor expectations and current practices', 'Board Effectiveness: Updating Progress, Promoting Best Practice' [211], 'Improving Corporate Governance and Shareholder Engagement'[212] were published regularly.

Apart from these reports and guidelines, the ABI is focusing on facilitating proactive engagement by its members. ABI members are increasingly developing more proactive mechanisms for identifying engagement targets that 'focused on specific thematic topics and identifying companies that are considered to be underperforming and/or which are considered to have poor management and/or governance'.[213] This proactive, but non-confrontational, approach has been developed into a service called the *Institutional Voting Information Service*[214], which is now one of the UK's leading providers of corporate governance research.

In addition, the ABI plays an important role in facilitating dialogue between investors and companies. The collective engagement through the ABI is a good example. The ABI collective meetings are usually initiated by members whose concerns have not been properly solved in their first attempt. In the beginning a pre-meeting will be arranged by the ABI executive with the aim of deciding areas of focus for the meeting. Then, specific company matters will be discussed formally at the Investment Committee of the ABI which is chaired by a senior figure among the ABI members. Such meetings are usually constructive and collaborative in nature, with the intention of increasing understanding on both sides. Followed by that, the Director of Investment Affairs will write a letter to the company following the meeting, which outlines commitments made by the company, highlight any areas of outstanding concern and conveys whether a further meeting would be required. Given the constructive nature of such meetings, the ABI develops a sustainable relationship with a wide range of companies, and companies increasingly contact the ABI executive with a view to facilitating collective engagement with members.

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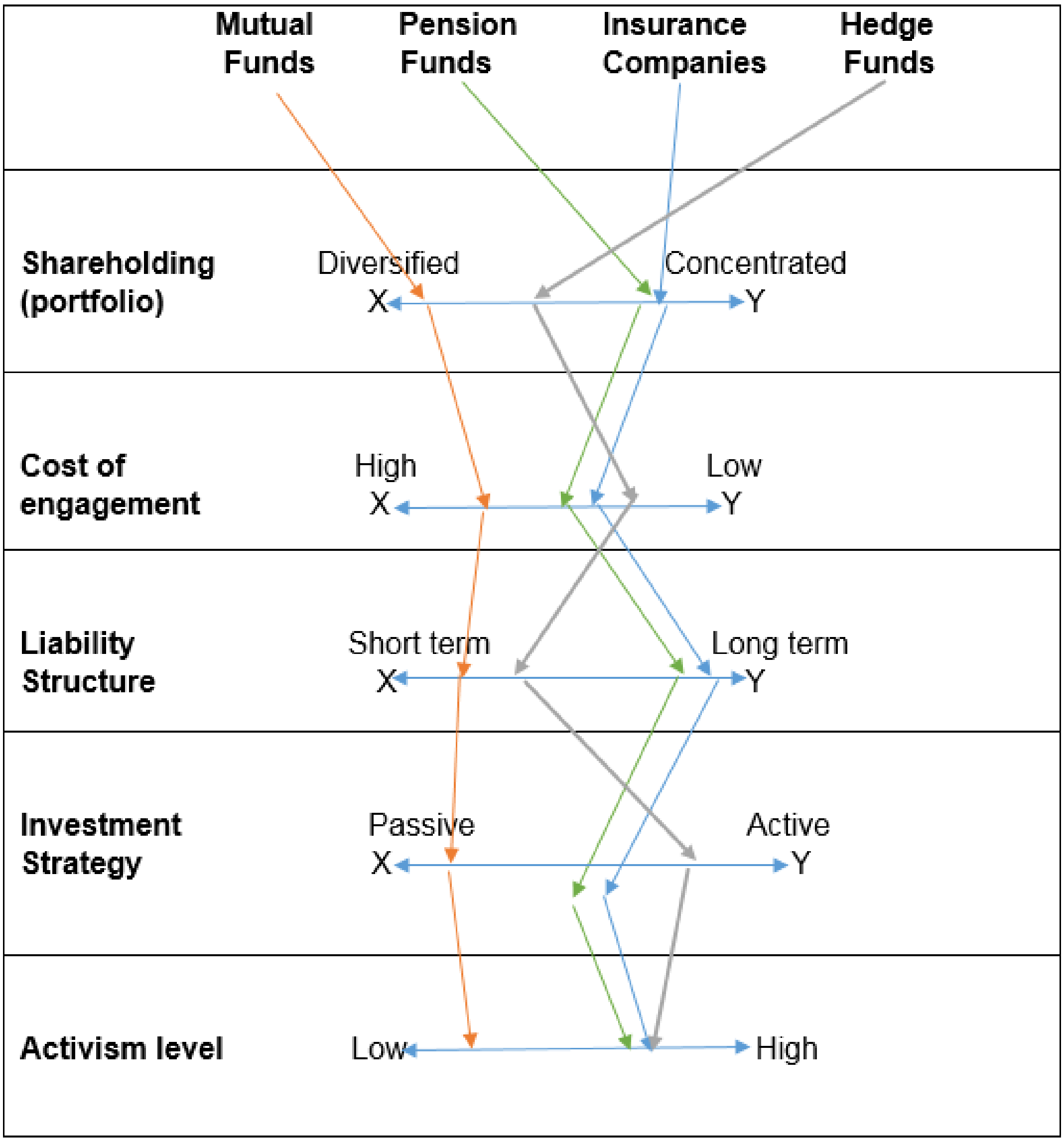
[211] ABI, 'Comply or Explain: Investor Expectations and Current Practices' (2012) <https://www.ivis.co.uk/media/5923/ABI-Report-on-Comply-or-Explain-Investor-Expectations-Dec-2012.pdf> accessed 13 September 2016.
[212] ABI (note 207).
[213] *Ibid*. 21.
[214] Hereinafter 'IVIS'.

4.3 Conclusion

This chapter took a closer look at institutional shareholder activism in the UK and US from a practical perspective. At the start of this chapter, five factors that could influence the degree of institutional shareholder activism were discussed: (1) shareholding (portfolio structure); (2) cost; (3) conflict of interest; (4) liability structure and (5) investment strategy. After examining the engagement activities taken by different institutional shareholders, it became evident that these factors do influence the preference and degree of institutional shareholder activism. Some institutions require liquidity more than others, such as mutual funds. They tend to hold large portfolios, which lead to their passivity in activism compared with pension funds and insurance companies, whose long-term obligation and predictable redemptions or outflows allow them to have the patience to go through many business cycles, and across many periods of boom and slump. With the help of proxy adviser firms and industry associations, the cost of engagement and forming coalitions is greatly decreased and the willingness to engage is much higher. As for conflicts of interest, although the analysis does not show much about this factor due to the secrecy of business relationships, research shows that their interviewees would keep a relatively low profile on corporate governance issues if there were actual or potential business relationships. However, as it is difficult to measure and there is not enough data and evidence to show how it influences the behaviour of institutional shareholders, this factor was not included in the analysis in figure 4.1 .The nature of the products institutional investors offer to the public also have an influence on their activism. As discussed above, pension funds and insurance companies are more likely to be long-term investors given their long-term obligation and predictable redemptions or outflows allowed, whereas mutual funds have to be at the ready to redeem on a much shorter basis. Long-term obligations are associated with more willingness to engage. First, longer-term 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.[215] Moreover, a close relationship between institutional investors and corporate management is found to be helpful to reduce the possibility of managerial

[215] Arnold W Sametz and James L Bicksler (eds), *The Battle for Corporate Control: Shareholder Rights, Stakeholder Interests and Managerial Responsibilities* (McGraw-Hill Inc 1990) 67–76.

short-termism by facilitating boards to adopt a longer-term investment strategy in their companies.[216] Finally, in terms of the investment strategies, different strategies do produce different ways of acting, which leads to different degrees of engagement. No one type of institution only focuses on one type of investment strategy. Many mutual funds and pension funds use a passive index strategy[217] and hedge funds are usually associated with 'active fundamental' strategy[218]. Therefore, Figure 4.1 could be expanded into Figure 4.2:



[216] Research on managerial incentives frequently found that managers tended 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, 2004) 271.
[217] Çelik and Isaksson (note 6) 1.
[218] *Ibid*. 1.

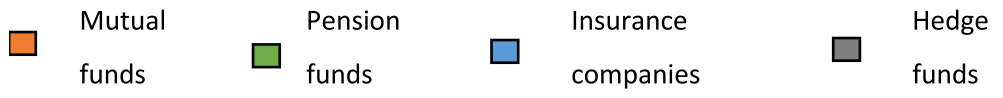


Figure 4.2: Factors that influence institutional shareholder activism

Four forms of institutional shareholder activism were discussed in this chapter. Private meetings with management and boards of directors are considered as the first option by many institutions when concerns arise over corporate issues. When private meetings fail, other forms of activism are followed. Among multiple channels for institutional shareholders to engage, the behind-the scene private meeting and proxy voting are the most frequent weapons used by majority institutional shareholders. According to Talner, shareholder activism in the 1930s was usually triggered by specific events, and was thus ad hoc, event-led and ex post in nature.[219] From the discussion above one can see that although some activism exercised by institutional shareholders may still be event-led, 'relational investing'[220] has become a significant development and more persistent engagement with companies could be seen on a more frequent basis.[221] Moreover, activism could be divided into 'offensive' and 'defensive' according to its motive. As seen in the Hermes case, the engagement approaches deployed by offensive activism are basically the same as that adopted in defensive activism.[222] In addition, the emergence of proxy advisory firms has led to an increase in the number of shareholders willing to take an active role in the governance of their investee companies. In addition, industry trade associations in the UK play an important role in encouraging institutional shareholder activism. They encourage their members to engage in governance of their investee companies in various ways.

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[219] Lauren Talner, 'Investor Responsibility' *The Origins of Shareholder Activism* (1983), now out of print, quoted in R Franklin Balotti, Jesse A Finkelstein, and Gregory P Williams. *Meetings of Stockholders* (Aspen Publishers, 1996) at para 5.4.

[220] Relational investing is frequently characterised by significant stakes held over a long period, with the shareholder committed to exerting internal discipline on managers; see Ian Ayres and Peter Cramton. 'Relational Investing and Agency Theory' (1993) Cardozo Law Review; Chiu (note 101).

[221] Such engagement may be carried out in order to safeguard investment value when issues arise that may threaten investment value. Some engagement may even be carried out with a view to influencing management on an ex ante basis. The latter may include regular and not merely ad hoc participation in general meetings, but also includes informal types of engagement outside the general meeting.

[222] For a detailed discussion and cases of hedge funds activism, see Jonathan R Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press, 2008).

In conclusion, the findings of this chapter are captured in Figure 4.3. The grey circle represents the internal environment in which institutional shareholder activism operates. The horizontal axis represents the factors mentioned in Figure 4.2 from X to Y. The vertical axis represents the level of activism. One could conclude from Figure 4.2 that there is a strong correlation between high activism levels and factors in the extent of XY. Therefore, this relationship is simplified on this axis. Analysis shows that some external factors, such as the friendly legal environment for institutional shareholders, the effects of proxy advisory firms and industry associations, all promote institutional shareholders to better engage in their investee companies. Therefore, these outsider factors (orange arrow) lift the overall level of activism (from black line 1 to square dot line 2). The circle on the left of the axis illustrates that the different routes of activity taken by institutional shareholders depend on different levels of activism. Those traders who have no interest in shareholder activism usually pick stocks and use technical assessments to judge the movements of the stock prices to find a perfect time to sell their shareholdings only for the profits of the price gap. However, those institutional shareholders who actively engage in their investee companies, used to hold a private meeting with the boards or managements as their first option. If this fails, other activism forms were followed. Rather than only focusing on the profit, these institutional shareholders are more concerned about the performance and governance of certain companies.

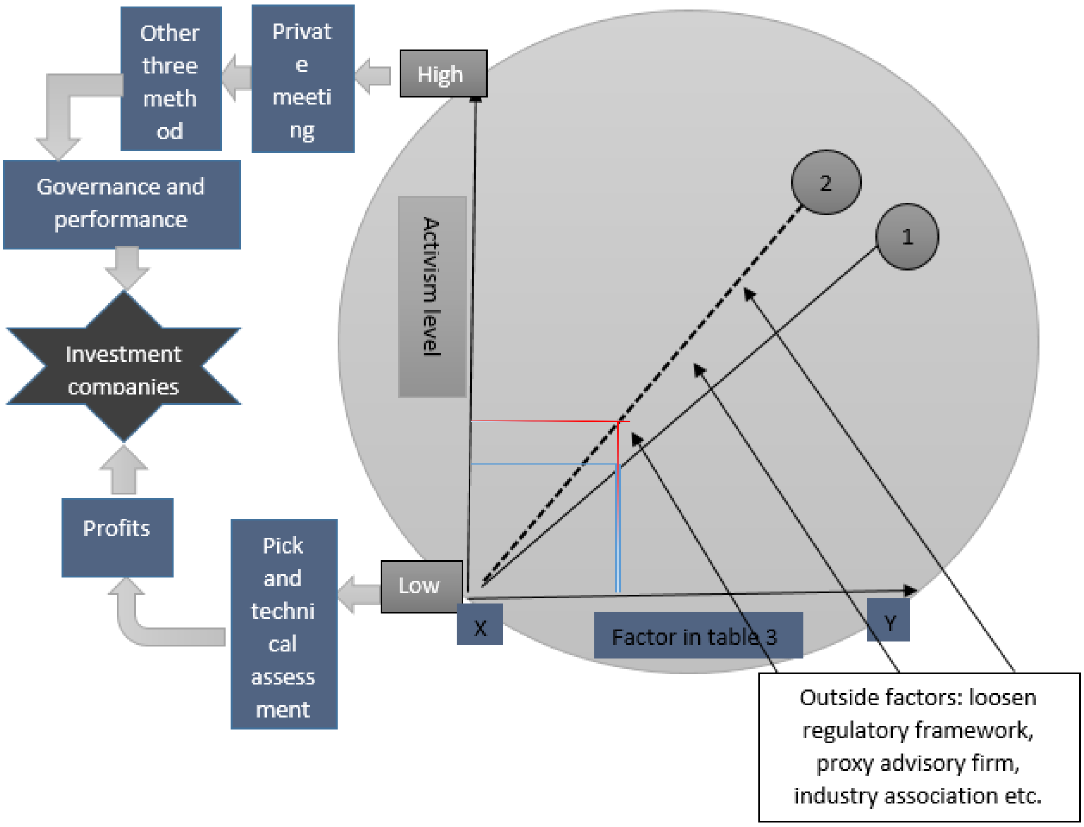

Figure 4.3: Relationship between factors in Figure 4.1 and activism level and different routines taken by institutional shareholders at different activism levels

The following Chapter 5 also takes an empirical perspective to investigate the level of institutional shareholder engagement in Chinese listed Companies.

Chapter 5: Institutional Shareholder Activism in China

In Chapter 4 institutional shareholder activism was analysed from a practical perspective in the UK and US. In this chapter the same pattern is followed when looking at how institutional shareholder activism is exercised in China.

5.1 Factors that influence institutional shareholder activism

In Chapter 4 five factors were presented that influenced the degree of institutional shareholder activism in the UK and US: (1) shareholding (portfolio structure); (2) cost; (3) conflict of interest; (4) liability structure and (5) investment strategy. Chapter 5 will also start with a review of the literature on factors that influence the way that institutional shareholders engage in the corporate governance of their investee companies in China.

As discussed in Chapter 2, according to the latest data, the tradable shares held by institutional shareholders have been increasing since 2001, with insurance companies (0% to 3.87%), pension funds (1.07% to 1.31%) and QFIIs (0.64% to 1.38%). The rise in these figures may be related to two factors: on the one hand, the government's policy which is friendly to the development of investment funds and, on the other hand, the gradual transfer of non-tradable shares to tradable shares during this period. Given the relatively short history of development compared with China's UK and US counterparts and limited information and data, the academic literature shows an astonishing indifference to the institutional shareholder activism phenomenon. There are only a few papers that look into the factors that influence the engagement activities undertaken by institutional shareholders.

The first is the research report published by the research centre of the Shenzhen Stock Exchange which focuses on the development of institutional shareholders.[1] In this report, the author pointed out the three factors that prevented institutional shareholders

[1] Jibao He and Xia Wang, 'Investigation the Development Strategies of Institutional Investors' [机构投资者发展战略研究] (Shenzhen Stock Exchange Research Centre, 2006) <http://www.szse.cn/UpFiles/Attach/1088/2006/08/01/1703111178.pdf> accessed 05 October 2016.

from engaging actively in corporate governance. The first is that the existing legal system is inflexible and out-dated compared with the burgeoning institutional shareholders. The second factor is the imbalance in the development between different types of institutional shareholders. The weak position of some institutions hindered their willingness to engage. The third factor is lack of expertise within institutions and lack of experience in engaging.

Feng and Li pointed out two factors that contributed to institutional shareholder passivity:[2] (1) investment restrictions faced by institutional shareholders greatly restricted their power and (2) the ownership structure and the presence of blockholders made institutional shareholders too weak to counterbalance them.

Gong pointed out that the cost and limited benefits may discourage institutional shareholders from engaging actively.[3] On the one hand, the cost of activism, such as bringing legal action, is huge.[4] Even if the suit is successful, the recoveries accrue to the company as a whole and institutional shareholders who proposed this litigation would only receive a pro rata benefit. On the other hand, the notion of institutional shareholder activism is relatively new to Chinese investors and beneficiaries might ignore institutional shareholders' efforts in engaging their investee companies. Therefore, Chinese institutional shareholders are likely to receive lower reputational gains than their UK and US counterparts. The burden of disclosure rule further exacerbates the passivity by creating legal impediments to shareholder collaboration action. According to the Chinese legal requirement, investors should disclose their shareholdings if certain thresholds have been met. Section 86 of the Securities Law 2005 prescribes that investors who hold more than 5% of a listed company' stock must notify the company and submit a report to the CSRC and the stock exchanges within

[2] Guo Feng and Anan Li, 'Investor Revolution, Shareholder Activism and the Structural Reform of Company Law' [投资者革命, 股东积极主义与公司法的结构性变革] (2012) Science of Law 112.
[3] Bo Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (Routledge, 2013) 185.
[4] The cost consists of at least two parts: (1) the court's fees and (2) the attorneys' fees. The court's fees includes 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 had to pay attorneys' fees. According to s 19 of the Supreme People Court's (hereinafter 'SPC') 'Measures on the People's Courts' Acceptance of Litigation Fees 1989', the losing party should bear the cost of the filing fees and other litigation fees allocated by the court, excluding attorneys' fees.

three days from the date on which such shareholding occurred.[5] Moreover, each 5% increase or decrease in the shareholding of this listed company' stock must be reported. During the reporting period, and for two days after the report and announcement have been made, the investor may not continue to purchase or sell shares of the listed company.[6] The information that the investors need to complete the report includes facts about their identity, the number of shares held,[7] their trading activities within the six months prior to the disclosure (including the number of shares he or she traded monthly and the price range of the trading),[8] the intention to increase or decrease shareholding, and their plans for the following 12 months.[9] Moreover, there are cultural factors that influence the behaviour of Chinese institutional shareholders. The traditional Confucian culture does not encourage people to resolve a dispute publicly and, therefore, puts pressure on institutional shareholders who could like to take action.

In addition to the works cited above, three PhD theses contain research on institutional shareholder activism in China. Only one analysed the factors that influence institutional shareholder activism. Besides the factors pointed out above, the aforementioned thesis shows that Chinese institutional shareholders focus on speculation and short-term benefits. The prevalence of this kind of trading makes shareholder activism a useless weapon for them. Besides, the shareholding of institutional shareholders in certain companies determines their attitude towards activism.[10]

The conclusion reached from the above analysis is that institutional shareholder activism is influenced by factors such as the shareholding, cost, investment strategy, development stage of institutions, and some external factors that exert an influence on shareholder activism, such as legal barriers and culture. These factors are listed in table format (Figure 5.1) as in Chapter 4.

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[5] Securities Law 2005 s 86.
[6] Securities Law 2005 s 86(1.)
[7] Securities Law 2005 s 87.
[8] CSRC, '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', s 36.
[9] *Ibid.* s 20.
[10] Peitao Gao, 'Research on Institutional Investors' Intervention in Corporate Governance of Listed Companies in China [机构投资者参与我国上市公司治理的理论与实践研究] PhD thesis submitted to Shandong University <http://gb.oversea.cnki.net/KCMS/detail/detail.aspx?filename=2010102638.nh&dbcode=CDFD&dbname=CDFD2010> accessed 07 October 2016.

Factor	Effect			
Shareholding (Number of shares)	Large		Small	
Cost of engagement	High		Low	
Development level of institutions	Low		High	
Investment strategy	Passive index	Passive fundamental	Active fundamental	Active quantitative
Legal and cultural factors	Many		Few	

Figure 5.1: Internal factors that influence institutional shareholder activism

5.2 Unveiling institutional shareholder activism in China

As already indicated, Chinese institutional shareholdings have been experiencing rapid development during recent years. However, this growth does not necessarily mean that institutional shareholders will take more responsibilities in corporate governance. As was seen in Chapter 4, academic scholars and institutional industry associations have conducted much research and written many articles to lift the veil of institutional shareholder activism in their investee companies in the UK and US. In China, however, empirical evidence aimed at investigating institutional shareholders in corporate governance is much less compared with the UK and US, despite the fact that institutional investment has gained increased popularity in the past years. Seven empirical studies related to institutional shareholder activism have been listed below which could help one gain a better understanding of Chinese institutional shareholder activism:

a. Yang's work on shareholders' voting rights and shareholder meetings.[11]

[11] Jinzhu Yang, 'Shareholder Meetings and Voting Rights in China: Some Empirical Evidence' (2007) 18 International Company and Commercial Law Review 4.

b. Peng's study on the exercise of shareholders' voting rights at annual general meetings in 2005.[12]

c. A special chapter of the ISS' survey on corporate governance, which focuses on the view of ten Chinese institutional investors on Chinese corporate governance in 2006.[13]

d. Yuan et al.'s study on the role of financial institutions in the corporate governance of Chinese listed companies in 2006.[14]

e. Clarke's study on derivative actions in Chinese companies in 2011.[15]

f. Gong's empirical research on institutional shareholder activism in China in 2013.[16]

g. Cai and Yu's research on the promotion of institutional shareholder activism in Chinese listed companies in 2015.[17]

These research works contributed much to the present investigation into the activism of Chinese institutional shareholders. However, none of this research provides a full and comprehensive overview of Chinese institutional shareholder participation. Some of these studies focus on only one or several perspectives of institutional shareholder activism, such as on shareholders voting or derivative actions. Several research works on theoretical aspects without the support of empirical findings. Therefore, it was necessary to collect case studies (see section 6.3.1 of this thesis) for these years regarding institutional shareholder activism to find evidence to make the study feasible.

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[12] Wan Peng, 'Call for More Exercising of Voting Rights by Investors' [专家呼吁投资者行使投票权] (*Sina Finance*, 3 March 2005) <http://finance.sina.com.cn/stock/t/20050303/11031399998.shtml>

[13] Institutional Shareholder Services, '2006 Global Institutional Investor Study: Corporate Governance; From Compliance Obligation to Business Imperative' <http://maga.econ.msu.ru/Work/%D0%A1%D0%A8%D0%90%20-%20Presentations/2006_ISS_Global_Institutional_Investor_Study_FINAL.PDF> accessed 07 October 2016.

[14] Rongli Yuan, Jason Zezhong Xiao, Nikolaos Milonas and Joe Hong Zou, 'The Role of Financial Institutions in the Corporate Governance of Listed Chinese Companies' (2009) 20 British Journal of Management 562.

[15] Donald C Clarke and Nicholas C Howson, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China' in Dan W Puchniak, Harald Baum, and Michael Ewing-Chow (eds), *International Corporate Law and Financial Market Regulation* (Cambridge University Press 2012) <http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1066&context=book_chapters> accessed 07 May 2017.

[16] Gong (n 3) 122.

[17] Yi Cai and Zhongbo Yu, 'Several Legal Opinions About Promoting Institutional Shareholders' Engagement' [关于推进机构投资者参与上市公司治理的若干法制建议] (2015) 1 Financial Law Forum < http://www.cqvip.com/qk/71483x/2015001/74827089504849534849484855.html> accessed 07 October 2016.

This part of the chapter reveals what institutional shareholder activism is really like in China. First, types of institutional shareholder activism will be discussed, followed by how different institutional shareholders utilise these forms of activism. Finally, a conclusion is drawn.

5.2.1 Typology of institutional shareholder activism

What follows are case studies of institutional shareholder activism until 2014. These cases were selected from two main sources: first, was the previous research on institutional shareholders.[18] These articles mainly focused on different aspects of institutional shareholder activism and may include some cases on that perspective. Articles from 2000 to 2016 yielded some relevant cases. Second, cases were traced in the Annual reports of the companies and news published on the Internet and in newspapers. However, owing to insufficient data, the latest case that was found was for 2014.

Year	**Case**	**Institutional shareholder**	**Type of activism**	**Result**
1994	Regrouping the board of directors of China Vanke Co. Ltd	Guotai Junan Securities firm	Press conference	F
2000	Regrouping the board of directors of Hubei Xingfu Ltd	Mingliu Investment company	Call for shareholder meeting and shareholder proposal	S
2002	Voting against the issuance of H shares of ZTE Corporation	Dacheng Fund Management Co. Ltd	Proxy voting (joint effort with other institutional shareholders)	S
2003	Voting against the issuance of securities in China Merchant Bank	China Asset Management Co. Ltd, NSSF, Shiji securities firm	Private meeting and proxy voting (joint effect with other institutional shareholders)	S
2004	Amending articles of the China Vanke Co. Ltd	China Asset Management Co. Ltd, Bosera Asset Management Co. Ltd,	Call for shareholder meeting and shareholder proposal	F

[18] See empirical research above.

Year	Case	Institutional shareholder	Type of activism	Result
		China Southern Asset Management Co. Ltd	(institutional shareholders)	
2004	Voting against the issueance of new shares in Chongqing Baihuo	Huabao Xingye Asset Management Co. Ltd	Proxy voting (joint effort with other institutional shareholders)	S
2007	Suing Yinchuan Guangxia Ltd for misrepresentation	Dacheng Fund Management Co. Ltd	Bring legal action	S
2008	Voting against the proposal to refinance Pingan China	Dacheng Fund Management Co. Ltd, Lion Fund Management Co. Ltd	Proxy voting	F
2008	Voting against a merger between Eastern Airline and Singapore Airlines	Rongtong Asset Management Co. Ltd	Proxy voting	S
2008	Advising ways to effect better corporate governance of Saima Ltd and proposal to elect new directors	Shanghai Baoyin Investment and Consultation Company	Private meeting and shareholder proposal	F
2010	Rejecting the proposal of Shuanghui Company	Havest Asset Management Co. Ltd, Bosera Asset Management Co. Ltd	Proxy voting	S
2011	Suing Xiaxin Electrical for misrepresentation	Shenzhen Hongshan Investment Company	Bring legal action	S
2011	Promoting the enactment of certain promises	Aegon Industrial Fund Management Co. Ltd, Orient Securities Co. Ltd (investment service company)	Press conference (joint effort with other institutional shareholders)	S
2011	Proposing to incentivise the management of Dashang Ltd	Shenzhen Heying Asset Management Co. Ltd, Penghua Asset Management Co. Ltd	Shareholder proposal (joint effort with other institutional shareholders)	Part succeed , part failed
2012	Proposing the removal of a	Dacheng Fund Management Co. Ltd	Shareholder proposal	F

Year	Case	Institutional shareholder	Type of activism	Result
	director of the Chongqing Beer company			
2012	Voting against the proposal for appointing new directors and proposing new directors in Gree Electrical Appliance Inc. of Zhuhai	Penghua Asset Management Co., Yale Endowment Fund	Proxy voting and shareholder proposal (joint effort with other institutional shareholders)	S
2012	Proposal corporate operational strategies for Beiyinmei Ltd	JVR International	Shareholder proposal	N
2012	Voting against the proposal to remove managers in Zhejiang Huahai Pharmaceutical Co. Ltd	Fullgoal Fund Management Co. Ltd, Lion Fund Management Co. Ltd	Proxy voting	S
2013	Proposing amendments to articles of association and electing a board of directors in Shanghai Jahwa Co. Ltd	Fullgoal Fund Management Co. Ltd, Huitianfu Fund Management Co. Ltd, Huashang Fund Management Co. Ltd	Shareholder proposal (joint effort with other institutional shareholders)	S
2013	Voting against a merger proposal of Dashang Ltd	Fuguo Fund Management Co. Ltd	Proxy voting	S
2013	Proposing new directors for China Merchant Bank	Anbang Insurance Group	Shareholder proposal	F
2014	Voting against the proposal in Chongqing Taiji Industry Co. Ltd	Baoying Fund Management Co. Ltd	Proxy voting	S
2014	Proposing new directors for Minsheng Bank	Anbang Insurance Group	Shareholder proposal	S

Year	Case	Institutional shareholder	Type of activism	Result
2014	Proposing company operational strategies	Zexi Investment Fund Company	Shareholder proposal	S
2014	Proposing company operational strategies	Zexi Investment Fund Company	Shareholder proposal	N
2014	Proposing the restructure of the board of directors in Gongda Shouchuang	Zexi Investment Fund Company	Shareholder proposal	N

F = Failure; N = Not known; S = Success

Figure 5.2: Cases of institutional shareholder activism, 1994-2014

After analysing the above cases, three pie charts can be produced to show the percentage of different types of activism, the types of institutional shareholders, the results and a line chart about the number of cases each year.

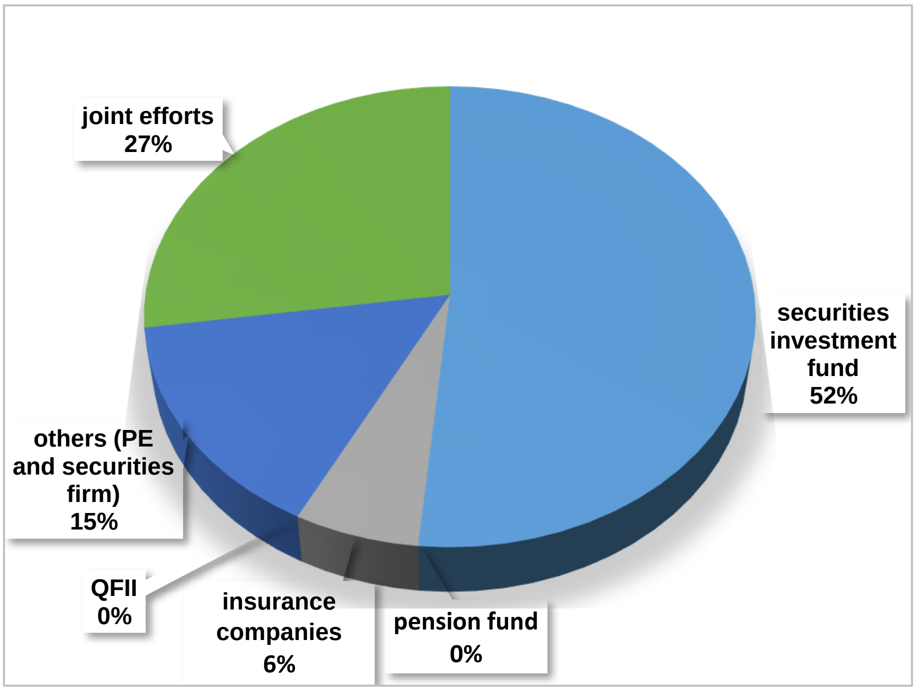

Figure 5.3: Types of institutional shareholders engaged in activism in Figure 5.2 cases

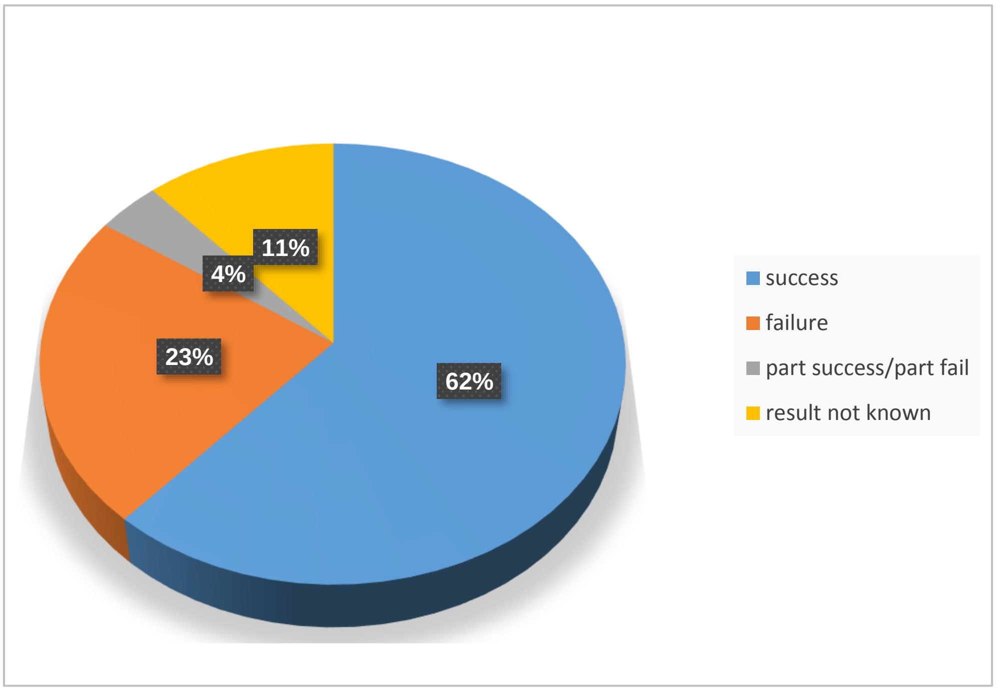

Figure 5.4: Results of institutional shareholder activism in Figure 5.2 cases

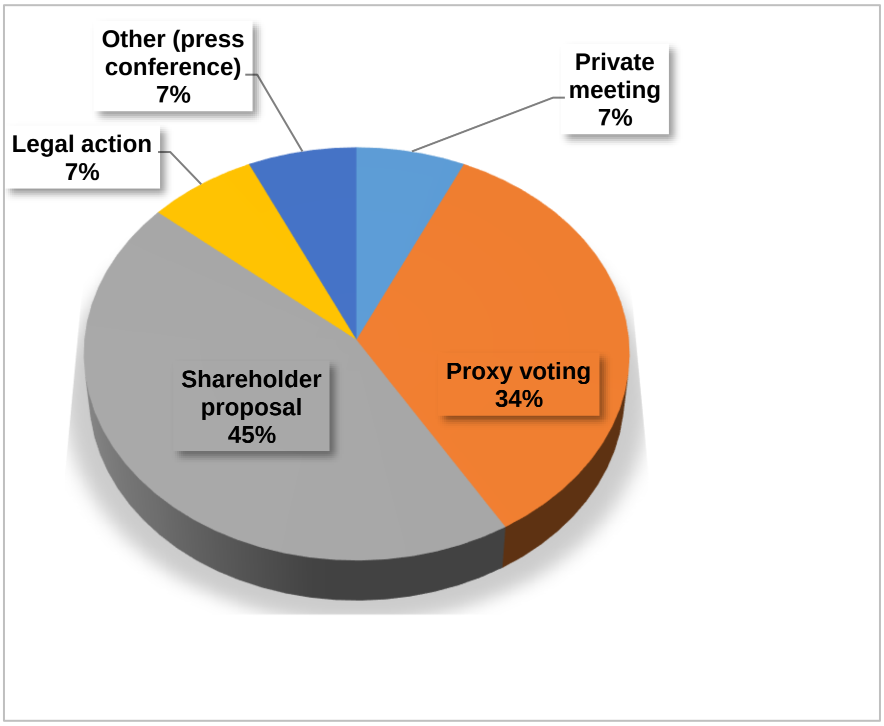

Figure 5.5: Types of activism by institutional shareholders in Figure 5.2 cases

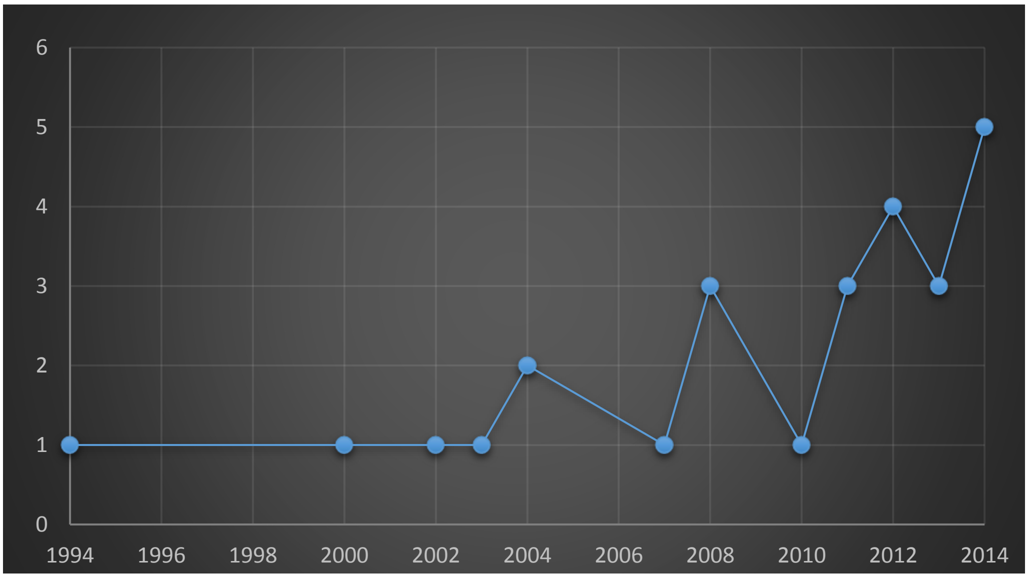

Figure 5.6: Number of institutional shareholder activism cases each year, 1994–2014

5.2.1.1 Private meeting

As described in Chapter 4, the first form of activism a shareholder may consider is to seek private communication with the board or executives of portfolio companies. When an issue arises, an institution usually begins its engagement process with a private discussion or negotiation with this company. If the company responds actively, they could reach agreement on this specific issue and perhaps no further action will be needed. If the response is negative, the institutional shareholder will determine what to do next, either making a proposal or voting against certain issues at the shareholders' meetings. Private meetings, whether in China or in UK and US, are often used as the first resort for shareholder activism.

Yuan, Milonas and Xiao's research found that there was a strong preference for private negotiation over other types of activism among Chinese institutional shareholders. It is often the first option considered by them.[19] Among 20 financial institutions and ten directors from listed companies, most institutions would communicate with the management of portfolio companies about their dissatisfaction and ways to solve it.

[19] Yuan et al. (n 14) 571.

They express their desire emphatically in some cases. In the event of voting against a board proposal, they inform the company in question in advance and offer an explanation for their behaviour.

Institutional Shareholder Services' global survey on corporate governance shows that some institutions regard private meetings as an investment necessity that could enable them to obtain some information that is not publicly disclosed.[20] The majority (12) of the institutions in Yuan et al.'s study also demonstrate that a private meeting could be relied on for the purpose of obtaining information about the company and the quality of the management team.[21] Therefore, a significant push factor for Chinese institutional shareholders to arrange private meeting with their investee companies actively is the information collected through this negotiation process.

As for the concerns about private meetings, according to Gong, it usually depends on the different aims of the meetings and the topics often focused on corporate financial performance, corporate strategy, and corporate growth opportunities.[22] The persons they get in touch with are often the secretary of the board, company chairperson, general managers or managers from functional departments.[23] In her research, Gong also collected a self-assessment report[24] of the targeted listed companies, in which they were required to disclose the ways in which they communicated with their shareholders. The respondents contacted investors in 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'.[25]Among these forms of contact investors' visiting, telephone calls and emails were the most commonly used methods for investors to get in touch with companies.[26] As for the frequency of the

[20] Institutional Shareholder Service, '2006 Global Institutional Investor Study: Corporate Governance; From Compliance Obligation to Business Imperative'(n 13) 61.
[21] Yuan et al. (n 14) 573.
[22] Gong (n 3) 143.
[23] Ibid.
[24] Chinese listed companies are required to conduct self-examinations on their corporate governance system by answering a list of questions provided by the CSRC. However, the self-examination report is not taken seriously by the listed companies and by looking at some reports, it could be said that almost all the reports use a one-size-fits-all model which could be downloaded online. Therefore, the usefulness and quality of the information have been reduced.
[25] Gong (n 3) 144.
[26] *Ibid*.

meetings, most companies in the sample reported that they met with fund managers and financial analysts each year. However, none of the targeted companies provided information with regard to the frequency of their contact with investors.

In the present empirical research into cases of intuitional shareholder activism, 2 out of 26 used private meetings as a way of communicating with their investee companies. The first institutional shareholder did so in 2003, when the board of directors of China Merchant Bank proposed a scheme aimed at the issuance of new shares; the institutional shareholders were strongly opposed to this. Therefore, a private meeting was held between China Asset Management Ltd and China Merchant Bank. Owing to the breakdown of the meeting, China Asset Management Ltd put forward a shareholder proposal on how the issuance scheme should work. The second case occurred in 2008 involving the rapidly developing Ningxia Saima Industry Co. Shanghai Baoyin Investment and Consulting Company had a positive attitude towards the future of this company, therefore, it communicated with the Ningxia Saima Industry Co. and proposed better ways to operate the company. However, there was no response from the company. Therefore, Shanghai Baoyin Investment and Consulting Company put forward a shareholder proposal to express its opinion.

What is interesting here is that both of the cases started out with a private meeting between both parties, and the failure of the meeting led to further actions; in this case, shareholder proposals put forward by institutional shareholders. Yuan et al.'s research revealed that there was an overwhelming preference for private negotiation over other forms of activism as the first action among Chinese institutional shareholders.[27] However, the data in the present study show that private meetings only accounted for 7% of the total cases. The assumption is that the results are not conflicting, given the fact that private meetings are always held behind closed doors. These two cases are public because further actions were taken. Shareholder proposals is a matter on which the media would like to report. There is no way of knowing which private meeting cases end in a satisfactory result for both parties.

[27] Yuan et al. (n 14) 574.

In conclusion, as the above research showed, Chinese institutions regard private meetings as a first option when concerns arise and it is an important means to improve shareholders–board communication.

5.2.1.2 Voting

According to the Company Law of the People's Republic of China, a notice of a general meeting should be given to shareholders 20 days in advance of an annual general meeting, and 15 days in advance of an extraordinary general meeting[28]. A shareholder can be either present at the meeting or appoint a proxy voting on his or her behalf.[29] The default voting system is one share, one vote. A general resolution must be passed with the approval of more than half of those with voting rights.[30] A special resolution with fundamental changes, such as modification of the articles of association, mergers and dissolutions, needs to be approved by a two-thirds majority of the voting rights.[31]

In particular, a cumulative voting mechanism is allowed in Chinese listed companies for shareholders to elect directors or supervisors.[32] According to article 106 of CL 2005, the term 'cumulative voting system' refers to 'when a general meeting elects a director or supervisor, the number of voting rights attached to each share is the same as the number of directors or supervisors to be elected, and that the voting rights held by a shareholder may be exercised collectively'.[33] Under the circumstances where cumulative voting is applied, votes held by each shareholder could be multiplied by the number of directors and supervisors to be elected. Shareholders can cast all their votes for a single nominee for the board of directors when the company has multiple candidates on its board.[34] For example, under straight voting, if shareholder A has 30 voting shares and there are three nominee directors, shareholder A has a maximum of 30 shares for any one nominee. In cumulative voting and other unchanged conditions shareholder A has three times 30, namely 90 votes in total. He or she can choose to vote

[28] Hereinafter 'EGM'.
[29] CL 2005 s 103.
[30] CL 2005 s 104.
[31] CL 2005 s 104.
[32] CL 2005 s 106.
[33] CL 2005 s 106.
[34] CL 2005 s 106.

all 90 to one nominee, or 30 for each one, or any percentage he or she would like to divide the 90 votes into.

In addition, electronic voting is allowed in the Chinese context. Although it is not stipulated explicitly in the company law, the Code of Corporate Governance for Listed Companies[35] admits that it 'make[s] every effort, including fully utilizing modern information technology means, to increase the number of shareholders attending the shareholders' meeting.'[36]

As for empirical findings on shareholder voting rates, Gong's study finds that the voting level at shareholders' meetings was around 60.49%,[37] which is higher than found in the prior work concluded by Yang (56.79%).[38] There are a number of likely contributory reasons for this difference. First, Yang's research was carried out in 2007, which electronic voting system was not introduced into Chinese shareholders' meetings. The use of electronic voting could be regarded as a booster to the increased level of voting as it provided shareholders with a cheap and convenient way to cast their shares, and thus promoted a higher level of shareholder participation in voting. Second, the companies selected in the Gong's sample are companies evaluated as having good corporate governance practice or large institutional holdings, suggesting that they may have a greater chance to encourage more shareholder participation. The last reason might be the government's efforts to promote good corporate governance practice and, therefore, raise the level of shareholder engagement. However, subject to insufficient data, one cannot get a clear picture about the exact voting level cast by institutional shareholders.

Among the cases selected for the present study, in 10 out of 25 cases institutional shareholders used their voting rights actively to exert influence on their investee companies. Most of the cases were the joint efforts of several institutional shareholders. Of the ten cases, the success rate was 90% with only one failure. The only failed case was for a 'vote against the proposal of refinancing Pingan China' which occurred in

[35] Hereinafter 'Chinese Code'.
[36] CSRC, Code of Corporate Governance for Listed Companies in China, s 1(2) <http://www.ecgi.org/codes/documents/code_en.pdf> accessed 10 May 2017.
[37] Gong (n 3) 155.
[38] Yang et al. (n 14) 575.

2008. A shareholder proposal about refinance was strongly opposed by individual and institutional shareholders. An online survey about the attitude towards this shareholder proposal showed that only 10% of the respondents had a supportive attitude.[39] However, this shareholder proposal was passed with 92.8%. The main reason behind this dramatic result is the large portion of non-tradable shares held by the state. Therefore, it is obvious that in most of the circumstances where institutional shareholders joined efforts with other shareholders to use voting to exert some influence on their investee companies, they were quite confident that their shares in total could play a decisive role without the interference of the majority shareholders. This could explain the high success rate in this research.

Apart from the ZTE Corporation case in 2002,[40] China Merchant Bank case in 2003,[41] Pingan China case in 2008[42] and Shuanghui Company case in 2010[43] where institutional shareholders rejected the shareholder proposal, from the news it is obvious that all these cases shared a similar background: rejected proposals were troubling controlling shareholder tunnelling and apparently the rest of the shareholders were all strongly opposed. Therefore, institutional shareholders take advantage of public opinion and their success is a guarantee to some extent.

5.2.1.3 Submitting a shareholder proposal

Submitting a shareholder proposal is another effective mechanism for institutional shareholders to voice their demands and ask for changes in their investee companies. Chinese Company Law 2005 stipulates that shareholders who hold 3% or more of the voting rights of a company may propose a resolution for a shareholders meeting by

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[39] Author unknown, 'Great Debate Arising About Ping'an Refinancing' [中国平安巨额融资惹争议] (*Sohu News*, 6 March 2008) <http://business.sohu.com/s2008/zgpa/> accessed 10 May 2017.

[40] ZTE official website, 'Relationships with Investors' [投资者关系] <http://www.zte.com.cn/china/about/investorrelations/announcement/200311/348996> accessed 10 May 2017.

[41] Hongze Ouyang, 'Suspense arises in the Results of the Merchant Bank's Convertible Shares, As The Legitimacy Has Been Questioned [合法性遭质疑，招行可转债陡生悬念] (Sohu News, 20 October 2003) <http://business.sohu.com/04/37/article214653704.shtml> accessed 10 May 2017.

[42] Dong Lv, 'Shareholder Proposal About Issuing More H Shares in Ping'an China' [中国平安 H 股增发议案] (*Sohu News*, 14 May 2008) < http://business.sohu.com/20080514/n256835555.shtml> accessed 10 October 2016.

[43] Author unknown, 'When Shuanghui Met Voters' [双汇遭遇投票门], Sina News <http://finance.sina.com.cn/stock/blank/shfz/> (*Sina News*, 05 March 2010) accessed 10 October 2016.

written submission to the board ten days before a meeting.[44] The board must circulate this resolution to other shareholders within two days after receiving it and must present it for consideration at the meeting.

Yang's research does not report any cases of a proposal raised by institutional shareholders among the 267 companies researched in 2007.[45] In Gong's research, there were only 2 out of 30 targeted companies in which shareholders submitted six resolutions at the shareholders' meetings from 2007 to 2008. To reveal the characteristics of shareholder resolutions in Chinese listed companies, she expands the time span (2002–2009) which entailed 25 proposals in total. It shows that 19 out of 25 (76%) were proposed by the largest shareholders, and the remaining six were proposed by the non-largest shareholders or individual shareholders.[46] Given the fact that most of the resolutions are posed by largest shareholders, the resolutions were passed with a 94%–99% support.[47] Therefore, although the exact number of the resolutions submitted by institutional shareholders is not available, it is safe to say that the number will be less than 24% (6 out of 25). As for the subjects to be considered in these proposals, Gong's research shows that the most popular was 'the directors and supervisors election, followed by the category of corporate financial performance and planning. The third most popular targets of shareholder resolutions are issues of executive remuneration and amendment of articles of association, followed closely by concerns about cash and bond offers'.[48] In Gong's opinion, submitting shareholder proposals is typically a mechanism largely used by large shareholders to seek changes of management. Considering their large shareholdings, proposals raised by these large shareholders are more likely to be passed with a high percentage of support.

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[44] CL 2005 s 103.

[45] Yang (n 11) 10.

[46] Another notable fact revealed in her research 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 in their UK and US counterparts; 3% might be a high threshold in companies with a diversified ownership structure, while in China, in the 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.

[47] Gong (n 3) 156.

[48] *Ibid*.

However, according to the empirical research conducted for the present research, there are 12 cases regarding proposals submitted by institutional shareholders, which is the most frequent form of activism (see Figure 5.5) and since 2012, it became the dominant form of institutional shareholder activism. The case of regrouping the board of directors of Hubei Xingfu Ltd in 2000, the shareholder proposal in Ningxia Saima Industry Co., Ltd in 2008, the shareholder proposal in Gree Electrical in 2012, the shareholder proposal in Shanghai Jiahua Co. Ltd in 2013, the shareholder proposal in China Merchant Bank in 2013 and of the shareholder proposal in Minsheng Bank in 2014 were all aimed at electing the person they selected as new directors to exert some influence on the board. There are a few other topics, such as corporate strategies and financial statutes. The present research shows great consistency with that of Gong. The result of shareholder proposals put forward by the investment fund company Zexi was not known due to the fact that all related news were blocked since the manager of Zexi had been arrested and charged with insider trading.

5.2.1.4 Legal actions

The shareholder derivative suit was first introduced to China in 2005, in chapter 6 of the Company Law 2005. It greatly improved the situation of minority shareholders, given the fact that it provides minority shareholders with a weapon against the abuse of power by majority shareholders. According to s 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 s 150 of the Company Law 2005, 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’.[49] If the request to bring a suit to remedy the alleged harm is ignored within 30 days, shareholders may bring suit in their own name.[50]

[49] CL 2005 ss 150, 152.
[50] CL 2005 s 152.

The survey conducted by Clarke[51] found that there were virtually no derivative suits involving listed companies by the end of 2009.[52] Lin found that there were 77 derivative action cases from 2006 to 2013, which all happened in limited liability companies.[53] They suggested that this absence of listed company-related cases is largely associated with potentially high litigation and transaction costs incurred.[54] Another reason that could account for this phenomenon is that courts may refuse to accept derivative suits involving listed companies because of the 'political sensitivity or technical complexity involved'.[55] Clarke and Howson pointed out that the court was under great influence from the local party as state officials have the power of appointment and of budgets. Courts might refuse to permit the litigation to proceed when they are with confronted interference from local governments or related institutions.

In the present empirical research, no case related to derivative action taken by institutional shareholders was revealed except two lawsuits about misrepresentation. Therefore, institutional shareholders regard legal action as a kind of mechanism of last resort.

5.2.2 Activism by different institutional shareholders

[51] Clarke (n 15) 1064.
[52] From 2006 to the date on which this article was completed, the author found only a few cases involving an unlisted CLS or large numbers of shareholders in an LLC; see, for example, *Li Xiaozhong and 28 other shareholders v Xiao Wuyong & Zhang Dingzhong re: Nanchuan Municipal Hardware Infrastructure Electric Chemical Industry Company Limited*, Chongqing Nanchuan City Basic-Level People's Court (2006), *Nanchuan Fa Min Chuzi* no. 538 http://vip.chinalawinfo.corn!Case/ displaycontent.asp ?Gid= 1 17 484117 and www.siaaacom/falvanliku/gongsixiangguan/ 200910/386516_2.html) [Nanchuan Chemical Industry 2006] (28 shareholders); *Dong Fengchang v Fang Yishu re: Shanghai Zhongjian Enterprise Company Limited*, Shanghai Hongkou District Basic-level People's Court, no. 2 Civil Division, case filed 26 September 2008, case opinion not reviewed, but report by Judge Luo Jianhao of the Hongkou District Basic-level People's Court, 26 February 2009 http://www.legaldaily.com.cn/zmbrn!content/2009-02/26/content_1043325. htrn) [Shanghai Zhongjian Enterprise 2008] (40 shareholders); *Zhu Yongjun and 20 other shareholder plaintiffs v Liu Huanren*, Zhu Yongjun and *Ma Zhonghua re: Shizuishan Municipal HengJ!Uan Metals Collection Company Limited*, Shizuishan Municipal Wukou District Basic-level People's Court (2008), Shi Da Min Zhu Zi 1008; on appeal Ningxia Hui Minority Autonomous Region Shizuishan Municipal Intermediate People's Court (2009), Shi Min Zhong Zi 25 http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=ll7633588) [Shizuishan Hengyuan 2009] (21 shareholders).
[53] Shaowei Lin, 'Derivative Actions in China' (2011) (PhD thesis, University of Edinburgh 2014) <https://www.era.lib.ed.ac.uk/bitstream/handle/1842/9749/Lin2014.pdf?sequence=2> accessed 10 October 2016.
[54] Clarke (n 15) 1064.
[55] *Ibid.*

5.2.2.1 Securities investment funds

Compared with the UK and US mutual funds, China's fund industry has a short history, which is less than 30 years. Despite the late start, the industry keeps growing at an impressive pace and has emerged as a significant investment tool. At present, as the key institutional shareholders in China, securities investment funds accounted for 85% of the total institutional shares. However, what seems disproportionate is the shares held by securities investment funds and their desire to engage in corporate governance. Some of the funds clearly state in their prospectuses that they 'will not pursue controlling power in listed companies and not engage in corporate governance of the investee companies'.[56] In addition, they are notorious for their short-termism. Dated back to 2000, *Caijing*, which is a leading financial magazine in China, published an article that revealed the inside story of the fund management industry. It disclosed that in order to gain unlawful shorter-term profits, many fund managers had manipulated the price of their holdings.[57] This news immediately drew public and regulatory attention, and this was the turning point for the funds industry. After that, regulators quickly stepped in and responded to this malpractice behaviour. The Chinese Government has set strict investment threshold and limits with a view to tightening the control of the SIF' investment in the securities market. Under Fund Law, a SIF is not allowed to hold more than 10% of its net assets in the shares of a single issuer.[58] It is also not allowed to hold more than a total of 10% of one company's shares in the fund managed by the same fund manager.[59] It has been 17 years after that notorious news. However, securities investment funds are still struggling with this short-term investment strategy.[60] Although securities investment funds have greatly increased in numbers, they are basically almost hybrid funds and their portfolios are made up of a mix of stocks and bonds. Given this similarity, the competition between SIFs is fierce,

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[56] Hua *Yang, Reforms in Need: Exploring the Roads to Marketization Reform of the Chinese Capital Market* [变革与突破：中国资本市场发展研究] (China Financial and Economic Publishing House, 2014).

[57] Jing Li, Dark Realities of Securities Investment Funds, [基金黑幕] (*Cajing News*, 05 October 2000) <http://magazine.caijing.com.cn/2000-10-05/110059644.html> accessed 15 October 2016.

[58] Fund Law, s 31(1).

[59] Fund Law, s 31(2).

[60] Jia Ronglei, 'Ways to Respond to the Herd Behaviour in Chinese Securities Investment Funds' [我国证券投资基金的羊群效应问题及对策] (2015) Contemporary Economics 34.

which induces them to focus more on short-term benefits.[61] A research paper on the behaviour of securities investment funds in the field of management[62] pointed out that securities investment funds relied heavily on the social network[63] of managerial teams or boards of directors. Therefore, whenever there was conflict between the management and the board of directors, the Chinese securities investment funds would evaluate the strengths of both sides and support the one who could offer more social networks and profits for them. Therefore, it could be said that the behaviour of securities investment funds is mainly benefit-lead, even in issues of corporate governance.

However, in recent years, especially from 2011 onwards, securities investment funds have caught people's eyes with their active engagement in some corporate governance cases. They are the dominant players in institutional shareholder activism according to the present research. Among the 26 cases, there are 17 in which SIFs have a role to play. The reason behind this activism may be that they contribute to the raise in awareness that their engagement could influence their investee companies. However, the underlying reasons may lie in the problems experienced with SOEs. As discussed in Chapter 1, the stock exchange was established for the purpose of helping SOEs out of trouble. Therefore, the main players in the stock exchange were the SOEs. Given the fact that some of them are suffering from severe agency problems and bad performance, the companies that have shown good and steady performance would be the target of securities investment funds when they are investing. In companies such as the Shanghai Amarsoft Information & Technology Co. Ltd, according to Xinhua Net, securities investment funds occupied nine seats in the top ten shareholders of Amarsoft in 2015.[64] Therefore, this led to, on the one hand, the failure of the 'Wall Street rule' and, on the other, the power to counterbalance majority shareholders is growing.

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[61] Qingbin Meng, Weixing Wu and Shangyao Yu, 'Career Anxiety and Investing Style Oof Securities Investment Funds', [基金经理职业忧虑与其投资风格] (2015) 50 Economic Research Journal 115.
[62] Jue Wang and Jigao Zhu, 'Securities Investment Funds Engaging in Corporate Governance: Behaviour Logic and Pattern Choosing' [基金参与公司治理: 行为逻辑与路径选择] (2015) 5 China Industrial Economics 135.
[63] According to Laumann et al, a *social network* can be defined as 'a set of nodes (e.g., persons, organizations) linked by a set of social relationship (e.g. friendship, transfer of funds, overlapping memberships) of a specified type. See Edward O Laumann, Joseph Galaskiewicz, and Peter V Marden, 'Community Structure as Interoranizational Linkages' (1978) Annual Review of Sociology.
[64] Author Unknown, 'Nearly Forty Percentage of the Tradable Shares Are Controlled by Securities Investment Funds' [近四成流通股被基金掌控] (*Xinhua News*, 18 May 2015) <http://news.xinhuanet.com/fortune/2015-05/18/c_127811552.htm> accessed 15 October 2016.

As a new phenomenon, securities investment fund activism in investee companies is rarely studied and most of the studies on SIFs focus on their influence on market stability and their performance. Two studies were conducted on securities investment fund activism [65] but none of them revealed the engagement behaviour of SIFs. Eissenhardt points out that a case study is extremely useful when almost nothing is known about the research object or when the aim is to approach it from a new perspective. [66] Therefore, the case study method was used here to assist with a better understanding of SIF activism.

Gree Electrical Appliance case in 2012 was chosen for two reasons: first, this company is the leading company in its industry, the media continues to focus on this case and the massive amount of information provided in the news makes the case study available. In contrast, other cases are reported in limited information and the detailed procedures are unknown to the public. Second, this the most typical case in terms of the typology of activism. Shareholder proposals are used to exert influence on the composition of the board, which is a typical form of activism.

Gree Electrical Appliance Inc. of Zhuhai is a state-owned enterprise whose largest shareholders are the Zhuhai stated-owned assets supervision and administration commission (see Figure 5.5). The Gree Group Co. Ltd collectively held 19.37% of the shares of Gree Electrical in 2012. The second largest shareholder is its retailer, Heibei Jinghai Co. Ltd. The other large shareholders are institutional shareholders, such as Penghua Asset Management Co., the Yale Endowment Fund and Yifangda Asset Management Company. Jianghong Zhu is the founder of Gree Electrical and he retired in 2012, therefore, shareholder meeting was held to re-elect the board of directors.

[65] Two studies focus on securities investment fund activism: (1) Michael Firth, Chen Lin and Hong Zou, 'Friend or Foe? The Role of State and Mutual Fund Ownership in the Split Share Structure Reform in China' (2010) 45 The Journal of Financial and Quantitative Analysis; 2) Shujun Ding, Chunxin Jia and Zhenyu Wu. 'Mutual Fund Activism and Market Regulation During the Pre-IFRS Period: The Case of Earnings Information in China from an Ethical Perspective' (2016) 138 Journal of Business Ethics. There are also some Masters and PhD dissertations on their activism, but no related information

[66] Kathleen M Eisenhardt, 'Building Theories from Case Study Research' (1989) 14 Academy of Management Review 532.

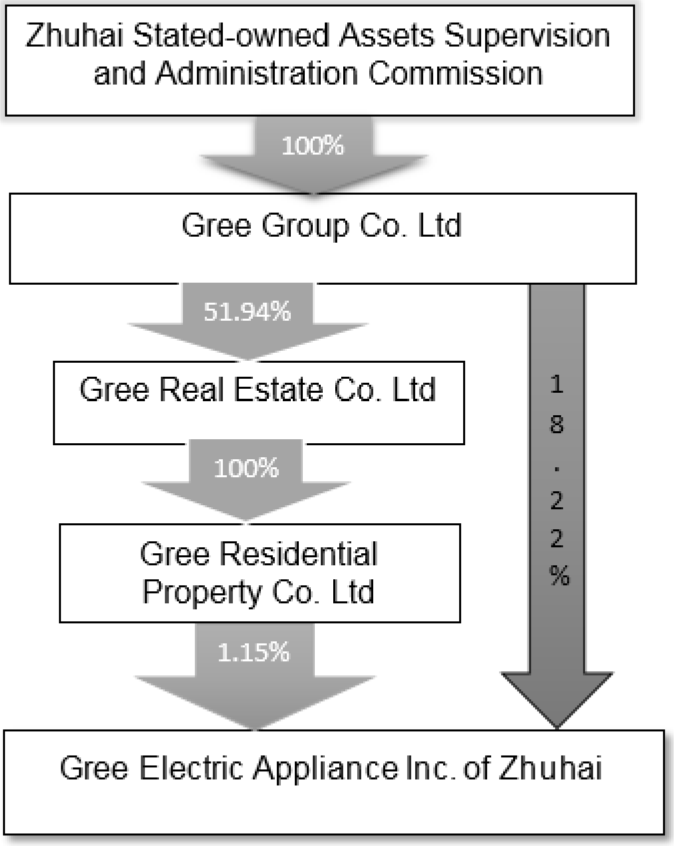

Figure 5.7 State-owned shares in Gree Electrical Appliance Inc. of Zhuhai, 2012[67]

Before the shareholder meeting, the Penghua Asset Management Company and the Yale Endowment Fund held a private meeting to decide to recommend and elect Jiyong Feng as the director candidate. At the same time, Zhuhai SASAC decided to recommend and elect one of its officers, Shaoqiang Zhou, as director candidate. However, institutional shareholders strongly questioned this decision and thought Shaoqiang Zhou had no experience in governing an electrical company and the future was unpredictable.

In May 2012, Gree Electrical held its shareholder meeting. During the meeting the largest shareholders, Gree Group Co. Ltd, proposed four director candidates: Mingzhu Dong, Shaoqiang Zhou, Junsi Lu and Hui Huang. The second largest shareholders,

[67] China Management Case-sharing Center, <http://wenku.baidu.com/link?url=OUsZwY1LHrQ-7AmT6ejlHDW5ajFKhKAW_oOsH31m8WripA4mkgNufR75jwZuqKGFdGhac4RTxgvHvOXcYwsKFJZe1_Gj4htJ2AqKbZb-om3> accessed 15 October 2016.

Hebei Jinghai, proposed one director candidate, Jundu Zhang. The Penghua Asset Management Company and Yale Endowment Fund proposed Jiyong Feng as their director candidate.

Shareholder	Number of shares	Proportion of voting rights (%)
Gree Group Co. Ltd	548,127,812	27.47
Hebei Jinghai	282,099,476	14.14
Gree Real Estate Co. Ltd and Gree Residential Property Co. Ltd	34,452,437	1.73
Yale Endowment Fund	52,808,544	2.65
Penghua Asset Management Company	50,365,800	2.52
Jianghong Zhu	21,507,416	1.08
Mingzhu Dong	21,148,846	1.06
Others	7,722,989	0.38

Figure 5.8: Main shareholders and their portion of shares on the day of the shareholder meeting[68]

The voting results are shown in Table 5.3. As accumulative voting system was adopted, the director appointed by Zhuhai SASAC only received 36.6% of the support and failed to be elected as director, whereas directors proposed by Penghua Asset Management Company and the Yale Endowment Fund received 113.66% of the support and successfully gained a director's seat on the board of directors

Director candidate	Total vote of the shareholders attending the meeting	Number of votes gained	Percentage (%)
Mingzhu Dong	1,995,391,682	2,515,105,800	126.05
Shaoqiang Zhou	1,995,391,682	730,345,048	36.6
Junsi Lu	1,995,391,682	1,951,141,658	97.78
Hui Huang	1,995,391,682	1,953,467,335	97.7
Jundu Zhang	1,995,391,682	1,951,351,409	97.79
Jiyong Feng	1,995,391,682	2,268,056,760	113.66

Figure 5.9: Votes gained by each director candidate[69]

[68] *Ibid*.
[69] *Ibid*.

In this case, the success of Penghua Asset Management Company and the Yale Endowment Fund is attributable to a number of factors. First, the ownership of Gree Electrical is quite diffused compared with other SOEs. The largest shareholder, Gree Group Co. Ltd holds 19.37% of the total shares and institutional shareholders hold 30.82% collectively,[70] which makes it possible for them to confront the largest shareholders and their alliances. Second, the use of the cumulative voting system played a role. Although the Gree Group Co. Ltd held 27.47% of the voting rights compared with the no more than 5.17% of Penghua Asset Management Company and the Yale Endowment Fund, the Gree Group Co. Ltd proposed four directors and that the voting be diffuse. The institutional shareholders only proposed one director. Therefore, they could vote all of their shares to him if they wished to do so. Therefore, as mentioned above, the cumulative voting system can really make a difference in certain circumstances. Third, the willingness of institutional shareholders to engage in corporate governance and working together was another factor. Before the shareholder meeting, institutional shareholders already expressed their objection to the decision of Zhuhai SASAC which shows that they cared about the operation of their investee companies. Penghua Asset Management Company and the Yale Endowment Fund had meeting privately to reach a consensus on the election of directors. The high support rate shows that other institutional shareholders might also have voted for them during the shareholder meeting. All three these factors working together make the Gree Electrical case a notable milestone in the process of promoting institutional shareholder activism.

In addition, one research study pointed out that securities investment funds would evaluate the strength of both sides and support the one who could offer them more social networks and profit when there were conflicts between the management and the board of directors.[71] This case complied with this research result. On the one hand, as Figure 5.7 shows, the Zhuhai Stated-owned Asset Supervision and Administration Commission was the largest shareholder. However, it held shares in Gree Electrical indirectly through its parent company, Gree Group Co. Ltd, rather than holding shares directly. Besides, the influence of the Zhuhai SASAC is limited inside the company. In

[70] Wang and Zhu (n 62) 142.
[71] *Ibid 143*.

contrast, Mingzhu Dong, the CEO and the chairperson of the board of directors, has been in this position for 11 years and the company was under her de facto control. In addition, she was the representative of the National People's Congress, and enjoyed a good reputation which could offer institutional shareholders the social network they needed. Therefore, institutional shareholders voted against the proposal to elect the director appointed by the SASAC and support whoever could bring them more benefits.

In the 2013 case of Shanghai Jahwa Co. Ltd, a shareholder proposal to amend the articles of association by several securities investment funds also succeeded. The shares held by the largest shareholders amounted to 29.15%, while the shares held by institutional shareholders amounted to 43.27% collectively, according to research conducted by Chinese scholars.[72] Therefore, it is evident that SIFs willingly engage in corporate governance if their power is big enough to make a difference and joint efforts are common among them.

5.2.2.2 Insurance companies

In terms of insurance companies, they were prohibited from investing in equities until 2004. Although their investment channel has been enlarged in the past decades, they remain subject to strict regulations. The upper limit for directly investing in stock is 20% of total investment value.[73] In addition, insurance companies are permitted to access the securities market through investing in SIFs, but the aggregate investment in SIFs should not exceed 15%.[74] Therefore, although insurance companies are an important part of the Chinese capital market, they are invisible to some extent.

Among the cases selected for the present research, insurance companies were engaged in 2 cases out of 26. These two cases were taken by the same insurance company, Anbang Insurance Group. From the limited information of the China Merchant Bank case, Anbang Insurance Group held 2.76% of the total shares at the shareholder meeting

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[72] *Ibid*.
[73] CIRC, Provisional Measures on Administration of Operation of Insurance Capital, s 16(4).
[74] CIRC, 'Second Quarterly Press Conference in 2009' (*China News*, 31 July 2009) <http://www.chinanews.com.cn/cj/cj-gncj/news/2009/07-31/1798879.shtml> accessed 15 October 2016.

in 2013.[75] The ownership percentage in 2013 is not known. However, according to the ownership percentage in 2016,[76] it is evident that there were some large shareholders, namely the Hong Kong Securities Clearing Company Nominees Limited[77] (18%); China Merchants Group Steamship Company (13.04%); China Ocean Shipping (Group) Company (6.24%) and other shareholders are some institutional shareholders who held 3–4% of shares. Therefore, the Anbang Insurance Group's portion of shares was insufficient to influence the result of the shareholder proposal. In the case of Minsheng Bank in 2014, Anbang Insurance Group held 9.06% of the total shares, before the shareholder meeting, Anbang increased its shares to 15% from direct or indirect control. This high percentage of shares may contribute to the success of its activism in this case. The aim of both actions was to propose their own directors.

The year 2016 witnessed the biggest boardroom wars. Baoneng, a little-known conglomerate owned by the Shenzhen tycoon, Yao Zhenhua, used its insurance arm, Qianhai Life Insurance, to raise funds to bid for Vanke, a leading home developer. Because insurance companies are attracting people's attention,[78] many takeover attempts followed. Baoneng's move was just one of dozens of hostile takeover attempts by insurance companies. As they caused great gyrations in the stock market, Liu Shiyu, the chairperson of the CSRC called them 'barbarians', 'bandits', 'evil monsters' and 'poisonous demons,[79] and the CSRC decided to tighten the regulation of insurance companies.

5.2.2.3 Pension funds

[75] Author unknown, Anbang Increase Its Shareholding in Merchant Bank [安邦财险增持招行] (*China Economic News*, 24 December 2013) <http://finance.ce.cn/rolling/201312/24/t20131224_1982060.shtml> accessed 15 October 2016.
[76] "Major Shareholders of Merchant Bank' *Sina Finance* <http://vip.stock.finance.sina.com.cn/corp/go.php/vCI_StockHolder/stockid/600036/displaytype/30.phtml> accessed 15 October 2016.
[77] Hereinafter 'HKSCC Nominees Limited'.
[78] Frank Tang, 'China's Muddled Regulatory Battlefront against Stock Market 'Monster" (South China Morning Post, 11 December 2016) <http://www.scmp.com/news/china/economy/article/2053563/battling-beasts-black-stock-market-lagoon> accessed 15 October 2017.
[79]Author Unknown, 'CSRC and CIRC Criticised 'Barbarians'' [保监会证监会齐喊话, 剑指'野蛮人'] (*Xinhua News*, 05 December 2016) < http://news.xinhuanet.com/fortune/2016-12/05/c_1120050125.htm> accessed 15 October 2016.

The pension fund industry in China still faces tight restrictions on stock ownership given its importance to national stability. For CPFs, it may not be no more than 30% of the fund's net assets when managed by an investment management company, investments in equities, investment-type insurance products and equity funds, with investments in equities alone not being more than 20% of net assets.[80] 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’.[81]

For the NSSF, investment in safe channels, which are bank deposits and government bonds, should be no less than 50%. For the remaining assets, no more than 40% of them may be invested in equities.[82] Therefore, securities investment must be a minority portion of total assets and it is perhaps not surprising that among 26 cases selected for this research, none of them were initiated by pension funds.

5.2.2.4 Qualified foreign institutional investors

Just like other institutional shareholders, QFIIs are subject to both investment scope and ownership shareholdings. On the one hand, the investment scope of QFIIs is limited. QFIIs are allowed to invest in ‘shares (excluding B shares), treasuries, convertible bonds and enterprise bonds listed on China's stock exchanges’.[83] Non-tradable shares and legal person shares of listed companies and derivative securities products are off-limits to QFIIs. On the other hand, 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.[84] Moreover, investment by a single foreign investor through a QFII scheme in a single

80 Measures for the Management of Enterprise Annuities Fund [企业年金管理法办法] (2011) s 47 <http://www.gov.cn/flfg/2011-02/23/content_1808854.htm> accessed 4 November 2016.
81 *Ibid.* s 47.
82 Interim Provisions on Administration of NSSF Investment’ [全国社会保障基金投资管理暂行办法] s 28 < http://www.ssf.gov.cn/xxgk/flfg_1139/200904/t20090427_6891.html> accessed 4 November 2016.
83 ‘Measures on Administration of Domestic Securities Investments by Qualified Foreign Institutional Investors’ [合格境外机构投资者境内证券投资管理办法] <http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgz/jjl/201012/t20101231_189872.html> s 9.
84 *Ibid.* s 10.

listed company must not exceed 10% of the total shares of that listed company.[85] Although faced with tight control, in the Gree case discussed above, the Yale Endowment Fund, a QFII, in joint efforts with Chinese domestic securities investment companies, successfully expressed their voice in a shareholder meeting.

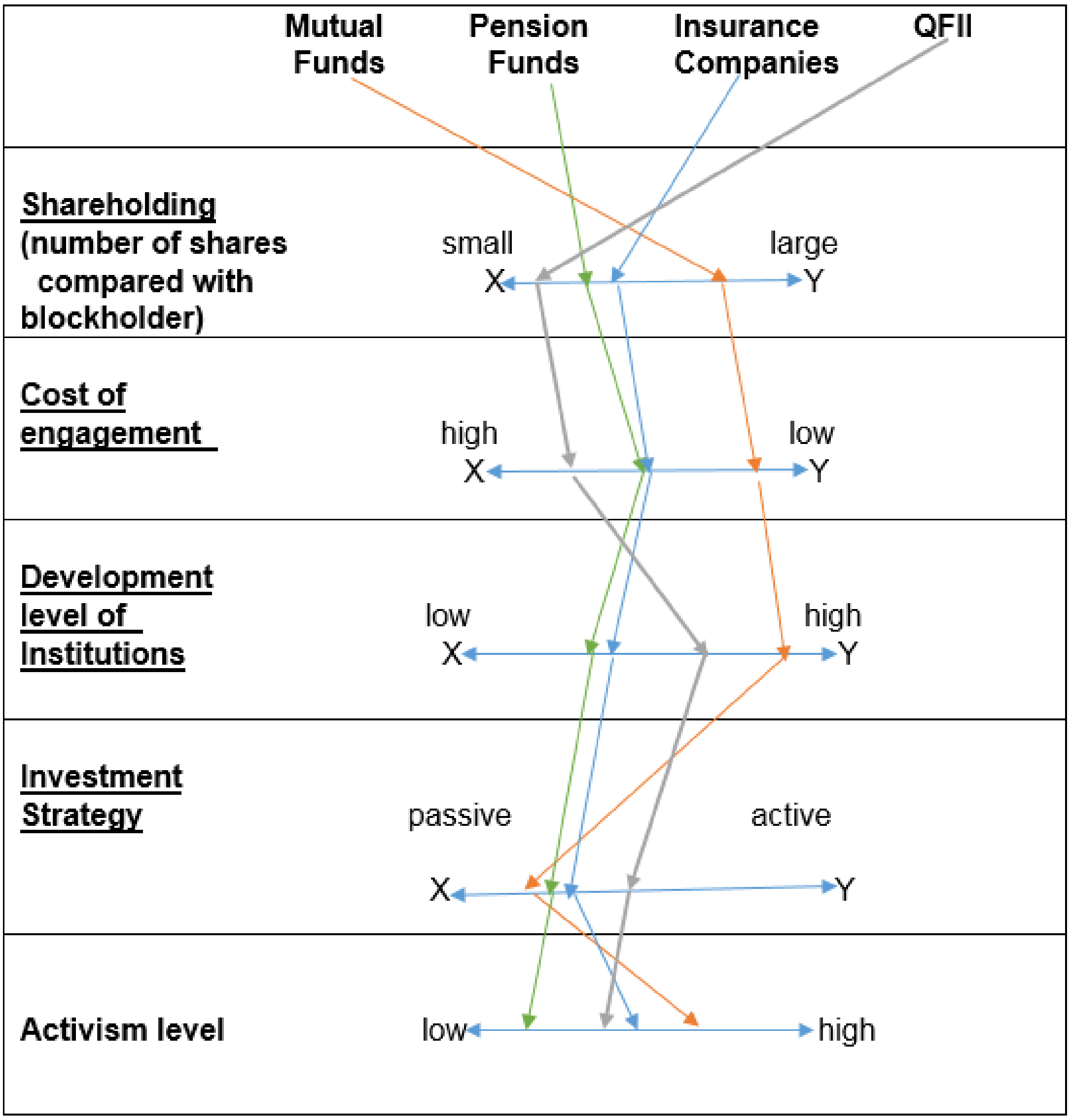
5.3 Conclusion

In this chapter, institutional shareholder activism in China was approached from the primary perspective of case studies, with the reflection on the limited range of secondary sources. In terms of the types of activism, as in the UK and US, a private meeting is also the first option for most Chinese institutional shareholders. The case study used as illustration does not involve many cases of private meetings, given the fact that private meetings are always held behind closed doors. However, the main purpose of private negotiation, according to Yuan et al.'s study, is to obtain information about the company and the quality of the management team[86] rather than improve corporate performance. Shareholder proposals are also a popular form of activism among Chinese institutional shareholders, followed by voting and legal action. In terms of Chinese institutional shareholders, SIFs are the key institutional shareholders in the Chinese equity market and the key activists in engaging in corporate governance. However, the case study reveals that their power to counterbalance blockholders is the major factor they consider before taking any action. Investment funds evaluate the strength of both sides and supports the one that can offer them more social networks. Therefore, the activism taken by securities investment funds is carefully weighed behaviour aimed at gaining certain benefits. Long-term institutions, insurance companies and pension funds face strict restrictions and low levels of development. They, therefore, almost disappear in shareholder activism except for one insurance company. The influence and power of QFIIs is also limited to some extent.

At the start of this chapter some factors that could influence institutional shareholder activism were discussed. Analysis showed that a factor that highly influenced institutional shareholders activism was their power to counterbalance the largest

[85] *Ibid.* s 10.
[86] Yuan et al. (n 14) 575.

shareholders, that is, the percentage of shareholding in the hands of both sides. The success of the Gree and Jahwa cases is attributed to the large shareholding of institutional shareholders. The cost of engagement and coalition all matter. Third, the development level of institutional shareholders plays an important role in deciding their engagement activities. Securities investment funds, who are well developed compared with other institutions, are more willing to engage in corporate issues. However, compared with the UK and US, they are still at an embryonic stage and it is evident from the case study above that the activism is still event-led and profit-driven, without the intention to improve the performance of investee companies. Therefore, their investment strategy is basically speculative in nature. Figure 5.1 on internal factors that influence institutional shareholder activism could be developed into Figure 5.10.



Mutual funds   Pension funds   Insurance companies   QFIIs

Figure 5.10: Internal factors that influence institutional shareholder activism

In addition, legal restrictions and political influence on institutional shareholder activism cannot be underestimated. The restriction on the percentage of shares that can be invested in the equities limits the shares that one institution could hold in its investee companies. Besides, the complicated disclosure rule further frustrates their activism. In addition, political factors, to some extent, determine the role that institutions could play. The CSRC's criticism of the takeover attempts by insurance companies meant that this kind of behaviour has been banned ever since and insurance companies' activism was 'nipped in the bud'. Therefore, these external factors exert reverse influence on institutional shareholder activism compared with external factors in the UK and US. As can be seen in Figure 5.11, the overall activism level is much lower (black line 1) and these external factors further lower the activism to the dotted line.

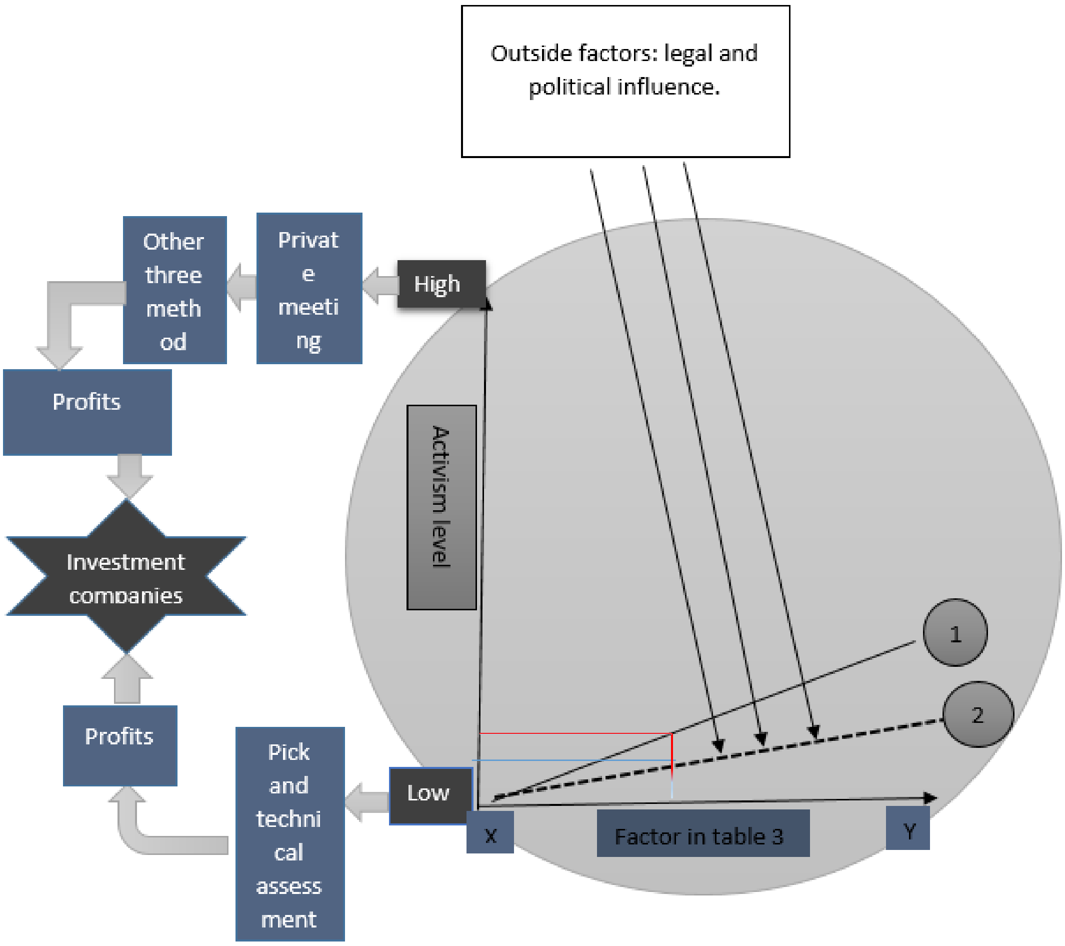


Figure 5.11: Relationship between factors in Figure 5.1 and activism level and different routines taken by institutional shareholders on different activism levels

In the next chapter, we will move on to the conclusions. The findings in chapter 4 and 5 will be summarized and the question raised in the beginning of the thesis will be answered.

Chapter 6: Conclusion

In Chapters 4 and 5 the extent of institutional shareholder activism in the UK, US and China was explored from an empirical perspective respectively. In general, as the figure at the end of each chapter presented, institutional shareholders in the UK and US are more willing to engage in corporate governance, compared with their Chinese counterparts. This chapter delves more deeply into this phenomenon and an attempt is made to answer the core questions of this thesis: whether institutional shareholders are able to fulfil the responsibilities that are placed on them under the recent SOE reforms and whether more institutional shareholder activism can be expected. The first part of this chapter provides a summary of the findings in the previous two chapters and a conclusion is drawn about the effects of institutional shareholder activism in the UK, US and China. The second part is an analysis of the reasons for the differences in the effects of institutional shareholder activism. The thesis concludes with an analysis of the possibilities for more institutional shareholder activism and the possible way forward.

6.1 Summary of the effects of institutional shareholder activism

In Chapter 4 institutional shareholder activism was analysed from an empirical perspective in the UK and US. In terms of the typologies of institutional activism, the meeting between institutional investors and companies is the first approach that most institutional investors consider and it is one of the most commonly used approaches to shareholder engagement. The evidence found in institutional reports, academic research and newspapers shows that private meetings are an effective way of communication which could avoid public confrontation, and are welcomed by both company and institutions. Certain types of institutional shareholders rely on frequent meetings. These meetings usually focus on general issues, such as the long-term strategy of the company, instead of short-term topics, such as current trading. Voting is another frequently used option and the voting rate is quite high, due, in some instances, to the help of voting agencies. In terms of voting agendas, board composition, say on pay, bylaw changes and shareholder proposals are topics that are most common. Submitting proposed resolutions for a shareholder meeting and bringing legal actions are further options for institutional shareholders to engage in corporate governance. Although these two options are not used as frequently as private meetings and voting, they assist institutional shareholder activism in their own way and could be helpful in certain circumstances. In terms of institutions that do engage actively in corporate governance, long-term institutional shareholders are more willing to engage in corporate governance. Hedge funds act as offensive shareholders and are also active players in corporate governance. Therefore, although institutional shareholder activism is a topic of debate both theoretically and empirically, in some instances, institutional shareholder activism really does improve the governance of targeted companies. Apart from contributing towards managerial accountability, achieving the benefit of reducing the majority–minority agency costs, institutional shareholder activism can also promote the performance of targeted companies to some extent. The absence of unified positive empirical results supporting institutional shareholder activism should not in itself be viewed as establishing some kind of presumption against institutional shareholder activism and it seems clear that the potential benefit could be expected in appropriate cases with specific objectives, proper techniques for intervention and responsible institutional shareholders. Therefore, one could say that in the UK and US institutional shareholders activism could play a certain monitoring role that relieve agency problems and promote corporate governance to some extent.

In Chapter 5 institutional shareholder activism in China was examined. As reports by institutional shareholders and academic research are limited, cases on institutional shareholder activism were collected to assist with the study. It is evident from these case studies that private meetings, whether in China or in the UK and US, are often used as the first resort for institutional shareholder activism. However, the purpose of these meetings is not only to focus on the performance of targeted companies, a significant push factor for Chinese institutional shareholders is to arrange private meetings with their investee companies in order to gain access to the unpublicized information collected through this negotiation process. As for voting, the voting rate is increasing and Chinese institutional shareholders usually make concerted efforts with other institutions to achieve expected results. Submitting shareholder proposals is another effective mechanism for institutional shareholders to voice their demands and ask for changes in their investee companies. Of the cases selected for the present study, 12 relate to proposals submitted by institutional shareholders, which is the most frequent form of activism (see Figure 5.1) and since 2012 it has become the dominant form of institutional shareholder activism. However, after careful analysis, it was found that in most of these cases the proposal put forward by institutional shareholders is focused on the nomination of directors, which means that in order to counterbalance blockholders and obtain more information and benefits, they usually dispatch one of their own as nominee director, and through a shareholder proposal and joint voting efforts attempt to achieve their goal. Legal action is the last resort and Chinese institutional shareholders usually avoid taking legal action, given the influence of Confucianism. The situation is quite different in China from that in the UK and US respectively in terms of the institutions that engage in corporate governance. As discussed in Chapter 2, the government encourages the development of securities investment funds, and several policies and regulations are issued with the aim of promoting SIFs. Therefore, SIFs are the key institutional shareholders in the Chinese equity market and major players in engaging in corporate governance. The case studies reveal that when they intervene, they do not focus on improvements in corporate governance, but the private benefits that they stand to gain. An example of this is when the blockholder and the management team are in different camps. Investment funds usually evaluate the strength of both sides and supports the one who could offer them a greater social network. Apart from SIFs, other institutional shareholders play a minor and supplemental role. Therefore, one could say that the positive and beneficial role exercised by Chinese institutional shareholders in corporate governance is quite limited compared with their UK and US counterparts. The management monitoring role, and the checks and balances of blockholders that are expected of Chinese institutional shareholders are not properly exercised.

Therefore, although it appears that there is institutional shareholder activism with similar features in the UK, US and China, the role that institutional shareholder activism plays in corporate governance is different.

6.2 Reasons for the differences in institutional shareholder activism

The growth in institutional shareholders in the UK, US and China is impressive, and calls for more institutional shareholder engagement in their investee companies is increasing as well. However, despite similar features in institutional shareholder activism in China, Chinese institutional shareholder activism is different from that in the UK and US. The analysis therefore moves to the question of what those reasons for the differences in shareholder activism might be. This question could be answered from nine perspectives:

a. As discussed in chapter 2, the emergence and development of institutional investors were propelled by different forces. In the UK and US the demand for market and financial innovation was the main diving force and the development of institutional investors was the results of both self-motivation and policy encouragement. However, in China the emergence and growth of institutional investors has been driven mainly by the governmental need for economic reform and it is policy that influences the development of institutional shareholders. Therefore, institutional shareholders cultivated by policy lack inner incentives to intervene to improve the corporate performance of targeted companies

b. Chinese institutional investors are much younger than their UK and US counterparts and they are, to some extent, immature in their investment and engagement strategies. Under the restriction of limited investment instrument, speculation of short-term profits is a popular way of investing among institutional shareholders. The imbalanced development of different institutions has led to the powerlessness of institutions (especially long-term institutions, such as pension funds) who are more likely to engage in corporate governance.

c. The inconsistent objectives between companies and institutional shareholders may lead to the low level of institutional shareholder activism. In the UK and US most of the companies are for-profit and the goal of achieving better financial performance was admitted and shared among companies and institutional shareholders. However, most listed companies are SOEs with political and social objectives, and the financial performance was not the only factors that were considered by the board and management team. Therefore, the interests of institutional shareholders and the companies may not be aligned and this reduces the possibility of institutional shareholder activism.

d. Another reason would be the difference in the aims of corporate governance. In the UK and US the main objective of corporate governance is to reduce the agency costs generated in the process of dispersing shares, and provide management teams with a certain degree of incentive and monitoring. In China, as discussed in Chapter 1, the aim of establishing 'modern corporations' with a proper corporate governance mechanism is to lift SOEs out of trouble. The ultimate aim of corporate governance is to maintain the predominant power of public ownership (i.e., SOEs). The differences in corporate governance aims lead to the differences in the policies and regulations that are published.

e. Ownership structure also influences the way that institutional shareholders engage. Under the dispersed ownership structure, the problems faced by institutional shareholders are the agency costs generated from the inconsistency in interests between managers and shareholders. Therefore, institutional shareholders have a clear and unitary objective when engaging. However, in China the presence of concentrated ownership and blockholders makes the situation complex. On the one hand, the decision and voting power of blockholders make institutional shareholder rights useless to some extent. As discussed in Chapter 5, whether their shares are large enough to counterbalance the blockholders is the main concern when Chinese institutional shareholders contemplate activism. On the other hand, the existence of vertical and horizontal agency problems poses a dilemma for institutional shareholders. When there is a conflict between blockholders and management, institutional shareholders have to make a choice and as we see from the case in Chapter 5, institutional shareholders evaluate the strength of both sides and support the ones who could offer a more extensive social network for them.

f. The legal and regulatory framework also plays a distinct role in institutional shareholder activism. As is evident from the evolution of US institutional shareholders, the legislation in 1929–1970 laid the foundation for the development of institutional shareholders. The well-regulated capital market and securities market, sophisticated disclosure requirements, and good protection for minority shareholders all guaranteed a favourable institutional environment for shareholder activism. In China the promulgation of related legislation lags far behind the development of institutional shareholders. Although some specific rules are transplanted into Chinese company law and securities law from the UK and US, many of them are no more than 'empty words'. The protection for minority shareholders, the quality of information disclosure and the regulation of market players are all inefficient. Much of the governance of UK listed companies is left to governance codes with a 'comply or explain' enforcement approach that is flexible and friendly to shareholder activism. Whereas the regulations and rules related to Chinese corporate governance are largely compulsory in nature. In addition, legal barriers and investing thresholds also discourage Chinese institutional shareholder activism.

g. The role of the state also influences the way that institutional shareholders engage. In the UK and US, the state plays a neutral role in the capital and securities market. Although the policy may vary in different periods, the main goal of the state is to protect the proper operation of the market and to ensure the welfare of the market players. The unbiased attitude leaves room for the development of any market participants who fits in the market. In China, the state plays a dual role both as 'athlete' and 'referee'. On the one hand, the state plays the role of regulator as in the UK and US; and on the other, it is the shareholder or even the blockholder of the SOEs. Therefore, the welfare of SOEs is the main focus when making decisions and the state can make use of its regulatory position to firm its control over listed companies. As seen in Chapter 5, many regulations and rules are enacted with the aim of preserving the state's control over the economy and this leads to a situation where it is the government who decides what kind of institutional shareholders are encouraged to develop and to what extent institutional shareholders could engage in corporate governance depending on the influence on SOEs.

h. From a wider context, well-functioning capital and securities markets are prerequisites for institutional shareholder activism. In the UK and US the securities market is sophisticated and operates well when institutional shareholders actively engage in corporate governance. However, the Chines securities market is still suffering from unstable fluctuation called the '*policy market'* because the policy published by the government deeply influences stock trends. It is no wonder that institutional shareholders pay more attention to short-term gains rather than long-term investment. Furthermore, as mentioned in Chapter 2, a large number of the listed companies on the Chinese stock exchange are SOEs. As the most important players in the securities market, these SOEs are struggling with non-viability.[1] Without the ability to earn acceptable profits in a free, open and competitive market, they cannot distribute dividends to shareholders. Considering that institutional shareholders cannot benefit by holding stocks for a long time due to the non-viability and unprofitability of those listed companies, they therefore make profits only by speculating on stock prices.

i. As shown in the present research, the presence of proxy advisory firms and industry associations greatly facilitates the way that institutional shareholders engage in corporate governance. The leading companies in shareholder activism which serve as a kind of role model could lead the way towards more activism.

In conclusion, the different levels of institutional shareholder activism are the result of various factors, both from institutional investor themselves and the environment in which institutional shareholder activism operates. One could therefore say that although Chinese policymakers borrowed experiences from the UK and US and some rules and regulations on shareholder activism seems largely identical, great discrepancies exist. All these factors and differences deeply influence the level at which Chinese institutional shareholders can engage. The question that remains is what does the future hold for institutional shareholder activism in China.

6.3 Possibility for more institutional shareholder activism

After analysing the different roles of institutional shareholders in corporate governance and the reasons behind such differences, the natural step is to see whether more institutional shareholder activism can be expected in China. First, the question needs to be asked: is institutional shareholder activism rational? If it is, does China need it? If the answer is still positive, then what is the possibility of Chinese institutional shareholders becoming more actively involved in corporate governance?

[1] Justin Yifu Lin, 'Demystifying the Chinese Economy' (2013) Australian Economic Review 46(3) 259, 268.

As shown in Chapter 3 and the empirical research above, although institutional shareholder activism is a topic of debate and the research results are not overwhelmingly positive, there is no solid basis for the theory that institutional shareholder activism is detrimental to corporate governance. The empirical analyses in Chapters 4 and 5 reveal that institutional shareholder activism is collectively valuable as an efficient tool to reduce agency costs and ensure managerial accountability in circumstances where proper activists are engaged and proper activism was exercised. Shareholders have inborn advantages in supervising, monitoring and engaging compared with other corporate governance devices. Therefore, institutional shareholder activism is rational and, if not encouraged vigorously, this approach should at least be tried to improve corporate governance.

The fact that institutional shareholder activism is rational and beneficial to corporate performance under certain circumstances does not mean that it is needed in China. Whether more institutional shareholder activism can be expected depends on the extent to which it fits within a broad tapestry of economic reform. As shown in Chapter 4, SOEs are now standing at the crossroads of mixed ownership reform, which means certain percentages of state-owned shares will become tradable and the ownership structure will become more diversified. On the one hand, given the fact that SOEs are large in size, small companies and individuals are too weak to participate in mixed ownership reform and, therefore, institutional shareholders and some powerful companies are expected to play a major role in this reform. On the other hand, horizontal agency costs between blockholders and minority shareholders would be less of a problem when the ownership structure is further diversified. Therefore, as in the UK and US, the vertical agency problems between managers and shareholders will create demand for institutional shareholder engagement. In addition, with the development of the securities market and financial innovation, Chinese institutional shareholders are expected to be more sophisticated in both investment strategies and governance strategies. Therefore, institutional shareholder activism, together with other corporate governance mechanisms, would become increasingly more important and replace direct regulatory control from the state in certain areas in the near future.

Now that the first two questions have been answered positively, could more Chinese institutional shareholder activism be expected, that is, will institutional shareholders overcome their passivity and engage in corporate governance actively? It is evident from Chapters 4 and 5 that big institutional shareholders with large shareholdings and long-term investment horizons are more likely to intervene in targeted companies because (1) it is easier to change corporate affairs given their sufficiently large shareholding; (2) they have more sophisticated investment strategies: and (3) they will receive more benefits as a result of activism, which could outweigh the cost generated in the process of engagement. First, the possibility of institutional shareholders counterbalancing majority shareholders will be addressed. With the implementation of mixed ownership reform, blockholders will gradually exit and it could be expected that the shareholdings of institutional shareholders will increase. However, considering the socialist ideology and the role of the CPC in China, one cannot be too optimistic about the extent to which shares will be dispersed. Furthermore, cumulative voting also enhances the likelihood of counterbalancing majority shareholders. However, the legal barriers to investment thresholds remain a problem. Although deregulation is taking place and higher thresholds are introduced, this process seems slow and hysteretic. These legal barriers are set for two reasons. One is to curb market abuse and maintain market stability, and the other is to strengthen state control of the economy. These two aims are fundamental, therefore the state has adopted a cautious attitude. The deregulation has a long way to go. Second, it is unrealistic to expect institutional shareholders who are in the embryonic stage to deploy sophisticated long-term investment strategies and actively engage in corporate governance. It is a process of gradual learning and growing. Third, when institutional shareholders actively engage in corporate governance, they have an expectation that their intervention could improve corporate performance and, in turn, the rise in share prices could benefit them. However, as already discussed, the Chinese securities market is heavily influenced by government policy and it cannot reflect the true value of a company. Therefore, Chinese institutional shareholders are more short term in nature. From the perspective of institutional shareholders, it is not easy for them to overcome passivity to actively engage in corporate governance.

6.4 The way forward

Institutional shareholder activism appears to have come of age in the UK, US and China. It has long been considered vital to good corporate governance, and policymakers in the UK and US have issued a variety of regulations and guidelines to promote institutional shareholder engagement. China is following this trend. Recent decades have witnessed the rapid rise of institutional investors and their initiatives in engaging in corporate governance. This massive development in the scale of institutional investors, together with the increases in their level of activism, suggests the possibility of the beginning of a new era in corporate governance. Policymakers also place great emphasis on the role that institutional shareholders could play in the ongoing SOE reform. However, after exploring and comparing the effects and the extent of institutional shareholder activism in the UK, US and China, it was found that institutional shareholder activism is influenced by ownership structure, corporate governance framework, the role of the state, the level of maturity in institutional shareholders, the role of the securities market and ideology. All these factors and the existence of path dependency force Chinese institutional shareholders to face a tougher reality compared with their UK and US counterparts. Therefore, the advantages and potential of institutional shareholder activism do not in themselves mean that there will be more activism in future. The focus should not only be on the positive effects of institutional shareholder activism without looking at the preconditions that make institutional shareholder activism positive. Before exploring the preconditions and possible reform, it is necessary first to deal with the possibility of experiential learning and legal transplantation.

Legal transplantation, which is a way to transfer legal experiences or rules from one jurisdiction to another, is commonly observed as ‘most changes in most systems are the result of borrowing’.[2] Given the sharp contrast in ideology and legal systems between the UK and US and China, the borrowing experience from the West may not fit in well with special national conditions. However, it would be less of a problem in the area of corporate governance. The development of corporate legislation and the corporate governance system in China are in themselves borrowing processes from the West, and convergence relating to institutional shareholder activism is under way.[3] The borrowing

[2] A Watson, *Legal Transplants: An Approach to Comparative Law* (Scottish Academic Press, 1974) 94.
[3] For example: first, the core functional features are limited liability, shared ownership by investors, and the division of power and responsibilities between directors, managers and shareholders. The corporate

and transplantation must be carried out with caution, and should not be a 'pick-and-mix' approach. The consideration should be whether the imported rules could work well with the fundamental principles in the accepting country. Cognisance must also be taken of the preventative role played by 'path dependency', which influences the expected results achieved by the imported rules. The suggested reforms are divided into two categories. In the first category are the suggestions and reforms that are practicable, easily transplanted and that may be able to work in conjunction with current legal systems. Another category contains those reforms that may be prevented by the current legal and political framework but that could be expected in the long term.

First, reform should begin with the cultivation of institutional shareholders. The greatest obstacle to the development of institutional shareholders is the dominance of state-owned shares in listed companies. The reduction in state ownership is the foremost reform that should be proposed. However, as discussed in Chapter 1, the dominant position of SOEs in the national economy is the distinct feature of a socialist system and the extent to which shares become dispersed is totally dependent on decisions of the government and there is almost nothing to be done to change the situation. A practicable reform would be tax relief. The beneficial tax treatment in the UK and US at different periods promoted the growth of institutional shareholders. In the light of their experience, certain degrees of tax relief could be granted to long-term institutional shareholders, such as pension funds and insurance companies. Furthermore, the government also needed to promote market integrity and stability, and increase financial innovation.

Second, in terms of promoting institutional shareholder activism, relaxing institutional investment restrictions would be a good, but unrealistic, approach. Given the immaturity of Chinese securities market and institutional shareholders, the restrictions on investment would serve as an efficient barrier for shareholders to avoid unbearable financial losses. In the UK, although the larger pension schemes control its own

governance framework is similar except for the presence of political governance in China. Second, the way tin which shareholders engage in corporate affairs is basically the same. Third, there are similarities at the less formal regulatory level, such as the corporate governance code; for more, see Bo Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (Routledge, 2013); Iain G MacNeil, 'Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies' (2002) Journal of Corporate Law Studies 289(2), 306.

investments, the Pension Act requires trustees or fund managers to have regard to the need for diversification and the suitability of investment.[4] Besides, they also operate under a 'prudent person' model, in which the investment of pension assets was undertaken with care, the skill of an expert, prudence and due diligence. Whereas in China the quantitative portfolio regulation was the only approach adopted to regulate the investment industry. As suggested by Davis, it could be rational to impose regulatory restrictions on institutions in a country where the institutions are not sufficiently experienced and the market is more volatile.[5] The experience of the UK and US also shows that adopting a strict regulatory regime is helpful in the initial stage of institutional investment if the institutions are not sophisticated enough. With the development of institutional investors and the securities market, the regime could be relaxed accordingly. Furthermore, the implementation of the 'prudent person' approach may face legal difficulties given the fact that both regulators and asset managers in China are unfamiliar with the concept of fiduciary responsibilities in a civil law jurisdiction. Therefore, a gradualist approach to relax the regulatory regime of institutional investors is currently more feasible. In addition, the reluctance to engage in corporate governance is due to the fact that the Chinese securities market is heavily influenced by government policy and cannot reflect the true value of a company. Therefore, the government should also focus on promoting the optimal operation of the securities market. Some practicable reform could be carried out to promote a more active involvement in corporate governance.

Industry trade associations have facilitated the roles played by their members in organizing collective action among institutions as well as promoting good corporate governance practice in UK. Therefore, Chinese industry trade associations are expected that they could learn from the UK experiences in ways to co-ordinate institutional shareholder engagement. Besides, the establishment of self-regulatory organizations will generate other benefits apart from promoting shareholder engagement in the Chinese context. On one hand, trade associations could speed up the process of reducing political and administrative control over companies by relying more on indirect regulatory methods. On the other hand, it can enhance the government's

[4] Iain G MacNeil, *An introduction to the law on financial investment* (2nd, Hart Publishing 2012) 180.
[5] PE Davis, *Private Pensions in OECD Countries* (Organisation for Economic Cooperation and Development, 1997).

regulatory efficiency and capacity by co-operating with self-regulatory bodies. Moreover, the UK case show that provisions in the Codes or guidelines could pave way for the further legal changes in company law and securities law. As discussed in chapter two, China has established several industry trade associations as a sub-branch of the governmental supervision regulator. Given the fact that it is still at the initial stage, we could providing special support, such as training professional staffs, promoting industrial exchange to learn experience from other countries. In the meantime, the independence of the trade associations should be strengthened. The regulatory body could grant more power to those associations for the purpose of exercising its flexibility. Besides, internal regulation and governance of the trade associations is an important aspect to maintain its independence.

Furthermore, the role of proxy voting services cannot be ignored. Foreign proxy voting services could be invited to develop their business in China as well as develop Chinese proxy voting services. The question of how to develop Chinese proxy voting services offers fertile ground for future research.

Apart from establishing a more effective legislative framework and a more sophisticated institutional investor base, the cultivation of a culture of good corporate governance is also important. In the past Chinese history, the influence of political intervention and the worship for authority seems overgrowth. In the UK. many matters concerning the corporate governance are left to private ordering, whereas Chinese corporate legislation relies heavily on a mandatory approach, such as 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, it Chinese counterparts are largely compulsory in nature, issued by organs of the state, and backed by formal sanctions. Given the fact that neither the legal system in the UK nor the legislative framework in the US is equipped with optimal level of flexibility, we could say that the legal framework is evolved with the development of the society. With the increase in the complexity of the economic behaviour, the possibility of the foreseeing and prescribing everything by law is decreasing. Under this circumstances, the purpose of law is shifting from prescribing everything to allocating power to those institutions that could fix the problem caused by future contingency. Therefore, the soft law norm published by trade associations could be regarded as a sign of legal improvement and cultural progress. As the culture cannot be nurtured overnight and it is not a matter simply regarding laws and theory, it demands long-term efforts and the assistance of government's advocacy.

6.5 Issues for further research

The initially stated overarching aim of this research was to analyse the role of institutional shareholder activism and explore whether Chinese institutional shareholders are able to fulfil the responsibilities that are placed on them under the recent SOE reforms. Although the thesis has largely achieved this aim, there are limitations and weaknesses. Therefore, future researches could focus on following aspects.

First, the typologies of institutional investors focused on as part of this research was limited. Only institutional shareholders who accounted for a relatively large percentage were analysed due to the limited available data and space constraints. Other types of institutional investors, such as foundations and endowments could form part of future studies.

Second, in terms of the effects of institutional shareholder activism, only the financial results of shareholder activism were analysed. As sustainability is an issue growing in popularity, empirical research dealing with the relationship between activism and social and environmental outcomes could be collected and analysed.

Third, the conclusion figures drawn at the end of chapter 4 and 5 are based on the investigation and analysation in these two chapters. Therefore, they are evidence-based interpretation of findings, rather than figures concluded from precise data analyse. It constitutes an interesting topic for the future research to design a mathematical model to investigate the exact extent of correlation between factors.

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