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Mähönen, Jukka Tapio

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Shareholder activism: a driver or an obstacle to sustainable value creation?

Jukka Mähönen*

1 Introduction

There are, in a modern listed public company, two dominant types of shareholders: the active marginal trader who sets market price often through using algorithmic trading,[1] and the activist (or potential activist) *institutional investor*[2] who exerts pressure on company governance.[3] Pressure can take a number of forms. These range from shareholder dialogue and temporary voting blocks of investors with relatively small shareholdings, to full takeovers. Between these two are found hedge fund activism and proxy fights.[4] Share ownership has, at the same time, not been concentrated solely by shareholders owning larger blocks of shares, but also by the use of different classes of shares that grant multiple voting rights and by the issue of no voting shares to the public.[5] Concentrated share ownership is widespread around the world, including in Europe, the Nordic countries and Italy.[6] For example, close to two thirds of all listed companies in the Nordic area have at least one shareholder who controls more than 20 per cent of total votes. Around one fifth of companies in the Nordic countries are also under the absolute

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[1] See e.g. T.C.W. Lin, 'The New Investor', (2013) 60 *UCLA Law Review*, 678.

[2] By 'institutional investors', I mean institutions investing others' savings on their behalf ('*money managers*'). Typical institutional investors are public and private pension funds and companies, insurance companies and other joint investment properties such as civil law foundations and sovereign wealth funds, as well as hedge funds. E.B. Rock, 'Institutional Investors in Corporate Governance', in J.N. Gordon and W.-G. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance* (Oxford: Oxford University Press, 2018), available at www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780198743682.001.0001/oxfordhb-9780198743682-e-23. Institutional investors hold 41 per cent of the global market capitalisation of listed companies; A. De La Cruz, A. Medina and Y. Tang, 'Owners of the World's Listed Companies' (2019), OECD Capital Market Series, 5, available at www.oecd.org/corporate/owners-of-the-worlds-listed-companies.htm.

[3] L.E. Strine, Jr., 'Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law' (2014) 114:2 *Columbia Law Review*, 449, 452 fn 6.

[4] M.R. Denes, J.M. Karpoff and V.B. McWilliams, 'Thirty years of shareholder activism: A survey of empirical Research' (2017) 44 *Journal of Corporate Finance*, 405-406.

[5] A.H. Choi, 'Concentrated Ownership and Long-Term Shareholder Value' (2018) 8:1 *Harvard Business Law Review* 53; J.G. Hill, 'Good Activist/Bad Activist: The Rise of International Stewardship Codes' (2018) 41 *Seattle University Law Review*, 497; K.M. Kahle and R.M. Stulz, 'Is the US Public Corporation in Trouble?' (2017) 31 *Journal of Economic Perspectives*, 67.

[6] Choi, 'Concentrated Ownership', 63-65; J. Cullen and J. Mähönen, 'Taming unsustainable finance: the perils of modern risk management' in B. Sjåfjell and C. Bruner (eds.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge: Cambridge University Press, 2019), Chapter 8; J. Mähönen and G. Johnsen, 'Law, culture and sustainability: corporate governance in the Nordic countries' in Sjåfjell and Bruner (eds.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Chapter 16.

control of a single shareholder.[7] Forms of control, however, vary from country to country, and from institutional investors such as pension funds to founders, states, sovereign wealth funds, families and foundations that act more as direct shareholders.[8] There is considerable heterogeneity in the ecosystem. The two dominant types of shareholder still, however, prevail.

The *investments* themselves have, at the same time, become more short-sighted than previously. In for example the United States (US), the shareholder base of public companies turns almost fully over each year,[9] the average holding period for institutional investors being a mere eight months.[10] There are unfortunately no comparable results for Europe, most European research being conducted using US data. The *EU High-Level Expert Group on Sustainable Finance* (HLEG), which was established by the European Commission, urged in its Final Report that the European Commission and European Supervisory Authorities establish globally consistent data on portfolio turnover.[11] In its February 2019 call for advice to the European Supervisory Authorities (ESAs), the European Commission urged the ESAs to collect evidence of the exertion of undue short-term pressure on corporations by the financial sector.[12] The turnover ratios for both equities and bonds are, according to the ESAs' December 2019 responses, quite stable and relatively low for example in the insurance sector.[13] Short-termism in holding periods was also not seen as being a problem among banks.[14] The ESAs, however, recognised in their responses the short-termism issue among other financial sector undertakings, particularly the two dimensions of short-termism - short-termism of investors and the short-termism of investments. Long holding periods do not necessarily correlate with long-termism in the investments themselves,[15] the potential differences in the *investment*

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[7] P. Lekvall (ed.), *The Nordic Corporate Governance Model* (Stockholm: SNS Förlag, 2014), 23.

[8] As an example of the Nordic area, see in Norway J. Mähönen, S. Sjåfjell and M. Mee, 'Stewardship Norwegian-style: fragmented and state-dominated (but not without potential?)' in D. Katelouzou and D.W. Puchniak (eds.), *Global Shareholder Stewardship: Complexities, Challenges and Possibilities* (Cambridge University Press, 2020), also available at SSRN: https://papers.ssrn.com/abstract=3635359.

[9] L.E. Strine, Jr., 'One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?' (2010) 66:1 *The Business Lawyer*, 1, 17.

[10] M.W. Roberge, J.C. Flaherty, Jr., R.M. Almeida, Jr. and A.C. Boyd, 'Lengthening the Investment Time Horizon' (2014), *MFS White Paper Series*, available at https://conferences.pionline.com/uploads/conference_admin/mfse_time_wp_12_13.pdf.

[11] EU High-Level Expert Group on Sustainable Finance, 'Financing a Sustainable European Economy: Final Report 2018, 48, available at https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf.

[12] European Commission, 'Call for advice to the European Supervisory Authorities to collect evidence of undue short-term pressure from the financial sector on corporations' (1 February 2019), available at https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190201-call-for-advice-to-esas-short-term-pressure_en.pdf. The ESAs include the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

[13] European Insurance and Occupational Pensions Authority, 'Potential undue short-term pressure from financial markets on corporates: Investigation on European insurance and occupational pension sectors: Search for evidence' (18 December 2019), available at www.eiopa.europa.eu/content/potential-undue-short-term-pressure-financial-markets_en.

[14] European Banking Authority, 'EBA Report on undue short-term pressure from the financial sector on corporations' (18 December 2019), available at https://eba.europa.eu/file/461440/down-.

[15] European Securities and Markets Authority, 'Report: Undue short-term pressure on corporations' (18 December 2019), 20–21, available at www.esma.europa.eu/press-news/esma-news/esma-proposes-strengthened-rules-address-undue-short-termism-in-securities.

horizons of institutional shareholders being undermined by the short-term nature of investments. Some institutional investors, such as pension funds, *might* have longer-term investment horizons than for example mutual funds, pension funds in principle supporting sustainable investments.[16] This, however, appears to not play a significant role at the end of the day, due to United States domiciled institutional investors accounting for 65 per cent of global institutional investor holdings.[17] This major capital market shift, which Gilson and Gordon have labelled 'agency capitalism,' has important implications for both investor 'activism' and regulation.[18]

Modern capital markets are ruled by intermediaries in the extended investment supply chains. There is therefore a disconnect between the individual ultimate beneficiaries of these chains, such as pension fund customers whose funds are managed by institutional investors, and the productive firms[19] in which the institutional investors invest. The investment chain places the focus on the institutional investors and other investment intermediaries. The ultimate beneficiaries are therefore not able to directly influence the practices of the firms in which they invest.[20]

Even more important is what *Mark Carney*, the Governor of the Bank of England, characterises as the 'tragedy of the horizon'[21] and the inability to manage the risks from this which 'fall beyond the traditional horizons of most actors – imposing a cost on future generations that the current generation has no direct incentive to fix.'[22] For example, the rise of increasing passive index investing, led by the 'Big Three (BlackRock, Vanguard and State Street), threatens to further undermine this investment model. Capital providers investing in the entire equity market or a subsection of it through exchange-traded funds or index trackers, chase short-term returns. This is likely to lead to mono-dimensionality in portfolio allocation, money managers allocating capital to corporations that are likely to provide superior short-term returns. These factors overwhelm sustainability considerations through money managers disregarding environmental, social and governance (ESG) investment principles.[23]

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[16] T. Jain and D. Jamali, 'Looking Inside the Black Box: The Effect of Corporate Governance on Corporate Social Responsibility' (2016) 24:3 *Corporate Governance: An International Review*, 253, 260.

[17] De La Cruz et al, 'Owners of the World's Listed Companies', 9.

[18] R.J. Gilson and J.N. Gordon, 'Agency Capitalism: Further Implications of Equity Intermediation' in J.G. Hill and R.S. Thomas (eds.), *Research Handbook on Shareholder Power* (Cheltenham: Edward Elgar Publishing, 2015), 32-33; Hill, 'Good Activist/Bad Activist', 500.

[19] In this article I use the concept 'productive firms' or 'productive corporations' to differentiate between these target corporations and the corporations investing in them. The dichotomy managers of productive corporations, money managers, is used for instance in Strine, 'Can We Do Better', 451.

[20] V. Harper Ho, 'Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk' (2016) 41 *The Journal of Corporate Law*, 647, 677.

[21] M. Carney, 'Breaking the Tragedy of the Horizon – Climate Change and Financial Stability', speech given at Lloyd's of London, 29 September 2015; see Cullen and Mähönen, 'Taming unsustainable finance', 104.

[22] Ibid., 3.

[23] Cullen and Mähönen, 'Taming unsustainable finance'; compare however with M. Condon, 'Externalities and the Common Owner' (2020) 95:1 *Washington Law Review*, 1, that claims that universal institutional investors have an incentive to internalize their intra-portfolio negative externalities by activism against unsustainable businesses.

A major proportion of the ultimate beneficiaries of institutional investors are '*forced capitalists*'.[24] An example of forced capitalism are employees enrolled in an employer-provided pension plan, in which investments are made by both the employee and the employer via an intermediary, in a pension fund or a pension insurance company. In forced capitalism, employers directly or indirectly select the intermediary.[25] Most ordinary ultimate beneficiaries therefore have little choice but to invest in the market indirectly. Their economic security is based on their ability to sell their labour, such forced capitalists therefore having no interest in quarter-to-quarter earnings or in beating the market for quick bursts of cash at the expense of sustainable growth. Their asset managers do, however, have an interest in this.[26]

In Europe, a positive view of shareholder engagement underpinned a number of recommendations of the 2012 UK *Kay Review*. This review was established to examine the impact of activity in UK equity markets on the long-term performance and governance of UK listed companies.[27] There have been no legislative responses to the Review. The HLEG, which was established by the European Commission, also emphasised in its Final Report the dominance of short-termism. The report stated that '[t]here is much evidence of the strong short-term pressures that corporate management experiences. A 2005 survey shows that 78% of executives feel pressure to sacrifice long-term value to meet earnings targets. A more recent McKinsey and Canada Pension Plan Investment Board (CPPIB) survey of over 1,000 board members and executives finds that 86% believe that if they had a longer time horizon to make business decisions, this would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.'[28] The HLEG Final Report stressed that sustainability and long-term orientation required a number of supporting strategies. This includes a sufficient number of investors who, in their relations with the companies they invest in, support a focus on long-term value creation and long-term research. Companies should also focus more strongly on issues and metrics that are relevant to the longer-term success of the business.

Institutional shareholders have, despite these problems, been continuously seen to be important in corporate governance. Shareholder 'empowerment' has been an important part of this new trend, this furthermore involving a policy shift that makes corporate managers accountable to shareholders as 'owners' of the company.[29] Corporate boards

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[24] A concept coined by L.E. Strine, Jr., 'Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in A More Rational System of Corporate Governance' (2007) 33:1 *The Journal of Corporation Law*, 1, 4.

[25] The Economist, 'Reinventing the deal: America's startups are changing what it means to own a company', *The Economist*, 24 October 2015, from the print edition, available at www.economist.com/news/briefing/21676760-americas-startups-are-changing-what-it-means-own-company-reinventing-deal.

[26] Strine, 'Toward Common Sense', 4.

[27] J. Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making', Final Report, July 2012, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf.

[28] High-Level Expert Group, Final Report, 47 (footnotes omitted).

[29] 'Owners', as we do not know any jurisdiction in which the shareholders of a limited liability company are recognised as its owners under property law. Shareholders own shares that entitle their holders to rights and duties in a company. From a property rights perspective, a company owns its assets and owes its responsibilities. B. Sjåfjell, A. Johnston, L. Anker-Sørensen and D. Millon, 'Shareholder Primacy: The Main

should therefore, according to this policy thinking, be 'independent' and focus on monitoring the company on behalf of the shareholders as opposed to managing it independently. Shareholders should also 'engage' with companies on issues ranging from strategy to corporate responsibility, which are mandated to the board by law.[30]

Corporate governance regulation reflects also the new stewardship trend, shareholder engagement and empowerment policies from the early 1990s being increasingly embedded in corporate governance codes, listing rules, company legislation, European Union directives and transnational regulatory standards.[31] The influence of this trend has become even stronger after and in response to the global financial crisis of 2008–2009. This is despite doubts that the crisis was due the shareholder empowerment trend, but despite this trend. We see this in particular in the 2017 reform of the 2007 Shareholders' Rights Directive (SHRD I),[32] a number of European jurisdictions also seeing the emergence of specific stewardship codes. The 2017 amended Shareholders' Rights Directive (SHRD II)[33] includes elements found in previous stewardship codes, such as a requirement that institutional investors publicly disclose their policy for integrating shareholder engagement in their investment strategies or provide an explanation of why they have chosen not to do so ('comply or explain').[34]

Encouraging shareholders to act as 'stewards' is, according to the arguments behind the codes and stewardship regulation such as the SHRD II, a way forward not only towards better corporate governance in the mainstream economics-focused sense, but also towards more sustainable and responsible companies in terms of the environmental and social challenges we as a global community face.

Shareholders play a crucial role in promoting better governance of companies according to the EU Commission's Company Law Action Plan of 2018, which is the Commission's response to the HLEG Final Report. This furthermore is a role that is in the interests of shareholders and the company.[35] The Commission's proposal to amend the SHRD I, which was approved in 2017 as SHRD II, more specifically promoted an 'effective and sustainable shareholder engagement' as a cornerstone of listed companies' corporate

Barrier to Sustainable Companies' in B. Sjåfjell and B.J. Richardson (eds.), *Company Law and Sustainability: Legal Barriers and Opportunities* (Cambrigde University Press, 2015), 79, 80.

[30] S. Deakin, 'Against shareholder empowerment' in J. Williamson, C. Driver and P. Kenway (eds.) *Beyond shareholder value: The reasons and choices for corporate governance reform* (London: Trades Union Congress, July 2014), 36-40, p. 36.

[31] Deakin, 'Against Shareholder Empowerment', 36.

[32] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, 17.

[33] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, 1.

[34] EY, 'Q&A on Stewardship Codes' (August 2017) 2, available at www.ey.com/Publication/vwLUAssets/ey-stewardship-codes-august-2017/$FILE/ey-stewardship-codes-august-2017.pdf.

[35] Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan: European Company Law and Corporate Governance – A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies. COM(2012) 740 final, 3 ('Company Law Action Plan').

governance model. This, however, depends on checks and balances between the different organs and different stakeholders.[36]

The stewardship concept reflected in SHRD II is widely connected to institutional investors, and refers to the actions that asset managers can take to enhance the value of the companies that they invest in on behalf of their beneficiaries. The nature of stewardship varies, however, from jurisdiction to jurisdiction based on shareholder structures. In the Nordic region (which is similar to many Asian jurisdictions), the role of states, sovereign holding companies and wealth funds, other public market actors such as public pension funds, families, family-controlled investment companies and family-based foundations is significant compared with (other) national and international institutional investors.[37]

The EU approach is, however, based on an agency theory[38] idea of all shareholders being principals of the company, and particularly in relation to the board and the management.[39] This approach is not, however, based on European nor Member States' company law.[40] The shareholder empowerment movement is generally inspired by three phenomena: (1) changing investment practices and especially institutional investor drive, spearheaded by aggressive hedge funds, (2) the emergence of shareholder proxy advisory services that concentrate investor voice, and (3) the creation of complex financial instruments that are capable of decoupling, which separate voting rights from economic interests, and as key developments in the strengthening of shareholder power.[41] Activist investors are deemed to be benevolent champions for the other non-controlling shareholders.[42]

Complicating this picture is the representation of both types of equity investors, marginal traders and institutional investors, by a group of agents that can be called 'money managers' or 'asset managers'. Corporate life means life with these money managers for actors involved with listed companies, whether they are board members, management, or other employees. The 'owners'[43] that managers and board members of productive firms deal with are largely anonymous due being represented by such 'money managers'

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[36] Proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, COM(2014) 213 final ('Commission Proposal'), 12.
[37] See Mähönen et al, 'Stewardship Norwegian-style'; G. Goto, A.K. Koh and D.W. Puchniak, 'Diversity of Shareholder Stewardship in Asia: Faux Convergence' (2020) 53 *Vanderbilt Journal of Transnational Law*, 829.
[38] A.A. Alchian and H. Demsetz, 'Production, Information Costs, and Economic Organization' (1972) 62:5 *The American Economic Review*, 777; M.C. Jensen and W.H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics*, 305.
[39] W.W. Bratton and M.L. Wachter, 'The Case Against Shareholder Empowerment', (2010) 158 *University of Pennsylvania Law Review*, 653, 662.
[40] Sjåfjell, Johnston, Anker-Sørensen and Millon, 'Shareholder Primacy: The Main Barrier to Sustainable Companies', p. 79.
[41] I. Anabtawi and L.A. Stout, 'Fiduciary Duties for Activist Shareholders' (2008) 60 *Stanford Law Review*, 1255, 1280–1281; V. Harper Ho, '"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide' (2010) 36 *The Journal of Corporation Law*, 59, 66.
[42] Generally, see R.J. Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119:6 *Harvard Law Review*, 1641.
[43] In the legal sense, shareholders of course do not own the company they have invested in. They own shares that bring rights and duties in the company.

buying and selling securities. Money managers furthermore operate to achieve a balance between quarterly results to keep the corporate management sharp and long-term investments to keep the companies growing.[44] Most corporate literature is, however, focussed on the duties of corporate managers and board member towards these 'owners'.[45]

Financial intermediaries, due to institutional shareholder complexity, are now at the centre of corporate ownership and of debate. This further reflects how the capital of forced capitalists is put to work and how the mountain of shares owned for their benefit is used to influence the management of listed companies, is no longer determined by the forced capitalists or the board members of the productive companies, but by these intermediaries or to be exact their 'money managers'.[46] As stated in the *G20/OECD Principles of Corporate Governance*, the real world of corporate governance and ownership is therefore no longer characterised by a straight and uncompromised relationship between the performance of the company and the income of the ultimate beneficiaries of shareholdings.[47]

There has also been a normative change. The increasing power of institutional investors searching worldwide for investment opportunities has been accompanied by their vocal calls for effective governance. Firms seeking to obtain capital in international securities markets will therefore be compelled to adjust their governance practices to meet the expectations of potential activist institutional investors. Pressures from foreign institutional investors to improve standards of behaviour, financial reporting, board accountability, and shareholder activism has furthermore stimulated the development of codes of good governance.[48] A primary example of these are the 'stewardship codes' modelled by the *UK Stewardship Codes*.[49] The perceived shift in the corporate governance role of corporate shareholders, 'stewardship', is therefore due to the change in controlling structures from dispersed shareholdings to more concentrated ones of institutional shareholders.[50]

These conflicting interests, short-termism and regulation, all impose costs and externalities. Money managers, however, reductively focus on equity returns. They therefore turn a blind eye to any consideration of the externality effects or the larger economic outcomes upon the economy for its citizens.[51] End-user investors such as

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[44] The Economist, 'Reinventing the company: Entrepreneurs are redesigning the basic building block of capitalism', *The Economist*, 24 October 2015, from the print edition, available at www.economist.com/news/leaders/21676767-entrepreneurs-are-redesigning-basic-building-block-capitalism-reinventing-company?frsc=dg%7Cd.

[45] See, for instance, Strine, 'One Fundamental'.

[46] Strine, 'Toward Common Sense', 4–5.

[47] OECD, *G20/OECD Principles of Corporate Governance* (Paris: OECD Publishing, 2015), p. 29. http://dx.doi.org/10.1787/9789264236882-en.

[48] R.V. Aguilera and A. Cuervo-Cazurra, 'Codes of Good Governance Worldwide: What is the Trigger?' (2004) 25:3 *Organization Studies*, 417, 430.

[49] Financial Reporting Council, The UK Stewardship Code, July 2010; Financial Reporting Council, The UK Stewardship Code, September 2012; Financial Reporting Council, The UK Stewardship Code 2020; see Hill, 'Good Activist/Bad Activist'. On stewardship codes generally see Katelouzou and Puchniak (eds.), *Global Shareholder Stewardship: Complexities, Challenges and Possibilities*.

[50] Hill, 'Good Activist/Bad Activist', 499.

[51] Strine, 'Can We Do Better', 461.

employees, saving for retirement benefits, depend on their portfolios' ability to generate sustainable long-term growth. Short-term bubbles in equity prices caused by money managers therefore come at the expense of their need for more durable and higher long-term growth, and so the need for sustainability. The system of forced capitalism is so very counterproductive for its ultimate beneficiaries, but also for society as a whole. Further empowering money managers with short-term holding periods will subject employees to lower long-term growth and job creation, to wreckage from corporate failures due to excessive risk taking and debt, and the collateral harm caused when corporations face strong incentives to cut regulatory corners to maximize short-term profits.[52]

The fundamental question about shareholder activism is whether it creates societal value, measured as value in the target company and in society as a whole.[53] Yet, paradoxically, the institutional investors in Europe are seen as being an increasingly active force for *sustainable finance*. The HLEG urged, in its Interim report, a more 'active responsible ownership', and use of corporate governance and stewardship codes (for example the UK Stewardship Code) as tools to increase sustainability in the investment community, by making institutional shareholders more effective in holding firms to account.[54] The HLEG also proposed, as a recommendation, the development of 'a set of European stewardship principles (building on established principles) that incorporate active ownership and long-term value creation'.[55]

The purpose of this chapter is to focus on the activism of institutional investors and the impact of that activism on both the target productive companies and their ultimate beneficiaries, and how they could be incentivised to more sustainable behaviour in their activism. The focus is on the European Union. However, the markets for institutional investors are global. A broader perspective including, for example, North America and Asia is therefore taken. The most important impact of institutional activism is arguably normative, causing changes in corporate governance. Specific attention is therefore given to governance questions.

The structure of the remainder of the Chapter is as follows. In section 2 I discuss the nature of shareholder activism in general, in both the US and in Europe. In section 3 I discuss the possibilities for activism for sustainability, and particularly how law should respond to the challenge from activists for sustainability. The Chapter ends with conclusions in section 4.

2 Age of activism: the voyage across the Atlantic

Shareholder activism has its roots in the 1980s' hostile 'corporate raiders'.[56] The picture has, however, become more colourful, more critical and more robust, as has the idea of the purpose of a listed company and the agency relationships prevailing in it. Globalization and the rapid growth in international financial markets increased the presence of US style institutional investors all over the world. Institutional investors such

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[52] Ibid., 459.

[53] Denes, Karpoff and McWilliams, 'Thirty years of shareholder activism', 409.

[54] HLEG Interim Report, 26 (using the French, German and Dutch codes as positive examples).

[55] Ibid., 61.

[56] See e.g. P.H. Eddey, 'Corporate Raiders and Takeover Targets' (1991) 18 *Journal of Business Finance & Accounting*, 151.

as pension funds have become important capital providers, particularly in equity markets which otherwise struggle to provide sufficiently accessible capital. The presence of Anglo-American institutional investors in the global equity market therefore acted as a catalyst for the worldwide diffusion of corporate governance practices.[57] Pension funds and other institutional investors, especially hedge funds and mutual funds, have changed the behaviour of especially 'independent' board members to one in which they are more willing to compromise with the short-term interest of activists, than stand on principle for a company's long-term interest. This change has been facilitated by withhold campaigns, proxy contests, proposals to eliminate takeover defences, proposals to increase shareholder power in key areas of corporate decision-making, and campaigns to change corporate business plans.[58] These tactics also include letter writing, litigation, publicity campaigns. They also include dialogue with corporate management or the board, and just asking questions at general meetings and filing formal shareholder proposals.[59]

Activists ultimately also affect the law. For example US corporate law makes corporate managers accountable to only one constituency (the shareholders), this accountability being tightened because market developments have concentrated voting power in the hands of institutional investors and because information technology innovations have made communication and joint action among shareholders easier.[60] The idea of the sole purpose of a US public corporation being to maximize financial gain for its shareholders is not new.[61] The concept of '*shareholder primacy*' has, through activism, however come to be widely accepted among practitioners. Activism therefore represents, in practice and in law, a new and radical shift from the passive, dispersed, and faceless individual shareholders described by *Adolf Berle* and *Gardiner Means*.[62]

Institutional investors have, through the power provided by forced capitalism, been able to challenge the managers and board members of the companies they invest in on a variety of issues. This includes urging firms to make structural changes to their boards and redesign firm voting procedures. Leading US institutional investors such as the *California Public Employees' Retirement System* (CalPERS) for example believe that 'good governance is good business', and therefore by default creates shareholder value. CalPERS had, as early as 1996, established a specific corporate governance office to pressure domestic and international firms to adopt shareholder-friendly proposals and other measures designed to improve share performance.[63] The rise of institutional investors has therefore not been caused by market forces alone. US regulation was also an important force in urging, for example pension funds in particular, to activism. The Employee Retirement Income Security Act of 1974 (ERISA) and similar state regulation (such as the California Constitution for CalPERS) set a mandatory trust structure for most private pension and retirement accounts through a 'prudent investor standard' requiring fiduciaries to act

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[57] Aguilera and Cuervo-Cazurra, 'Codes of Good Governance', 430.

[58] L.E. Strine, Jr., 'Making It Easier for Directors to 'Do the Right Thing'?' (2014) 4 *Harvard Business Law Review*, 235,239.

[59] R.V. Aguilera, K. Desender, M.K. Bednar and J.H. Lee, 'Connecting the Dots: Bringing External Corporate Governance into the Corporate Governance Puzzle' (2015) 9:1 *The Academy of Management Annals*, 483, 535.

[60] Strine, 'Making It Easier', 241–242.

[61] See *Dodge* v. *Ford Motor Company*, 170 NW 668 (Mich 1919).

[62] A.A. Berle and G.C. Means, *The Modern Corporation and Private Property* (New York: The Macmillan Company, 1932).

[63] Aguilera and Cuervo-Cazurra, 'Codes of Good Governance Worldwide', 430.

exclusively and solely in the interests of the fund's beneficiaries.[64] This exclusive and mandatory focus on the financial benefits obtained for beneficiaries distinguishes US pension law from that in the UK and Europe, which is more tolerant of non-financial investment factors such as ESG.[65]

Not all institutional investors nor their activism are, however, similar. Shareholder activism is a more recent phenomenon in Europe than in the US,[66] and European regulation of pension funds and companies is also more tolerant of ESG investing than the US equivalent. For example, Norwegian domestic institutional investors have long been interested in activism,[67] and investor engagement in Sweden, due to shareholder friendly corporate governance, has in recent years led to both domestic activism and foreign activism towards management. Nordic activism, which is based on dialogue with boards rather than confrontation, is 'softer' and more long term oriented than for example in the US.[68] Shareholder activism is also generally viewed in Europe in a far more positive light than in the US, as illustrated by the European Commission's desire to increase shareholders' say in European listed companies and by a neutral attitude towards hedge funds and proxy advisors working with them. According to the EU 2012 Company Law Action Plan, an effective corporate governance framework is of crucial importance, and so is the shareholders' role in the promotion of corporate governance, which can have a positive effect on both the company's and its shareholders interests.[69] In the 2014 European Commission proposal for amending SHRD I with SHRD II, the Commission iterated that effective and sustainable shareholder engagement is one of the cornerstones of listed companies' corporate governance model.[70] It also iterated that effective shareholder control is a pre-requisite for sound corporate governance and should therefore be facilitated and encouraged.[71]

3 Activism for sustainability

3.1 How to regulate investors to sustainability?

Is there then hope for sustainable shareholder activism as the EU HLEG for example claims, or is it a mission impossible? The stewardship trend sends a mixed message, as the Danish example shows. In January 2016 the Danish Minister of Business and Growth requested that the Danish Committee on Corporate Governance, which is responsible for

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[64] See M.M. Schanzenbach and R.H. Sitkoff, 'Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee' (2020) 72 *Stanford Law Review*, 381, 384, 394.

[65] Schanzenbach and Sitkoff, 'Reconciling', 3, 15–16. According to Schanzenbach and Sitkoff (p. 15–16), the US position reflects a 'paternalistic public policy of protecting the financial security of a retired worker against poor spending and investment decisions by her younger self.'.

[66] D. Katelouzou, 'Worldwide Hedge Fund Activism: Dimensions and Legal Determinants' (2015) 17:3 *University of Pennsylvania Journal of Business Law*, 789, 791–792.

[67] B. Scholtens and R. Sievänen, 'Drivers of Socially Responsible Investing: A Case Study of Four Nordic Countries' (2013) 115 *Journal of Business Ethics*, 605.

[68] See Mähönen and Johnsen, 'Law, culture and sustainability'; Mähönen et al, 'Stewardship Norwegian-style'.

[69] European Commission, Company Law Action Plan, 3.

[70] Commission Proposal, 12; see in detail K. Reynisson, 'Related Party Transactions: Analysis of proposed Article 9c of Shareholders' Rights Directive' (2016), 13:5 *European Company Law*, 175–182.

[71] Para 3 of the Preamble of the Commission Proposal.

the Danish Corporate Governance Codes,[72] drafted a stewardship code 'in order to encourage the kind of stewardship in Danish listed companies that is beneficial to their value creation'.[73] The Code, published in November 2017, consists of seven principles - engagement policy, monitoring and dialogue, escalation,[74] collaboration with other investors, voting policy, conflicts of interest, reporting. The aim of the Stewardship Code is, according to the Danish Committee on Corporate Governance, similar to that of its Corporate Governance Code and is 'to promote the companies' long-term value creation and thereby contribute to maximising long-term return for investors'. The Codes therefore 'are mutually reinforcing in serving a common purpose'.[75] Birkmose and Madsen consider that it would be better, instead of working with two parallel codes, to seek a closer integration between the duties of the institutional investors and asset managers and the duties of the boards of the investee companies. SHRD II is, however, unlikely to have much effect on Danish stewardship due to the many parallels with the existing Stewardship Code.[76] The Danish Corporate Governance Code was revised in 2020 to reflect the implementation of SHRD in Denmark. Unlike the previous codes, the 2020 Code is based on sustainability and long-term value creation as a company's purpose.[77]

There is however no one single type of activist shareholder, despite the focus in the international discussion on short-term-focused activists such as hedge funds. The focus in the more positive European discussion is, however, on money managers. Action 7 of the European Commission Action Plan *Financing Sustainable Growth* states that EU law requires institutional investors and asset managers to act in the best interest of their end-investors or beneficiaries. Institutional investors and asset managers do not systematically consider sustainability factors and risks in the investment process, nor do they sufficiently disclose to their clients whether and how they consider these sustainability factors in their decision-making. As the Commission stated, end-investors may not therefore receive the full information they require to be able to take into account sustainability-related issues in their investment decisions. Investors therefore and as a result of this, do not take the impact of sustainability risks sufficiently into account when assessing the performance of their investments over time.[78]

The investment motives and horizons of institutional investors may, despite possible fiduciary duties and disclosure rules, differ materially.[79] They can vary widely from 'fearless defenders of long-term investors to short-term profit maximization seekers to

[72] The Committee on Corporate Governance, Recommendations for corporate governance 2005–2020, available at https://corporategovernance.dk/recommendations-corporate-governance.
[73] The Committee on Corporate Governance, Stewardship Code (November 2016) (Danish Stewardship Code), 3, available at https://corporategovernance.dk/stewardship-code.
[74] 'Escalation' means enlarging stewardship activities beyond regular monitoring and dialogue; Danish Stewardship Code, 8.
[75] Danish Stewardship Code, 3.
[76] H.S. Birkmose and M.B. Madsen, 'The Danish Stewardship Code – The past, the present and the future' in Katelouzou and Puchniak (eds.), *Global Shareholder Stewardship: Complexities, Challenges and Possibilities*, also available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3533834.
[77] Danish Committee on Corporate Governance, Danish Recommendations on Corporate Governance (2 December 2020), 3, 7, available at https://corporategovernance.dk/sites/default/files/media/anbefalinger_for_god_selskabsledelse_engelsk.pdf.
[78] European Commission, Action Plan, 8.
[79] J.C. Coffee and D. Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2015), 521 *Columbia Law and Economics Working Paper*, 104, available at SSRN http://ssrn.com/abstract=2656325.

social activists with non-financial agendas'.[80] There are two key motivations for engaging in activism. Financial motivation (to increase shareholder value) and social motivation (such as to divest from conflict zones, and adopt corporate social responsibility practices). What is, however, clear is that activists such as hedge funds have contributed to a fundamental change in the division of powers between corporate organs in listed companies. This is particularly so in the US, where board selection has traditionally been staggered to prevent sudden policy changes. It is also so where the board has been vested with general competence in material and fundamental decisions, such as in the People's Republic of China or the Nordic countries, but not in for example the UK. The UK abandoned a management-centric governance model in the mid-twentieth century, opting for an American-style shareholder-centrist model of director accountability to shareholders, as explicitly shown from 1948 to 2006 in the Companies Acts.[81] The corporate governance environment has simultaneously changed decisively in the United States since the 1980s, due to the activism of shareholders such as hedge funds. This has narrowed the board's competence and expanded the competence of the annual general meeting, in particular in board member selection and in major corporate transactions.[82] The role of shareholders in non-Anglo-American jurisdictions has, however, also strengthened due to legislative actions such as SHRD II in the EU, or influential control-holders such as in the Nordic countries, China and other Asian countries.

The key to the differences between ESG and non-ESG investing is therefore regulation, and whether it is restrictive, permissible or mandatory for sustainable finance. Three alternatives are proposed: increasing shareholder rights, increasing disclosure and reforming company law in a more fundamental way.

3.2 Increasing shareholders' rights?

Those hoping for greater institutional investor commitment to sustainable finance have contributed to empowerment projects such as the stewardship codes or to the EU SHRD II.[83] These projects are, however, unlikely to achieve success, because they do not truly create incentives to act in accordance with them for institutional investors.[84] On the contrary, passive investors eagerly ally with activists who have the opportunity to, through shareholder empowerment, achieve a short-term abnormal return through a promise of dividends and share buy-backs. Passive investors therefore can quickly ignore the lip service they have paid to long-term return development.[85] An exception might be public institutional investors, whose management remuneration is moderate and is not tied to the institutional investor's income.[86] However, as stated in the UK Stewardship Code, the core goal of stewardship or active ownership is, at the end of the day, the 'enhancing and protecting . . . [of] value for the ultimate beneficiary or client.'[87] The

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[80] Aguilera, Desender, Bednar and Lee, 'Connecting the Dots', 534–535.

[81] A. Johnston, 'Market-Led Sustainability through Information Disclosure: The UK Approach' in Sjåfjell and Bruner (eds.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Chapter 15.

[82] Strine, 'One Fundamental', 13–16; Coffee and Palia, 'The Wolf at the Door', 18 and 100.

[83] See Rock, 'Institutional Investors', 15–17.

[84] Gilson and Gordon, 'The Agency Costs of Agency Capitalism', 888; Rock, 'Institutional Investors', 13.

[85] See Katelouzou, 'Worldwide Hedge Fund Activism', 792 and the examples therein.

[86] Gilson and Gordon, 'The Agency Costs of Agency Capitalism', 889.

[87] UK Stewardship Code, 6.

stewardship codes, in that sense, enhance short-term activism. The same applies in a clearer way to, for example, the Danish stewardship code.

No matter how attractive the idea in theory is, efforts to increase shareholders' rights are a risk to a company's interests where active shareholders' interests differ and there is no evidence of their positive impact on the company's long-term value. The ideal situation is where efforts to increase shareholders' rights do not discourage those investors who wish the company's best and who want to create added value, and also where bad corporate raiders and seekers of suboptimal returns can be prevented from gaining control through acquisitions. This is, however, unfortunately impossible.[88] The examples show that the first to suffer from activists' attacks on corporate management is the long-term corporate interest.[89]

There is furthermore a counter-effect. The focus when analysing in detail the European regulation for encouraging a more long-term engagement of shareholders, is solely on shareholder identification, the transmission of information, the facilitation of the exercise of shareholders rights and the oversight of executive remuneration policies.[90] SHRD II gives the right to listed companies to identify their shareholders and requires intermediaries to cooperate in that identification process. It also aims to improve the listed companies' communication with their shareholders, in particular the transmission of information along the chain of intermediaries and requires intermediaries to facilitate the exercise of shareholder rights. The Commission Implementing Regulation[91] even aims to prevent the diverging implementation of the provisions of the Directive.[92]

3.3 Disclosure only or something more?

Repealing prohibiting regulation and just facilitating and mandating investors to participate in active sustainable investing seems to not be enough however, because there are no market incentives. The Action Plan builds upon recommendations presented by the HLEG Final report and (unlike the Commission's Company Law Action Plan) is cautiously (re)taking a more regulatory path. The Action Plan has three main objectives: reorient capital flows towards sustainable investment to achieve sustainable and inclusive growth; manage financial risks stemming from climate change, environmental degradation and social issues; and foster transparency and long-termism in financial and economic activity.[93]

The Commission emphasises, in particular, that current EU rules on the duty of institutional investors and asset managers to consider sustainability factors and risks in investment decision processes, are not sufficiently clear nor consistent across sectors (see

[88] L. Enriques and M. Gatti, 'Creeping Acquisitions in Europe: Enabling Companies to Be Better Safe than Sorry' (2014) 15:1 *Journal of Corporate Law Studies*, 55.

[89] See Coffee and Palia, 'The Wolf at the Door', 5–6 and 9–10.

[90] See European Commission, Company Law Action Plan, 7–11.

[91] Commission Implementing Regulation (EU) 2018/1212 of 3 September 2018 laying down minimum requirements implementing the provisions of Directive 2007/36/EC of the European Parliament and of the Council as regards shareholder identification, the transmission of information and the facilitation of the exercise of shareholders rights, OJ L 223, 4.9.2018, 1.

[92] See preamble of the Commission Implementing Regulation.

[93] European Commission, Action Plan, 2.

above in section 3.1).[94] The Commission, to tackle this problem, proposed Action 7 to clarify institutional investors' and asset managers' duties. The Commission promised, subject to the outcome of an impact assessment, to table a legislative proposal to clarify institutional investors' and asset managers' duties in relation to sustainability considerations. The proposal will aim to (i) explicitly require institutional investors and asset managers to integrate sustainability considerations in investment decision-making processes and (ii) increase transparency towards end-investors on how they integrate such sustainability factors in their investment decisions, in particular their exposure to sustainability risks.[95]

As a first step, the Commission in May 2018 issued its proposal for a regulation for the disclosure obligations for institutional investors and asset managers of how they integrate environmental, social and governance (ESG) factors in their risk processes. Requirements to integrate ESG factors in investment decision-making processes as part of their duty towards investors and beneficiaries, will be further specified through delegated acts.[96] The Regulation was issued in November 2019, and will enter into force in March 2021.[97] The Disclosure Regulation applies to 'financial market participants'[98] and 'financial advisers'.[99] The Regulation adds directly applicable disclosure

[94] European Commission, Action Plan, 8.

[95] European Commission, Action Plan, 8–9.

[96] European Commission, Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, COM(2018) 354 final.

[97] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, PE/87/2019/REV/1, OJ L 317, 9.12.2019, 1.

[98] The definition of financial market participant in Article 1(1)-(10) of the Disclosure Regulation includes

- insurance undertakings which make available an insurance-based investment product (IBIP)
- investment firms as defined in Article 4(1)(1) of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12.6.2014, 349 (MiFiD II Directive) which provides portfolio management
- institutions for occupational retirement provision
- manufacturers of a pension product
- alternative investment fund managers (AIFMs)
- pan-European Personal Pension Product providers
- managers of a qualifying venture capital fund registered in accordance with Article 15 of Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds, OJ L 115, 25.4.2013, 1 (EuVECA Regulation)
- managers of qualifying social entrepreneurship funds registered in accordance with Article 15 of Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds, OJ L 115, 25.4.2013, 18 (EuSEF Regulation]
- management companies of undertakings for collective investment in transferable securities (UCITs)
- credit institutions which provide portfolio management.

[99] The definition of financial adviser in Article 1(11) of the Disclosure Regulation includes

- insurance intermediaries which provide insurance advice on IBIPs
- insurance undertakings which provide insurance advice on IBIPs
- credit institutions which provide investment advice
- investment firms which provide investment advice
- AIFMs which provide investment advice in accordance with Article 6(4)(b)(i) of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.7.2011,1 (AIFM Directive)

requirements to sectoral legislation such as the UCITS Directive,[100] the AIFM Directive, the MiFID II Directive, the Solvency II Directive,[101] and the IDD Directive.[102]

Financial market participants and financial advisors must, according to the Regulation, disclose on their websites information on their policies on the integration of sustainability risks in their investment decision-making processes. If they consider the principal adverse impacts of investment decisions on sustainability factors, or if they employ more than 500 people, then they are to provide a statement of due diligence policies for these principal adverse impacts. If they do not consider any adverse impacts of investment decisions on sustainability factors, then clear reasons are to be given for not considering this and, where relevant, it is to be clearly stated whether and when they intend to consider such adverse impacts. Information is also to be provided on how their remuneration policies are consistent with the integration of sustainability risks.

Financial market participants and financial advisors must also disclose, as part of their pre-contractual disclosure obligations, the manner in which sustainability risks are integrated into their investment decisions. This disclosure is to include the result of the assessment of the likely impacts of sustainability risks on the returns of their funds or portfolios. If sustainability risks are deemed not to be relevant, then a clear and concise explanation of why they are not relevant is to be given. If principal adverse impacts of investment decisions on sustainability factors are considered, or if they employ more than 500 people, then a clear and reasoned explanation of whether and how that fund or portfolio considers principal adverse impacts on sustainability factors is to be provided within 3 years of the entry into force of the Disclosure Regulation, for each fund or portfolio that they offer. A statement on principal adverse impacts on sustainability factors is to be provided in periodic reports. If the adverse impacts of investment decisions on sustainability factors are not considered, then a statement that the asset manager does not consider the adverse impacts of investment decisions on sustainability factors, and a reasoned explanation for not doing so, are to be provided.

The Disclosure Regulation is an important step. Market transparency is also an important corporate governance aim, as it is considered to be able to bring reputational benefits for companies and more legitimacy in the eyes of stakeholders and society as a whole.[103] The enhancement of transparency and shareholder engagement also, according to the Company Law Action Plan, go hand in hand.[104]

- UCITS management companies which provide investment advice in accordance with Article 6(3)(b)(i) of the MiFiD II Directive.

[100] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302 17.11.2009, 32.

[101] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), OJ L 335, 17.12.2009, 1.

[102] Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast), OJ L 26, 2.2.2016, 19.

[103] Para 5 of the Preamble of the Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting ('comply or explain') 2014/208/E, OJ L 109, 12.4.2014, 43; K. Reynisson, 'Related Party Transactions', 176.

[104] European Commission, Company Law Action Plan, 3, 4.

Transparency rules are important. They do, however, contain risks for sustainability. The Commission recognised the importance, in the Action Plan, of ensuring that accounting standards do not directly or indirectly discourage sustainable and long-term investments. Greater flexibility in the endorsement of International Financial Reporting Standards is therefore required to allow specific adjustments that would be more conducive to long-term investment.[105] The Commission emphasized an appropriate balance between flexibility and the standardisation of disclosure necessary to generate the data needed for investment decisions, through endorsing the so called Non-financial Reporting Directive.[106] This allows the disclosure of material information on key environmental, social and governance aspects and on how risks stemming from them are managed in a 'flexible manner'. The main problem, however, is that sustainability in these reports has remained biased due to a lack of a true sustainability basis in the reports. The meanings of sustainability, corporate social responsibility and related terms are ambiguous, and companies are therefore often uncertain how to define and implement sustainability.[107]

3.4 Harder line: Should company law respond to the activists?

One can turn, as the third alternative, to the target companies and their regulation as an answer to the potential activist threat. Contrary to that believed by the international corporate governance community, the effectiveness and the credibility of the corporate governance framework and company oversight cannot depend solely on the willingness and ability of institutional investors to make informed use of their shareholder rights, and to effectively exercise their ownership functions in the companies in which they invest.[108] If our conclusion is that shareholder primacy activists (or shareholders in general) in a free-market mostly create harm and only by coincidence create good for sustainable value creation, then preventing the devastating impact of activists through company law is difficult as the attempt itself may cause companies more harm than good. The starting point as such is simple. We should protect the 'good' activists from the 'evil' activists, because the evil activists may also infect the good investors. This is, of course, only a defensive victory. As long as shareholders have (and is one of the main axioms of company law) the last word on board composition, then activists cannot be prevented from sooner or later shortening the planning horizons of companies, so preventing them from long-term investment and curbing companies' commitment to research and development.[109]

It is, however, possible to slow them by using company law. European company law is still board oriented, despite the shareholder primacy drive and being strengthened by EU regulation (foremost SHRD II). Activists' entry cannot be prevented in a free market. The price they must pay for influence should, however, not be too low. The best interests of the ultimate beneficiaries are served by empowering a strong central authority (the

[105] European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth (8.3.2018, COM/2018/097 final), p. 10, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097#footnoteref34.

[106] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15.11.2014, p. 1–9.

[107] N. E. Landrum and B. Ohsowski, 'Identifying Worldviews on Corporate Sustainability: A Content Analysis of Corporate Sustainability Reports' (2018) 27 *Business Strategy and the Environment*, 128–151, 130.

[108] Cf. G20/OECD Principles of Corporate Governance, 30.

[109] Coffee and Palia, 'The Wolf at the Door', 105.

board) to make business decisions and not by interfering with its un-conflicted judgments.[110] The best way to ensure that corporations generate sustainable wealth for diversified shareholders is therefore to give the boards and managers a strong hand to take and manage risks and implement business strategies, without the constant disruption of shifting short-term market sentiments and without fearing displacement of themselves or those strategies by shareholders.[111]

The Action Plan can be seen to be a cautious step in this direction. Corporate governance can, according to the Commission, 'significantly contribute to a more sustainable economy, allowing companies to take the strategic steps necessary to develop new technologies, to strengthen business models and to improve performance. This would in turn improve their risk management practices and competitiveness, thus creating jobs and spurring innovation.'[112] The Commission promises in Action 10 to assess (i) the possible need to require corporate boards to develop and disclose a sustainability strategy, including appropriate due diligence throughout the supply chain, and measurable sustainability targets; and (ii) the possible need to clarify the rules according to which directors are expected to act in the company's long-term interest. The Commission invited the ESAs to collect evidence of undue short-term pressure from capital markets on corporations, and to consider any necessary further steps based on such evidence. The Commission more specifically invited ESMA to collect information on undue short-termism in capital markets, including (i) portfolio turnover and equity holding periods by asset managers; (ii) whether there are any practices in capital markets that generate undue short-term pressure in the real economy.

The Commission in February 2019 invited ESAs to each develop a report that presents initial evidence of potential pressures from the financial sector on corporations to prioritise near-term shareholder interests over the long-term growth of the firm. Qualitative sources and relevant literature should be complemented in the evidence gathering and, where feasible, by quantitative evidence such as data from public and commercial databases. The Commission also expected the ESAs to engage with the most relevant stakeholders, to develop the requested report. The request aimed at providing a pragmatic approach towards delivering the requested report by the ESAs, the deadline for the report being the end of 2019.[113]

EBA, EIOPA and ESMA advice was published on 18 December 2019.[114] ESMA recommended improvements in issuers' ESG disclosures by developing European

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[110] K.J. Arrow, 'Scale Returns in Communication and Elite Control of Organizations' (1991) 7 *The Journal of Law, Economics & Organization*, 1, 6; Bratton and Wachter, 'The Case Against', 660; Strine, 'Can We Do Better', 455 fn 19.

[111] Strine, 'Can We Do Better', 455; 457.

[112] European Commission, Action Plan, 11.

[113] European Commission, Cover letter to the call for advice to the European Supervisory Authorities to collect evidence of undue short-term pressure from the financial sector on corporations, 1 February 2019, https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190201-call-for-advice-to-esas-short-term-pressure-cover-letter_en.pdf.

[114] The European Securities and Markets Authority (ESMA), Report: Undue short-term pressure on corporations, ESMA30-22-762 (18 December 2019), available at www.esma.europa.eu/press-news/esma-news/esma-proposes-strengthened-rules-address-undue-short-termism-in-securities; European Banking Authority (EBA), EBA report on undue short-term pressure from the financial sector on corporations (18 December 2019), available at https://eba.europa.eu/eba-calls-banks-consider-long-term-horizons-their-strategies-and-business-activities; European Insurance and Occupational Pensions Authority (EIOPA),

regulation and international harmonization of disclosure frameworks, and by enhancing institutional investor engagement, for example by a review of SHRD II and of whether it effectively encourages long-term engagement. The EBA highlighted the need to promote long-term approaches, a robust regulatory prudential framework as a pre-condition for long-term investments and the disclosure of long-term risks and opportunities. The EIOPA recommended long-term performance benchmarks.

The market for shareholders' corporate influence should be in balance with the wide *competence* of the board and its *business judgment* safe harbour. The control and representation of the corporation should therefore be a part of the board's competence, not the shareholders'. The board also enjoys broad discretion under existing law to consider its best business judgement in fulfilling the company's interests. These legal firewalls protect a strong board from its shareholders, although the shareholder empowerment movement tends to compel the board to focus solely on shareholder wealth maximisation.[115] The law is, however, behind the board. Most jurisdictions in Europe also follow a 'business judgment rule', guiding the courts not to second-guess the management's business decisions.[116] Shareholder centrism is a 'market norm' or social norm, not a legal rule.[117]

The heterogeneity of shareholder (and general stakeholder) interests makes centralised decision-making by the board more, not less, essential to the efficient sustainable management of the firm.[118] This is especially important in those jurisdictions which have (so far) followed 'enlightened shareholder value' models, such as the UK[119] or Finland.[120] This emphasises long-term shareholder value and the requirement that the board considers the effects of their decisions on 'extended stakeholder constituencies'.[121] The board should on the other hand know the business, and should keep the management on a short leash. CEOs and management who are insulated from shareholder pressure and who do not receive high-power pay, are less prone to engage in risk-taking.[122] Conversely, equity-based pay, and so greater shareholder orientation, and greater risk-taking in

Advice: Potential undue short-term pressure from financial markets on corporates: Investigation on European insurance and occupational pension sectors: Search for evidence, Year-end 2018, EIOPA-BOS-19-537 (18 December 2019), available at www.eiopa.europa.eu/content/potential-undue-short-term-pressure-financial-markets_en.

115 Harper Ho, '"Enlightened Shareholder Value"', 61.

116 Sjåfjell, Johnston, Anker-Sørensen and Millon, 'Shareholder Primacy', 96; B. Sjåfjell, J.T. Mähönen, A. Johnston and J. Cullen, 'Obstacles to Sustainable Global Business. Towards EU Policy Coherence for Sustainable Development' (2019) 2019-02 *University of Oslo Faculty of Law Research Paper*, 32-34, available at SSRN: https://ssrn.com/abstract=3354401.

117 C.M. Bruner, 'Conceptions of Corporate Purpose in Post-Crisis Financial Firms' (2013) 36 *Seattle University Law Review*, 527, 530, 532.

118 Harper Ho, '"Enlightened Shareholder Value"', 69, referring to S.M. Bainbridge, 'The Case for Limited Shareholder Voting Rights' (2006) 53 *UCLA Law Review*, 601.

119 For instance section 172 of the UK Companies Act of 2006, c. 46.

120 J. Mähönen, 'Finland: corporate governance: Nordic tradition with American spices' in A. Fleckner and K. Hopt (eds.), *Comparative Corporate Governance: A Functional and International Analysis* (Cambridge: Cambridge University Press, 2013), p. 393.

121 Harper Ho, '"Enlightened Shareholder Value"', 79.

122 L.A. Bebchuk & H. Spamann, 'Regulating Bankers' Pay' (2010) 98 *Georgetown Law Journal*, 247, 262; C.M. Bruner, 'Conceptions of Corporate Purpose in Post-Crisis Financial Firms' (2013) 36 *Seattle University Law Review*, 527, 552.

financial firms tend to associate with the run-up to the financial crisis.[123] This requires insiders on the board.

The strategy chosen by the Commission has however, contrary to this approach of strengthening the role of the board, primarily been the opposite of this, as seen in the SHRD II. The *control rights* of institutional investors and asset managers over the corporate assets have been enhanced, to allow them a greater ability to protect their investments.[124] The most important aspect is that the focus has been on non-national institutional investors and asset managers, and their engagement.[125] In the same tone, the G20/OECD Principles urge engagement, such as a continuing dialogue between institutional investors and companies.[126] On the other hand, there is clear concern in the February 2019 call around the prevailing corporate culture that focuses on near-term performance at the expense of the mid to long-term objectives, around the influence of activist shareholder engagement that is focussed on short-term profit extraction and around short-term market pressure incentivising under-investment in long-term value drivers including innovation and human capital.[127]

4 Conclusions

The European examples illustrate that there is little future in activating passivists to sustainability without hard law. Passivists are the underdog in the free markets. Activist short-term investors are always able to engage in hedging strategies that limit their exposure if their preferred strategies for the corporation do not turn out to be sound.[128] They can always use derivatives and other financial innovations to decouple their voting power from their economic interest.[129] Other institutional investors are also of little help without strong regulation.[130] Public employee pension funds are furthermore vulnerable to being used as a vehicle for advancing political/social goals that are unrelated to shareholder interests in general.[131] The state as a market actor might, however, be in a different position. State actions are governed not only by market rationality and corporate law, but also by public law considerations. The state investor's governance structure is regulated by constitutional and administrative law, and its actions are governed by

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[123] S. Deakin, 'The Corporation as Commons: Rethinking Property Rights, Governance and Sustainability in the Business Enterprise' (2012) 37:2 *Queen's Law Journal*, 339, 341–43, 379; Bruner, 'Conceptions', 552. As an example, banks receiving bailout funds in the US had more 'independent' boards, larger boards, more outside board memberships and greater incentive pay for CEOs. See R.B. Adams, 'Governance and the Financial Crisis' (2009) 248/2009 *ECGI - Finance Working Paper*, 13, available at SSRN: https://ssrn.com/abstract=1398583.

[124] Commission Proposal 5; K. Reynisson, 'Related Party Transactions', 177.

[125] Commission Proposal, 3; K. Reynisson, 'Related Party Transactions', 177.

[126] G20/OECD Principles of Corporate Governance, 30.

[127] European Commission, Call for advice, 2.

[128] Strine, 'Can We Do Better', 455–456.

[129] H.T.C. Hu and B. Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review*, 811, 828–835; L. Anker-Sørensen, *The Multifaceted Corporate Group: Testing EU's response to hidden control structure* (Oslo: University of Oslo, 2019).

[130] Strine, 'Can We Do Better', 456.

[131] S.M. Bainbridge, *Corporate Governance After the Financial Crisis* (Oxford University Press, 2012), pp. 243–251.

judicial review.[132] Strong state market actors such as Norway are, in this sense, either directly as a shareholder in state-owned enterprises or indirectly through sovereign wealth funds, important drivers of sustainability. They also, however, have a drive to act as an index fund for maximising the benefits of their ultimate beneficiaries, the people.[133]

At the end of the day, the demands of money managers and their advocates for additional rights will compromise the ability of corporations to pursue the most profitable courses of action for those whose money is ultimately at stake, end-user investors. The board is, under the threat of a transfer of corporate influence, tempted to maintain its position by maximizing the distributable funds at the expense of the company's going concern value, so sacrificing a solid balance sheet, capital investments, research, development and ultimately jobs.[134]

How then, *in practice*, can companies be defended from activists? The typical defence tactics mentioned[135] include aggressively challenging the activists' short-term economic plans, electing shareholder-friendly board members based on the board's proposal and propagating the idea that activist board membership damages the interests of the company. Even if the other shareholders react positively to activism, that activists exist may be enough to encourage the board to perform better, without reserving seats on the board for them.

One strategy is to make shareholder activism more transparent. In Europe, the Transparency Directive[136] requires disclosure of major shareholdings where the proportion of voting rights reaches, exceeds, or falls below eight triggering thresholds ranging between 5 and 75 percent. The Member States remain free to adopt further thresholds, including lower ones, such as a 3 percent threshold in the UK or a 2 percent threshold in Italy.[137] Reducing the flagging thresholds and tightening the deadlines for flagging enables 'an activist attack' to be detected as early as possible.[138] Shareholders can

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[132] M. Kahan and E.B. Rock: 'When the Government is the Controlling Shareholder' (2011) 89 *Texas Law Review*, 1293, 1298; S. Davidoff Solomon and D. Zaring, 'After the Deal: Fannie, Freddie, and the Financial Crisis Aftermath' (2015) 95 *Boston University Law Review*, 371, 389.

[133] See, for instance, Mähönen and Johnsen, 'Law, culture and sustainability'.

[134] M. Lipton, 'Empiricism and Experience; Activism and Short-Termism; the Real World of Business' *Harvard Law School Forum on Corporate Goverance*, October 28, 2013, available at https://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/.

[135] R. Blackden, S. Foley and E. Crooks, 'Nelson Peltz fails to win board seats at DuPont' *Financial Times*, May 13 2015.

[136] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending directive 2001/34/EC, L 390, 31.12.2004, 38, as amended by Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC, OJ L 294, 6.11.2013, 13.

[137] Katelouzou, 'Worldwide Hedge Fund Activism', 809.

[138] Ibid., 809–811.

also be required to vote in their own name, not anonymously through proxy advisors.[139] For example, the Finnish Companies Act prohibits anonymous voting.[140] Other tools include making derivative arrangements transparent, requiring institutional investors to make their investment policies public, and tightening 'act in concert' regulation. These are just a few examples.[141]

These methods do not prevent shareholder activism, but make it less attractive. They are, however, not very popular in the present regulatory atmosphere. For example, The European Commission's attitude to these issues illustrates well that even where it proposes making proxy advisors' actions more transparent,[142] that this does not address the material problems associated with them.[143]

The third and the only long-term feasible alternative is to set both the productive companies' and also the institutional investors' boards specific fiduciary duties to being to act in the best interest of their end-investors and ultimate beneficiaries, as suggested by the HLEG in its Final Report in January 2018 and endorsed by the European Commission in its Action Plan on sustainable finance in March 2018. As emphasised in the Action Plan, several pieces of EU legislation already require institutional investors and asset managers to act in the best interest of their end-investors/beneficiaries.[144] To tackle these problems, the Commission suggested Actions 7 and 10, fostering sustainable corporate governance, attenuating short-termism in capital markets and clarifying institutional investors' and asset managers' duties. The Disclosure Regulation, implementing Action 7, is the first step on this path. The real challenge is, however, the Commission's ambitious sustainable corporate governance initiative, which aims to improve the overall EU regulatory framework on company law and corporate governance. This can enable companies to focus on long-term sustainable value creation rather than short-term benefits. It also aims to better align the interests of companies, their shareholders, managers, stakeholders and society, and help companies to better manage sustainability-related matters in their own operations and value chains in, for example, terms of social and human rights, climate change, and the environment.[145] The key issues are the definition of company purpose and board duties, including due diligence duties, in the Company Law Directive[146] and the shareholders' rights in SHRD II.

Traditional company law should not, however, be ignored. Shareholder-centred corporate governance legislation, which was previously promoted by the Commission, appeals to activists. Minority protection rules in European company law in particular play

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[139] Ibid., 811.

[140] See § 5:6(2) second sentence of the Finnish Companies Act.

[141] Katelouzou, 'Worldwide Hedge Fund Activism', 811–818.

[142] See Article 3 i(1) of the Commission Proposal.

[143] See, however, Coffee and Palia, 'The Wolf at the Door', 95–96 in which they make similar types of transparency proposals as the Commission in its proposal.

[144] The Solvency II Directive, the IORP Directive (Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs), OJ L 354, 23.12.2016, 37), the UCITS Directive, the AIFM Directive and the MiFID II Directive.

[145] European Commission, Sustainable corporate governance, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance.

[146] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law. OJ L 169, 30.6.2017, 46.

a key role in curbing corporate control opportunism.[147] It is difficult to weaken the most typical influence-enhancing tools used by the activist without undermining the essence of effective governance.[148] This is due to the minority's right to convene an extraordinary general meeting and the right to bring a matter before the general meeting.[149] These tools are also used by activists urging companies to sustainability.[150] More recent inventions such as the independence requirements for board members which create obstacles for insider information and that are so crucial for independent decision-making, nomination committees consisting of major shareholders instead of board members,[151] veto rights over issues that belong to the board's competence, compulsory cumulative voting when selecting board members, or a qualified minority's right to appoint board members, are not governance standards that are so crucial that they could justify undermining the board's competence and capability.[152]

These paths are, however, difficult. The relationship between heterogeneous activist shareholders and governments is complicated and, at the corporate level, novel. On the other hand, index investors tend to resist activism.[153] Activists have traditionally tried to influence regulatory policy to make it more investor friendly and to make their investments, based on the hope of the adoption of a particular government policy. Activists may seek favourable regulatory treatment, as have investors who have purchased failed banks from government receivers in the past.[154] On the other hand, more and more activism against unsustainable businesses can also be seen among institutional investors.[155] At the end of the day, the problem of corporate law is whether institutional investor and asset manager engagement contributes to long-term sustainability of public companies, or just increases their attractivity for short-term profit maximizing.

Ultimately, however, corporate governance is about value choices. Whether it is more efficient, from the point of view of shareholders, to focus on corporate added value to dividends and share buy-backs or investments and future added value. And whether this can be achieved without taking a position on which alternative would be more effective from a more general societal point of view. At the end of the day, the answer lies not in shareholders but in the boards of both financial and productive firms. What therefore is the boards' opportunity to ensure a sustainable business model? The only efficient way to ensure sustainability may therefore be hard law on corporate purpose and board duties - and not reliance solely on shareholders.[156]

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[147] See, for instance Mähönen, 'Finland'; Mähönen and Johnsen, 'Law, culture and sustainability'.

[148] Katelouzou, 'Worldwide Shareholder Activism', 821–823.

[149] Seemingly, minority derivative suits seem not to have significance for activists, as private benefits from these are small even in countries in which shareholders have the right to compensation of indirect damage; see ibid., 826–826.

[150] See for instance ShareAction, 'Voting Matters 2020: Are asset managers using their proxy votes for action on climate and social issues?' (2020), available at https://shareaction.org/wp-content/uploads/2020/11/Voting-Matters-2020.pdf.

[151] Swedish companies are presumably attractive targets for activists for this reason; see ibid., 825–826.

[152] Ibid, 824–826.

[153] See ShareAction, Voting Matters 2020.

[154] Davidoff Solomon and Zaring, 'After the Deal', 422–423.

[155] ShareAction, Voting Matters 2020; Condon, 'Externalities and the Common Owner'.

[156] See the reform proposals of the Sustainable Market Actors for Responsible Trade (SMART) project, B. Sjåfjell, J. Mähönen, T. Novitz, C. Gammage and H. Ahlström, 'Securing the Future of European Business: SMART Reform Proposals' (2020) 2020-11 *University of Oslo Faculty of Law Research Paper*, 20-08 *Nordic & European Company Law Working Paper*, available at SSRN: https://ssrn.com/abstract=3595048; B.

Sjåfjell and G. Tsagas, 'Sustainable value creation as the future of European business', Chapter 9 in this volume.