

Promoting the Institutional Investors' Engagement of Corporate Governance in Emerging Countries—From the Perspective of the Revision of the UK's Stewardship Code

Lin Yang*

*School of Humanities and International Education Xi'an Peihua University, Xi'an, Shaanxi,
710125, China*

**Corresponding author: 001859@peihua.edu.cn*

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Abstract: In the last three decades, we have witnessed a meteoric growth in the presence of institutional investors in global equity (and bond) markets, and a subsequent change in investment practices. This gave rise to questions about whether institutional shareholders, should be more engaged with long term company strategies and do more to challenge boards to take timely action to avoid corporate failures. Public and/or private (policy) actors in 20 jurisdictions, on 6 continents across the world, including the UK, have introduced Stewardship Codes (SC) or similar initiatives to counteract the perceived investor short-termism and improve the way institutional investors discharge their stewardship responsibilities, while the International Corporate Governance Network (ICGN) has also introduced global stewardship principles. Yet, changing market practices and structures raise doubts about the effectiveness of these regulatory initiatives. In order for this regulatory system to fully function, SC should be introduced to different countries and applied more efficiently. With this background, this essay will first focus on the introduction of the revision of the UK's stewardship code. It will then point out the alternative approaches to improve the institutional shareholder's engagement. This will be followed by the developing countries' corporate governance regime in institutional shareholder' issue. Finally, it will stress the policy approaches to promote institutional investors' engagement in emerging countries.

1. Introduction

Improving shareholder participation and long-term investment culture is one of the main goals of UK Company Act 2006. There is no doubt that the stewardship in the business field is to enhance long-term shareholder value. Actually, in the UK market, there is a lack of participation of institutional shareholders and the development of excessive attention to short-term interests. For example, banking institutional investors tend to take excessive risk-taking behaviors and lack a holistic study of corporate governance issues. The main reason is that institutional investors often do not care much about how to better exercise their voting rights, i.e. long-term corporate strategies. This model is completely contrary to "shareholder activism", which means greater participation in

corporate affairs. As pointed out by the UK pension fund, the attention of people only considers whether asset managers are maintaining acceptable levels of misrepresentation rather than further examining the final outcome. Furthermore, asset managers are unwilling to participate in long-term activities since their primary aim is not to lose the customer's authorization.

Based on above reasons, the Financial Reporting Council issued the UK Stewardship Code(SC) as best practices for institutional investors in response to the management's failure of short-term practices. In 2020,the UK's Stewardship Code marks its tenth anniversary with a substantial update and expansion of the Code by the Financial Reporting Council (FRC) to improve the efficiency of shareholder interactions with the companies in which they invest[1].The 2020 Code is still a voluntary code and only applies to those who sign up in good faith. The 2020 code though, has stricter requirements for signatories than the previous version. Signatories must now apply the principles and explain how they did so("apply and explain").The most notable change is that the wording of "guidance" used in previous editions has been replaced by "reporting expectations". The Reporting expectations emphasize that signatories must provide examples of how they have applied these principles in practice ("activities") and how these activities have contributed to valid conclusions ("results").The structural changes to the 2020 Code are very close to what the FRC intends to achieve. The desire is that signatories will no longer be able to provide empty disclosures against the broad principle of not telling their true actions, and instead, will enhance the quality, substance and meaning of their disclosures[2].In addition to structural changes, the FRC is also working to ensure that the 2020 Code consists of more than cosmetic changes.For the first time, the 2020 Code provides a definition of "stewardship": stewardship is the responsible allocation, management and monitoring of capital to create long-term economic, environmental and social value for clients and beneficiaries. This definition demonstrates another subtlety of the shift, now with a more explicit emphasis on long-term interests and those of beneficiaries.

The number of principles has been expanded to 12 divided into four categories. The first category is titled "Purpose and Governance" and urges institutional investors to ensure that their internal purpose, incentives and governance mechanisms support their stewardship responsibilities. The second category is the "investment approach", a principle that requires institutional investors to align their management activities with their needs and ensure services are provided by parties acting on their behalf. While environmental and social (ES) issues were referenced in the 2010 and 2012 versions of the code, under the 2020 code, environmental, social and governance (ESG) issues have become more general including the inclusion of holding and exit decision. The third category, "engagement", reflects the issuer-specific engagement that was extolled in previous versions of the code, encouraging institutional investors to engage with issuers, collaborate with other institutional investors, and, where necessary, escalate management activities. The last category, "exercise rights and responsibilities", again reflects issuer-specific engagement, primarily involving institutional investors' voting rights over issuers, and the policies and considerations that influence those decisions[3].

2. The Alternative Approaches to Improve the Institutional Shareholder's Engagement

Owing to lack of regulation on remuneration policy, the most effective solution to this problem is that the remuneration policy must be discussed with the shareholders. Just like the formalization of compensation, enhancing the voice of shareholders will promote a closer link between compensation and performance, thereby providing more effective compensation contracts and positive long-term economic performance. It is clear that the key issue is not whether the disclosure of voting records and the use of proxy voting services are mandatory, but the quality of information that investors disclose to their beneficiaries and the public. Hence, companies should publicly

disclose their remuneration policies and promote shareholder vote on compensation. Shareholders' approvals should include all detailed information on remuneration policies, in particular, information related to performance indicators. In addition, companies should explain how policies and compensation levels are consistent with the collective long-term interests of shareholders and the company's sustainable development prospects. Similarly, companies should explain how to consider employees' compensation levels and employment conditions when determining executive compensation, and publicly disclose the average pay ratio of full-time employees and senior executives. Because executive compensation plans are basically designed to curb agency problems[4]. In spite of this, compensation itself is also considered as an agency problem. Strengthening the role of shareholders in executive compensation accountability will promote a stronger link between compensation and performance. In the case of investor participation, it is particularly important to require that the remuneration policy of the company must be discussed with the shareholders. This policy must be approved by shareholders, which provides institutional investors with a clear means to express dissatisfaction with the performance of managers and directors. Many countries have introduced mechanisms that allow shareholders to vote on salary levels and amounts. The role of the proxy advisors is indispensable. As a value-maximizing entity, it is possible to tailor the voting proposal to suit the needs of its clients. And the accuracy and realism of the voting proposal are very necessary, including the disclosure requirements of key information about how the voting proposal is formulated and how the business relationship between the consultant and the customer influences the results. With exceptions, many agents' clients are very dependent on proxy advice. However, proxy advisors are seldom regulated as relatively new participants. Therefore, it is necessary to increase the supervision intensity around the voting proposal provider.

The UK Stewardship code is dedicated to fulfilling educational responsibilities by encouraging the disclosure of information about the ultimate goal of the group or other asset manager's agenda and its role concept. Since education itself is not a quick method, the improvement of investment means will not be completed immediately. Therefore, we should look for alternative measures to encourage more institutional shareholders to participate in management. Changing the attitude of institutional investors by education is not the only possible way[5]. It is clear that providing financial incentives will change the shortcomings of educational measures because institutional investors require additional financial incentives to promote the long-term development of the company, such as reduction of the capital gains tax rate. Related institutions can also establish the technical site that is open to all market participants and focus on corporate governance issues. This site links all company websites, operates under supervision, and allows anyone to be willing to express personal opinions on the company's corporate strategy. According to this proposal, the participation of investors will be greatly facilitated, which becomes the basis for more dialogue between the company and its shareholder, thereby increasing the market's understanding of the information disclosed.

Changing the interpretation of fiduciary duties is a necessary measure because financial intermediaries' perceptions of fiduciary obligations are focused on satisfying their clients' best economic interests. Such benefits are erroneously considered to be a strict interpretation of the term "fiduciary duty". Translating into a maximized financial return does not allow broader explanations, such as achieving long-term goals, which will help the company to further develop and increase investment. Further regulatory or legislative action is the most effective way to solve this problem. The UK's SC mentions the importance of "strengthening and protecting the value of ultimate beneficiaries or customers". Although this Code refers above sentence, it is undoubtedly unable to mention the requirement of expanding the scope of "fiduciary duties". The fair pension report put forward a more stringent obligation to introduce a new section in the Company Act in 2006, in

parallel with article 172, which will introduce fulfillment of fiduciary duties. These obligations may need to be considered when it comes to securing the ultimate beneficiaries' interests by encountering additional factors, such as the consequences of long-term investment decisions and various sustainable development issues. There is no doubt that statutory obligations will be more direct and feasible if UK gradually waives the UK's Code as a soft regulatory tool and adopts strict legal measures.

3. The Emerging Countries' Corporate Governance Regime in Institutional Shareholder' Issue

Corporate governance has received much attention in developing or emerging countries, partly due to the financial crisis. For example, the Asian Corporate Governance Association puts forward proposals for more disclosure before the meeting to better improve the shareholders' meeting and empower institutional investors by providing more systematic voting. In October 2005, China also introduced the fiduciary duty of Anglo-American model companies to the Chinese company law[6]. However, the influence of fiduciary duty in China is not obvious. The main reason is that the company's fiduciary duty as an aspect of corporate governance plays an important role in the board of directors only if the company's capital structure shows widely dispersed. When a company is governed by a single or family shareholder, it may not realize the importance of fiduciary duty. Thus, Anglo-American company's fiduciary duty makes it difficult to apply in developing or emerging countries. From the simple example above, it can be seen that there are many differences between developing countries and developed countries. This is mainly determined by the characteristics of these countries. For example, these countries have national ownership, and the interlocking relationship between the government and financial sector, and limited human resources. So developing or emerging countries should develop their own corporate

governance regimes, taking into account the cultural, political and technical conditions of each country. Emerging or developing countries, especially in stakeholder-oriented countries, believe that companies are social entities that affect the welfare of many stakeholders. Stakeholders as groups or individuals interact with companies and influence corporate goals or achieve corporate aims. For instance, the natural environment can be a key stakeholder. In recent years, introducing the Stewardship Code around the world encourages developing countries to adopt this regime. South Africa, Malaysia, Brazil, and Kenya regulate their own Stewardship Code[7]. These countries not only consider stewardship policy, monitor conflicts of interests and voting policy but also integrate environment, social and government (ESG) into Codes. Therefore institutional investors should consider the relevant ESG factors as their most important factors as their most important aspect in fulfilling their fiduciary responsibilities, and fully consider these factors. In South African Stewardship code, the first principle is that institutional investors should incorporate sustainability considerations into their investment analysis and investment activities, including ESG. In Kenyan Stewardship Code, principle 6 focuses on sustainability issues, including environment, social and ethical factors. Because interpreting sustainability factors is a part of their monitoring of compliance with the Corporate Governance Code. In Brazilian stewardship code, the principle 3 takes into account ESG factors in the investment process and management activities. Because association in Brazil seeks to promote the etiquette of institutional investors and develop responsible participations standards. Malaysian Stewardship Code also refers to internal tools based on ESG performance, dispute level and ESG country risk[8]. Sustainability consideration is fully embedded in the developing countries with stakeholder-oriented corporate governance as these are important to a company's ability to generate sustainable long-term returns.

However, the reality is that just a few developing or emerging countries regulate Stewardship

Code mainly because the nature of the Code is voluntary (comply or explain). The transplanted or domestically developed new rules, regulations, Corporate Governance Code, or the Stewardship Code is insufficient to justify the protection of minority shareholders' rights. Without effective enforcement, new laws or new codes will be ignored, the credibility of legal institutions may weaken. Likewise, the confidence in financial markets may disappear. The protection of minority shareholders is very important for the strong capital market and financial system reform in developing countries and emerging economies[9]. Hence, developing countries should not only show investors that they have already carried out corporate governance reforms, but also assure investors that they are capable of implementing these rules and standards. Soft law approach like the Stewardship Code may not be sufficient to promote institutional investors' engagement as this approach is not binding. Introducing hard law makes sense in these countries. The company law gives developing countries shareholder rights including participation in general meetings, the right to speak at these meetings and the right to vote at meetings. Furthermore, the company law also contains the special shareholder' rights including regulatory measures that give a certain percentage or more of various additional rights to hold shares or voting rights, such as the right to hold meetings and include items on agenda. In China, shareholders who hold more than 10% of the company's total share capital for more than 90 consecutive days or in aggregate may hold special general meetings.

4. The Policy Approaches to Promote Institutional Investors' Engagement in Emerging Countries

The short-term attitude of investors is the main reason for causing the Financial Crisis. Encouraging long-term engagement is an effective way to solve the defects of the corporate governance framework. Stewardship is characterized by an attractive long-term approach. Institutional investors seek to make meaningful contributions to corporate governance, management, and performance. The most important thing is participation which is not only voting. It also includes monitoring and a purposeful dialogue with the company on value creation, innovation as well as risk management[10]. The Stewardship Code is unique in their attempt to create more responsible and purposeful investors. It is clear that the concept of stewardship encourages institutional investors and asset managers to approach corporate management and the board of directors in a constructive manner that spans strategy, performance, risk including culture and compensation. Therefore, in order to meet the long-term interests of the invested company and its ultimate investors, institutional investors should consider that the participation of the steward as a more effective shareholder in the company's affairs should not only improve the governance and performance of the invested company but also help market effective operation and enhancement of the credibility of the entire market economy, such as long-term success, responsibility, purposeful dialogue, and transparency. It is believed that shareholder participation should exceed the company's governance discussion and follow the advice of an agency consultant. It should also contain a meaningful and constructive dialogue with institutional investors that can provide a competitive advantage for the company. Since institutional investors could provide external perspectives, assist in detecting strategic blind spots, raise awareness of external risks, and help to establish links with other stakeholders and add value. Based on the above advantages, developing or emerging countries should consider to transplant or develop their own Stewardship Code since soft legal measures have strong applicability which may increase awareness and compliance in a diversified investment environment.

In the future, it is evident that the strategy of focusing on emerging markets will fully integrate ESG considerations into its investment process will promote the realization of the long-term goals

of the company. There are several reasons why investors in emerging countries should consider ESG. First, the public supervision of companies and investors and their role in the economy and society are more common[11].Second, unlike other factors in the company's participation, public policy participation may extend the company's best practices to the entire industry or market, and establish a unified standard. The most important thing is that it can enable investors to solve the market structure, practice and transparency issues that may cause systemic risks to financial markets and the overall economy, such as the risk of the global financial crisis or climate change. Finally, emerging-market stocks are often considered to be less efficient than developed-market stocks and bear higher levels of risk[12].Positive investors can use ESG-related analysis to learn more powerful sources of information to generate risk-reducing insights. Therefore, ESG analysis has become indispensable for active investors, especially in emerging markets. The ESG analysis provides investors with additional independent inferences about the company's management quality, strategic positioning, operational efficiency, and exposure to potential risks. As the development of a stakeholder-oriented development country considers the interests of stakeholders more, the inclusion of ESG in management guidelines will promote the long- term interest of the company [13].

Clearly, corporate governance is one of the most important areas to focus on in emerging market investments, because poor governance practices can generate significant costs, in contrast, strong corporate governance can demonstrate greater transparency and stronger management, and it often coexists with better environmental and social practices. Not surprisingly, industry surveys have found that emerging market investors are willing to pay premiums for better corporate governance and create lower capital costs for governance leaders. ESG research clearly identifies which companies have strong governance standards, thereby helping to reduce investment risks. Although risk mitigation has traditionally been the primary consideration in incorporating ESG considerations in investment analysis, ESG research can now be understood as an engine for finding compelling investment opportunities. In the context of climate change, resource pressures and scarcity, and new technological opportunities, emerging economies and companies are gaining strength. This allows emerging market companies to find innovative solutions to solve environmental or social problems, gain scale in their home markets, and become a major supplier to other emerging markets and developed market economies. Investors keen to focus on ESG issues can identify leading innovators who can take advantage of the emerging end market. For example, in China, environmental degradation and air pollution have brought tremendous social pressure on the government to create harmful emissions. This helps create opportunities. For example, companies may invest in companies responsible for air pollution, find new ways to provide clean water, actively develop clean energy such as natural gas, and build affordable electric vehicle technologies[14].

Owing to the characteristics of emerging countries with stakeholder-oriented, it is clear that taking same situation countries' approach is a wise approach. In Chile, shareholders and board members must pursue company rights rather than individual rights. Institutional investors have played a huge role in improving and promoting good corporate governance and have become a strong opponent of controlling shareholders in Chile's centralized capital market. The main reason is that Chile has introduced investment incentives such as the "Chile Competes Plan". The plan includes income tax exemption from institutional investors (such as mutual funds and pension funds) [15]. As institutional investors play different roles in corporate governance, conflicts of interest are more likely to arise. Taking the Dutch Stewardship code as an example, principle 5 taught us how to mitigate conflicts of interest. This principle also considers how to deal with the relationship between stakeholders, for example, investors provide insurance contracts to companies. In these situations, when participating in group dialogues or other activities, participants need to wisely consider policies on conflicts of interest and insider information before the dialogue. In considering

stakeholder interests, Eumedion plays an important role in improving the participation of institutional investors. Participants of Eumedion are encouraged to take their ESG performance to a higher level. Moreover, it promotes the acceptance and compliance of corporate governance and sustainability standards and guidelines through listed companies and institutional investors, particularly in the Netherlands and Europe. Eumedion strives to achieve its mission through the following pathways, which developing countries should learn. The first step is to encourage joint consultations among institutional investors, listed companies, and their representative organizations[16]. Then regulators negotiated with the government, the EU institutions, other relevant departments and departmental organizations. The third step is to try to influence laws and regulations and provide its members with services in the area of corporate governance in the process. The final step is to carry out other activities, such as organizing seminars, symposiums, and round tables to promote the realization of the goals.

5. Summary

As shown above, it is evident that complying the code is an easy thing, but impacting institutional investors' behavior is had thing. Apart from revision, the UK can increase the participation of institutional participants by providing financial incentives and introducing mandatory legal measures by strengthening the voice of shareholders in the remuneration policy. These will all promote the involvement of institutional investors in the company's long-term issues. In developing or emerging countries, due to the country's own national conditions, corporate governance will consider the interests of stakeholders more. Therefore, in promoting the stewardship of companies in these countries, unlike the measures were taken by developed countries, including the integration of ESG, fiscal incentives, and the use of regulatory agencies, which may increase the participation of institutional investors, thereby promoting the long-term economic development.

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