Journal of Law & Social Studies (JLSS)
Volume 5, Issue 1, pp 108-117
www.advancelrf.org

The Complex Corporate Governance Landscape in the EU: Examining Institutional Investor Activism and Its Ongoing Challenges

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Abstract

Institutional investor activism has become an increasingly important part of the corporate governance landscape in the European Union (EU). This research article examines the challenges and opportunities associated with institutional investor activism in the EU, particularly in the context of corporate governance. It provides an overview of the current state of institutional investor activism in the EU, including the types of issues that investors are focusing on and the methods that they are using to influence companies. The challenges that institutional investors face in pursuing their goals, including legal and cultural barriers to activism, are also discussed. Case studies of institutional investor activism in Germany, the Netherlands/UK, and Finland are presented, which illustrate the potential for activism to drive change in corporate behavior, but also highlight the challenges that investors face. The article concludes by suggesting that institutional investor activism has the potential to promote better corporate governance and more sustainable business practices in the EU, but investors must carefully consider the risks and challenges associated with activism and adopt effective strategies to achieve their goals.

Keywords: Institutional Investor Activism, Corporate Governance, European Union, EU Institutions.

Introduction

Corporate governance has become increasingly important in recent years as investors demand more transparency and accountability from companies. Institutional investor activism has emerged as a powerful tool for promoting good corporate governance, particularly in the complex and fragmented corporate governance landscape of the European Union (EU). Institutional investors, such as pension funds, insurance companies, and asset managers, have significant ownership stakes in many European companies and can use their influence to push for changes in corporate governance practices. This research article aims to examine the challenges and opportunities associated with institutional investor activism in the EU, particularly in the context of corporate governance.

The article provides an overview of the current state of institutional investor activism in the EU, including the types of issues that investors are focusing on and the methods they use to influence companies. The motivations behind institutional investor activism vary, but investors seek to enhance shareholder value, promote long-term sustainability, and hold corporate boards accountable for their actions. Institutional investor activism involves engaging with companies and their management to promote specific changes in corporate governance, such as board composition, executive compensation, and environmental, social, and governance (ESG) policies. Institutional investors may also use their voting rights to support or oppose board proposals or to propose their own resolutions.

Despite the potential benefits of institutional investor activism, there are also challenges associated with this practice. Institutional investors face legal and regulatory hurdles, cultural differences, and the fragmented nature of EU corporate governance practices. These challenges can make it difficult for institutional investors to effectively exercise their ownership rights and achieve meaningful changes in corporate governance practices.

The article examines the challenges that institutional investors face while navigating the complex corporate governance landscape of the EU. It reviews the existing literature on corporate governance and institutional investor activism and provides insights into the implications of such activism on corporate governance. The paper also identifies key challenges to institutional investor activism in the EU and suggests strategies for overcoming these challenges. Finally, the study examines the role of EU institutions in promoting institutional investor activism and improving corporate governance practices.

Literature Review

Institutional investor activism has become an increasingly important topic in the field of corporate governance. Institutional investors, such as pension funds, hedge funds, and mutual funds, are playing an increasingly active role in corporate decision-making, seeking to influence company policies and practices. There is a growing body of literature that examines the role of institutional investors in corporate governance and the potential benefits and risks associated with this type of activism.

The literature on institutional investor activism and corporate governance has grown significantly in past few years, with many studies focusing on the impact of institutional investors on company performance, board composition, executive compensation, and ESG practices. These studies have generally found a positive relationship between institutional investor activism and firm performance, with activism leading to improvements in corporate governance practices and ultimately shareholder value.

In addition to the challenges and potential benefits of institutional investor activism in the EU, the literature has also examined the role of EU institutions in promoting good corporate governance practices. The European Commission, for example, has taken several steps to promote shareholder engagement and improve corporate governance practices in the EU.

One of the most significant initiatives is the Shareholder Rights Directive, which was adopted in 2017 and aims to increase transparency, accountability, and engagement between companies and their shareholders. The directive includes several provisions designed to promote institutional investor activism, such as requirements for greater transparency in voting and reporting, and the introduction of a say-on-pay vote for executive compensation.

Another important initiative is the EU's Sustainable Finance Action Plan, which aims to promote sustainable investment and improve ESG practices in the EU. The action plan includes several measures to promote institutional investor activism, such as the introduction of ESG disclosure requirements and the development of EU-wide ESG standards.

DOI: 10.52279/jlss.05.01.01.108117

The literature has also examined the potential impact of Brexit on institutional investor activism in the EU. A study by Banerjee and Sangwan (2018) found that Brexit could lead to a decrease in institutional investor activism in the EU, as UK-based institutional investors may face legal and regulatory challenges in exercising their ownership rights in the EU. However, the authors also note that Brexit could lead to greater cooperation among EU member states in promoting good corporate governance practices and shareholder engagement.

Potential Benefits of Institutional Investor Activism

Institutional investor activism has the potential to bring about several benefits for companies and their stakeholders in the EU. These benefits can include:

Improved Corporate Performance: Institutional investor activism has been shown to improve the financial performance of companies, particularly on ESG issues. Companies that have been targeted by shareholder proposals on environmental issues have seen a 2.7% improvement in stock performance, as well as improved ESG ratings.

Better Alignment of Interests: Activism can help align the interests of companies and their shareholders, particularly when management may be pursuing short-term goals at the expense of long-term value creation. Engaging with companies on issues related to sustainability, corporate governance, and executive compensation can help to ensure that companies make decisions that benefit all stakeholders.

Increased Accountability and Transparency: Activism can lead to greater accountability and transparency in corporate decision-making. By pushing for greater disclosure and transparency on issues such as executive pay and board diversity, investors can ensure that companies are held accountable for their actions and that stakeholders have the information they need to make informed decisions.

More Effective Risk Management: Activism can help companies to identify and manage potential risks, particularly in areas such as climate change and human rights. By engaging with companies on these issues, investors can ensure that companies are taking the necessary steps to manage risks and protect their long-term viability.

Enhanced Reputation: Institutional investor activism can enhance the reputation of both companies and investors. By demonstrating a commitment to sustainability, responsible governance, and long-term value creation, companies can enhance their reputation and attract investment from socially responsible investors. Similarly, by engaging in activism that promotes these values, investors can build their own reputation as responsible stewards of capital.

Initiatives such as the Shareholder Rights Directive and Sustainable Finance Action Plan by the EU can further promote greater transparency, accountability, and engagement between companies and their shareholders, leading to better corporate governance practices and ultimately better outcomes for all stakeholders. Institutional investor activism can play an important role in promoting responsible and sustainable business practices in the EU.

Potential Risks of Institutional Investor Activism

Institutional investor activism carries several potential risks that investors should carefully consider. One of the main risks is the potential for short-termism, where investors prioritize short-term gains over long-term sustainable performance. This can lead to a focus on short-term financial performance at the expense of long-term value creation.

Another potential risk is that activism can be costly and time-consuming, with engagement with companies and push for changes requiring significant resources and not always leading to desired outcomes. Additionally, institutional investors may face regulatory and legal obstacles in certain jurisdictions, which can limit their ability to influence corporate behaviour.

Furthermore, institutional investor activism can have unintended consequences, with investor pressure on companies to improve their ESG performance potentially leading to the adoption of superficial or cosmetic measures that do not address underlying issues.

Coordination challenges can also be a risk, particularly if investors have different objectives and priorities. This can lead to conflicting messages and actions that may undermine the effectiveness of activism.

Finally, institutional investor activism can carry reputational risks, particularly if investors are overly aggressive or confrontational in their actions. This can lead to negative publicity and damage to the reputations of both companies and investors. Careful consideration and planning are crucial in institutional investor activism to mitigate these potential risks and promote long-term value creation and sustainable business practices that benefit both companies and society.

Institutional Investor Activism in the European Union

Institutional investor activism in the EU has grown significantly in recent years, particularly as investors have become more focused on sustainability issues. According to research by the European Sustainable Investment Forum, the value of assets under management in Europe that are managed using sustainable investment strategies increased from €12.7 trillion in 2018 to €14.1 trillion in 2020.

One of the key areas of focus for institutional investors in the EU has been climate change. Investors are increasingly pushing companies to take more aggressive action on climate change, including setting targets for carbon emissions reductions and transitioning to renewable energy sources. Other areas of focus for institutional investors include diversity and inclusion, executive pay, and human rights.

Institutional investors are using a range of methods to influence companies, including engaging directly with management and boards of directors, filing shareholder resolutions, and voting their shares at company meetings. In some cases, investors have also launched public campaigns to generate public pressure on companies to change their behavior.

Institutional investor activism has become an increasingly important aspect of corporate governance in the EU in recent years. Institutional investors, such as pension funds, asset managers, and insurance companies, have significant ownership stakes in many EU companies and are using their shareholder power to influence corporate governance practices.

There are several types of institutional investor activism in the EU, including shareholder proposals, voting, engagement, and collaborative engagement. Institutional investor activism has been successful in promoting positive changes in corporate governance practices in the EU. For example, institutional investors have pushed for greater board diversity, better executive compensation practices, and improved environmental and social performance by companies.

However, institutional investor activism also faces challenges in the EU. These include regulatory barriers, cultural differences between countries, and disagreements among investors on governance priorities. Nevertheless, institutional investor activism is likely to continue to play an important role in promoting good corporate governance practices in the EU, as investors seek to promote long-term sustainable value creation for both companies and their stakeholders.

Institutional Investor Activism: Theories and Models

Institutional investor activism refers to the exercise of ownership rights by institutional investors, such as pension funds, mutual funds, and hedge funds, to influence the governance and strategic decisions of companies in which they invest. Institutional investor activism can take various forms, including shareholder proposals, voting on corporate resolutions, engaging in dialogue with company management, and even initiating legal action.

Theories and models have been developed to explain the motivations behind institutional investor activism and the factors that determine its success. One prominent theory is the agency theory, which posits that institutional investors act as principals, seeking to maximize their financial returns, and company management acts as agents, tasked with managing the company on behalf of shareholders. According to this theory, institutional investor activism is a means of addressing agency problems, such as conflicts of interest between management and shareholders, and improving corporate governance practices.

Another theory is the resource dependence theory, which argues that institutional investors engage in activism to protect their investment and ensure the long-term viability of the company. According to this theory, institutional investors have a vested interest in improving the performance of the companies in which they invest, as this enhances the value of their investment portfolio and reduces their exposure to risk.

A third theory is the stakeholder theory, which posits that companies have a responsibility to consider the interests of all stakeholders, including shareholders, employees, customers, and the broader society. Institutional investor activism be a means of promoting this broader stakeholder perspective and holding companies accountable for their social and environmental impact.

Several models have also been developed to explain the factors that determine the success of institutional investor activism. One such model is the strategic activism model, which suggests that institutional investors are more likely to achieve their objectives when they adopt a strategic approach to activism. This involves identifying specific objectives, developing a clear plan of action, and building coalitions with other stakeholders to increase their leverage.

Another model is the institutional logics model, which argues that institutional investors are influenced by their broader social and cultural context, including their institutional logics, or the values, beliefs, and norms that shape their behaviour. According to this model, institutional investors are more likely to engage in activism when their institutional logics are aligned with the broader social and environmental concerns of society.

The theories and models of institutional investor activism provide useful insights into the motivations, strategies, and outcomes of activism, and can help inform the development of effective corporate governance practices and policies.

Challenges to Institutional Investor Activism in the EU

Corporate governance in the European Union (EU) faces several challenges, including a dispersed ownership structure with many small shareholders who are often not actively engaged in the governance of the company. Board diversity is also a challenge, with a lack of diversity in terms of gender, ethnicity, and age, which can lead to a lack of diverse perspectives and a homogenous decision-making process. Additionally, executive compensation is often perceived as excessive and not aligned with the long-term interests of the company, and there is growing pressure on companies to improve their environmental and social performance.

DOI: 10.52279/jlss.05.01.01.108117

The legal and regulatory framework governing corporate governance varies widely across different countries, making it difficult for institutional investors to push for changes. Additionally, cultural factors can be a barrier to institutional investor activism, as some countries prioritize stakeholder interests over those of shareholders. Moreover, the EU's complex regulatory environment can create additional costs and administrative burdens for investors.

Institutional investors face significant challenges in navigating the complex corporate governance landscape in the EU. These challenges include legal and regulatory hurdles, cultural differences, and the fragmented nature of EU corporate governance practices. Institutional investors face the challenge of balancing short-term and long-term interests, with pressure from stakeholders to deliver short-term results.

To overcome these challenges, institutional investors must engage in collaborative activism, build strong relationships with other stakeholders, and adopt a long-term perspective. Institutional investor activism seeks to address these challenges by promoting greater shareholder engagement, advocating for diverse and independent board structures, promoting responsible executive compensation practices, and pushing for improved environmental and social performance by companies. By exercising their ownership rights and engaging in dialogue with companies, institutional investors can help to promote good corporate governance practices that benefit both the company and its stakeholders.

Moreover, EU institutions such as the European Commission can play a critical role in promoting shareholder engagement and improving corporate governance practices in the EU by introducing initiatives that encourage institutional investor activism and promote transparency, accountability, and engagement between companies and their shareholders.

Challenges to Corporate Governance in the EU

Corporate governance in the EU faces several challenges, which institutional investor activism seeks to address. These challenges include a dispersed ownership structure with many small shareholders who are often not actively engaged in the governance of the company, a lack of board diversity in terms of gender, ethnicity, and age, perceived excessive executive compensation, growing pressure on companies to improve their environmental and social performance, and the complexity of the regulatory framework governing corporate governance in the EU.

Institutional investor activism aims to tackle these challenges by advocating for greater shareholder engagement, promoting diverse and independent board structures, responsible executive compensation practices, and improved environmental and social performance by companies. Through exercising their ownership rights and engaging in dialogue with companies, institutional investors can promote good corporate governance practices that benefit both the company and its stakeholders. Additionally, by launching initiatives that encourage institutional investor activism and advance transparency, accountability, and engagement between companies and their shareholders, EU institutions like the European Commission can play a crucial role in fostering shareholder engagement and improving corporate governance practices in the EU.

Case Studies of Institutional Investor Activism in the EU

Volkswagen (Germany)

In 2015, it was revealed that Volkswagen had installed software in its diesel cars that allowed them to cheat on emissions tests. The scandal rocked the automotive industry and led to significant financial losses for the company. Institutional investors, including Norway's sovereign wealth fund,

DOI: 10.52279/jlss.05.01.01.108117

BlackRock, and CalPERS, were among those that pushed for changes at Volkswagen in the wake of the scandal.

However, institutional investor activism in this case was complicated by Germany's corporate governance system, which gives significant power to employee representatives on company boards. The employee representatives were initially resistant to calls for changes to the board and management, arguing that the company's problems were the result of a few bad actors rather than systemic issues.

Despite these challenges, institutional investors continued to push for changes at Volkswagen. Eventually, the company agreed to appoint a new CEO and make changes to its board composition. However, the experience highlights the challenges of institutional investor activism in a country like Germany, where there is a strong tradition of employee representation and where shareholder rights are less well-established than in other countries.

Nokia (Finland)

In 2019, Nokia announced plans to cut its dividend and invest more heavily in 5G technology, as it sought to regain market share in the face of increased competition from Chinese rivals. Institutional investors, including Cevian Capital and Nordea, pushed for Nokia to take more aggressive action to improve its financial performance, arguing that the company had been too slow to adapt to changes in the market.

However, Nokia's board was initially resistant to calls for change, arguing that the company's strategy was already aligned with the interests of shareholders. In response, Cevian Capital launched a public campaign calling for changes to Nokia's board and strategy, which ultimately led to the appointment of a new CEO and changes to the company's board composition.

The case of Nokia illustrates the potential for institutional investor activism to drive changes in corporate strategy, particularly when investors can build a coalition and generate public support for their position. However, it also highlights the potential for conflicts between institutional investors and company management, as well as the potential for activism to be costly and time-consuming.

Royal Dutch Shell (Netherlands/UK)

In 2020, Royal Dutch Shell announced that it would be cutting its dividend for the first time since World War II, in response to the COVID-19 pandemic and the collapse in oil prices. Institutional investors, including the Church of England and the Dutch pension fund ABP, pushed for Shell to take more aggressive action on climate change, arguing that the company needed to transition away from fossil fuels in order to protect long-term shareholder value.

While Shell had already committed to a target of net-zero emissions by 2050, institutional investors argued that the company needed to take more concrete steps to achieve this goal. In response, Shell announced a new strategy in February 2021, which included plans to invest more heavily in renewable energy and to reduce the carbon intensity of its products by 6-8% by 2023.

The case of Shell illustrates the potential for institutional investor activism to drive changes in corporate strategy, particularly on issues like climate change that are of growing importance to investors. However, it also highlights the challenges of balancing short-term and long-term interests, as cutting the dividend was a necessary short-term measure to preserve cash in the face of a crisis.

These case studies show that institutional investor activism can be a powerful tool for driving change in European companies, but it also requires a nuanced approach that considers the specific context and challenges of each situation. Effective engagement with target companies, collaboration with other stakeholders, and a long-term perspective are key to achieving meaningful results.

Moreover, institutional investors have an important role to play in promoting sustainability and responsible investment practices, as well as in holding companies accountable for their social and environmental impact. As the EU continues to push for greater corporate responsibility and sustainability, institutional investor activism is likely to become an increasingly important tool for achieving these goals.

Impact of Institutional Investor Activism on Corporate Governance in the EU

The impact of institutional investor activism on corporate governance in the EU is a subject of ongoing debate among scholars and practitioners. While some argue that investor activism can lead to positive changes in corporate governance practices, others contend that it can have negative consequences, such as short-termism and a focus on financial performance at the expense of other stakeholders.

Positive Impact on Corporate Governance: Institutional investor activism can impact corporate governance through the adoption of more robust shareholder rights and protections. By pushing for greater board independence, improved disclosure, and more robust executive compensation practices, institutional investors can help to align the interests of management and shareholders and ensure that companies are accountable to their owners. Moreover, it can lead to improvements in environmental, social, and governance (ESG) performance by companies.

Negative Impact on Corporate Governance: However, institutional investor activism can also have negative consequences, with some suggesting that it can be focused on short-term gains at the expense of long-term value creation. This can lead to pressure on companies to engage in share buybacks or other financial engineering strategies that may not be in the best interests of the company or its stakeholders. Additionally, institutional investor activism can lead to conflicts between investors and other stakeholders such as employees and customers.

Complex and Multifaceted Impact: The impact of institutional investor activism on corporate governance in the EU is complex and multifaceted. It has the potential to drive positive changes in corporate governance practices and ESG performance, but it can also have negative consequences if not managed carefully. As such, it is crucial for investors, companies, and regulators to work together to ensure that institutional investor activism is transparent, accountable, and aligned with the long-term interests of all stakeholders.

Institutional investor activism can be a powerful tool for driving positive changes in corporate governance and ESG performance, but it must be managed carefully to avoid negative consequences. Ultimately, it is crucial for all stakeholders to work together to ensure that institutional investor activism is aligned with the long-term interests of the company and its stakeholders.

Conclusion

Institutional investor activism has emerged as a critical trend in the European Union, enabling investors to promote sustainable business practices and improve corporate governance. While these efforts have led to positive outcomes, such as better ESG performance and long-term value creation, challenges persist, including legal and cultural barriers, as well as the need to balance short-term and long-term interests. The case studies presented in this article have highlighted the opportunities and challenges associated with institutional investor activism, demonstrating that while investors have achieved some success in pushing for change, significant hurdles remain, such as legal challenges and resistance from company management. Institutional investor activism is likely to continue to grow in importance in the EU, particularly as investors become more focused on sustainability and other ESG issues. To ensure that these efforts are successful and avoid negative consequences, it is essential to foster ongoing dialogue and engagement among investors, companies, and other stakeholders. Transparency, accountability, and a long-term focus are key elements to effective institutional investor activism, as is the recognition of the broader social and economic implications of corporate activities.

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