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The Long View

It takes two to tango – balancing the interests of companies and investors

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Corporate governance has been in the news in the UK recently. In October the Government announced that it was withdrawing regulations that would have required listed companies to make additional public disclosures, stating that it was doing so "to reduce the burden of red tape to ensure the UK is one of the best places in the world to do business"[1].

Shortly afterwards, the Financial Reporting Council announced that it was not proceeding with most of the changes to the UK Corporate Governance Code – the governance standard for UK listed companies – that it had previously proposed[2].

These decisions followed an announcement earlier in the year from the Financial Conduct Authority, the UK's securities regulator, that it intends to remove the right of shareholders to vote on some transactions such as acquisitions[3].

As you might expect, the response to this series of announcements has been very mixed. Business organisations have been broadly supportive, but investors have raised concerns about the potential impact on governance standards and their ability to hold their investee companies to account.

I am not going to weigh up the pros and cons of these decisions in the article, but I mention them as a topical example of something that is a perennial challenge for regulators – how to strike the right balance between the interests of companies and their investors (and other stakeholders as well, of course, although they are not the focus of this article).

As a former regulator I know that this is not straightforward. I also believe that there are two common mistakes that regulators make when trying to do so.

1. **Burdensome legislation withdrawn in latest move to cut red tape for businesses - GOV.UK (www.gov.uk)**
2. **Statement: FRC policy update**
3. **FCA proposes to simplify rules to help encourage companies to list in the UK | FCA**

The first mistake is that, consciously or unconsciously, regulators give greater weight to the views and interests of business than investors.

Partly this is simply because business shouts louder. Business organisations are generally much more effective at lobbying and getting their point across than investors. But it is also because the impact on companies is typically easier to understand if you are not an expert (which few regulators are). In my experience many regulators do not really understand how investment decisions are made – it was certainly true in my case when I started out – and as a result tend to underestimate or undervalue the impact on investors' behaviour.

The second, related, mistake is that regulators tend to define the impact on companies narrowly when assessing the costs and benefits of proposed regulations or standards. They focus almost exclusively on direct costs such as compliance burdens (the 'red tape' cited by the UK Government), rather than indirect costs.

As a result, there is a tendency to overlook the potential impact on factors such as the cost and availability of capital. There is often an unspoken or unrecognised assumption that investors will continue to invest in the companies in question regardless of the regulatory framework.

This is a false assumption. Investment is mobile. With a few exceptions such as some state investment funds, institutional investors are not under an obligation to invest in particular companies, countries or asset classes.

At Morrow Sodali we know from our work in many established and emerging markets that transparency and the existence of effective shareholder rights are important for many internationally mobile investors. They consider these issues alongside other factors such as the size and liquidity of the listed sector and political stability when deciding which markets to invest in and how much of their portfolio to allocate to them.

Actions by regulators that reduce investors' ability to hold companies to account can influence those decisions.

As mentioned above, investment is also mobile across asset classes. While there are some indications that the long decline in the percentage of assets under management allocated to equities over the last decade or two may have bottomed out, it remains much lower than in the past.

For example, in 2022 only 42% of assets under management in the UK were invested in equities compared to 52% in 2007. In the same year the percentage of those equities that were invested in the UK fell for the fourth successive year according to data published by the UK's Investment Association[4]. These trends are not unique to the UK; across Europe funds allocated 40% of their assets to equities[5] compared to roughly 47% in 2010[6].

In that context, I think there is a question as to whether actions such as those taken in the UK, or in other markets where listed rules have been relaxed to allow companies to make greater use of dual class share structures, are likely to reverse or accelerate those trends.

If the objective is to promote vibrant capital markets then these are exactly the sort of questions that regulators should ask themselves when considering whether to increase or reduce requirements on companies. After all, you can't have a vibrant capital market without both companies and investors. It takes two to tango.

4. **Investment Management in the UK 2022-2023.pdf (theia.org);** October 2023
5. **European Fund Industry Review, 2022 | Lipper Alpha Insight | Refintiv (refinitiv.com)**; March 2023
6. **Reuters Asset Allocation Poll Table (Europe) July 2010 | Reuters**

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