The role of institutional investors in corporate governance - a UK perspective

Address to the Harvard Law School and Harvard Business School

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Good afternoon ladies and gentlemen; it is a great honour to be here today at this joint seminar of the Harvard Law and Business Schools, and I would like to thank Professors John Coates and Jay Lorsch for the invitation to talk to you all. I hope that you can hear me at the back; on another occasion I heard a speaker ask the same question only to be told by a member of the audience “I can hear you but I’d like to swop seats with someone who can’t”.

The aim of my talk today is to offer some insights into the role of UK institutional investors in the corporate governance arrangements of companies and thereby provide some comparisons with practice in the USA. In this talk I would like to address three themes: what we actually mean by governance; the rights and powers of UK shareholders and the role of shareholder engagement in the stewardship of companies.

By way of setting the scene, it is worth reflecting on why this is such an important subject and the bearing that it will have on the career paths of many of you, whether you become fiduciaries or indeed shareholders in your own right. Before the turn of the new century, governance was considered to be one of the more arcane aspects of corporate life – there was little public information about the way companies were governed; it was something that companies “just did” and if they did it poorly, the shareholder could deliver a verdict by selling his or her shares.

But a string of corporate failures in the last twelve years, from Enron in the USA to RBS in the UK and the wider financial crisis of 2007-2008 have prompted a re-appraisal of this dynamic. These recent failures did not just eliminate equity and wealth for a few unlucky shareholders, but generated systemic risks in global financial structures and the economy. The policy response to these risks has been unprecedented and continues today. But these crises have also shone a spotlight on corporate accountability and, in the UK, the role of shareholders. The USA has gone down the route of direct legislative intervention: Sarbanes Oxley addressed the issues of transparency and executive management accountability to corporate boards. The Dodd-Frank Wall Street Reform and Consumer Protection Act has attempted to go a number of steps further by reinforcing board accountability, regulatory supervision and the promotion of greater scrutiny by shareholders. But as, in the often misquoted words of President Calvin Coolidge, “the chief business of the American people is business”, it remains to be seen if the statutory intention is borne out by reality.

The UK has taken, arguably, a more nuanced approach to these issues. In matters relating to corporate governance, the UK has persisted with a “Comply-or-explain” approach, which allows a degree of flexibility that traditional law (which imposes the same rules on companies, whatever their circumstances), does not. The Combined Code was updated in 2010 with the publication of the UK Corporate Governance Code, which introduced a number of changes such as the annual re-election of directors of large companies and emphasised the importance of issues such as diversity in the composition of boards. Shareholders and their agents did not escape scrutiny. In response to the charge of one government minister that institutional investors behaved like “absentee landlords”, the UK Stewardship Code was born. This was the successor to the good practice guidelines published by the Institutional Shareholders’ Committee in 2002. This Code invites institutional investors to state publicly how they engage with investee companies, their voting policies and how they address conflicts of interest.

But what do these portmanteau terms “governance” and “stewardship” actually mean to institutional investors? The word ‘stewardship’ has a pleasingly old-fashioned ring to it – it is a term that might easily
be found in the novels of Washington Irving and Edith Wharton, but perhaps not in those of Norman Mailer. In the UK however, it is a ‘hot topic’ and has been resurrected to capture those dynamics that are found in a successfully run corporation. For investors in a company, the key purpose of governance is to mitigate those conflicts of interest that arise from the separation of ownership of a company from its day-to-day control. That a company is well governed can be gauged from the quality of a company’s business practice and the quality of its reporting to shareholders. The effectiveness of this governance for the generation of shareholder equity can be measured by the extent to which these good practices allow a company to get ahead of its competition. But in the wake of the financial crisis, a new term has entered the lexicon, that of “stewardship”.

In an organisational context, stewardship refers to management’s responsibility to properly utilise and develop the resources of a company in a way that generates long term value on a sustainable basis. It is more than adherence to governance rules or best practice. It consists of factors which, while essential to the long term competitive success of a company, are too subtle to be captured by legislation or codes of behaviour. These factors include corporate culture and purpose, long term business sustainability, risk appetite and the allocation of resources, environmental management and relations with society.

For UK institutional investors, stewardship refers to their ongoing duty to act in the best interests of the ultimate beneficiaries of those assets of which they are a trustee. It also refers to their responsibility to use their best efforts to preserve and increase the value of these investments.

The concept of stewardship in an organisational context goes right to the heart of the ongoing debate about corporate purpose, namely whether it is solely the generation of shareholder value. The UK Companies Act explicitly recognises this issue – directors of a company have a fiduciary duty to act in the best interests of the company for the benefit of the shareholders, while having regard for other stakeholders. This idea of a duty to a constituency that is wider than that of a company’s owners has grown in resonance in the wake of the financial crisis and some high profile cases of the environmental damage that have been caused by poorly managed business practices.

The enlightened institutional investor recognises that the management and, where possible, harmonisation of stakeholder interests is not incompatible with the generation of long term value for shareholders. For successful companies, responsible stewardship and consideration of stakeholders is not a PR exercise in appearing benevolent, but a fundamental part of the way that they appraise business risks and opportunities while having a care for their corporate reputation.

How then should institutional investors influence the governance arrangements at companies? Given that the provision of perpetuity capital by investors is at the core of the relationship between a company and its shareholders, there is a surprisingly wide range of opinions on this matter. Some argue that regulations relating to corporate disclosure inhibit if not actually preclude a meaningful dialogue between investors and companies and that this justifies their passivity as investors. At the other end of the spectrum are the so-called “activist” investors who typically take advantage of corporate instability to engineer change with a quick payback, often from quite small positions of ownership.

The enlightened investor recognises that shareholders do not own companies in the same way that an individual owns, say, a car. They merely have the rights of ownership to the residual assets of a company once all the other liabilities have been satisfied. They do not have a right to use the company’s assets or products and have limited rights to set the way a company is run. They recognise that the prime objective of the company is to manage the shareholders’ risks and maximise the value of
investment after all other obligations have been met. On this analysis, the key role of investors should be to engage companies in a purposeful dialogue on stewardship matters, make constructive suggestions as are appropriate to the circumstances of the company and hold the companies to account for their actions.

In his *Review of UK Equity Markets and Long-Term Decision Making*, Professor John Kay gives explicit endorsement to this more active approach to stewardship by institutional investors. He contrasts the power of “exit” with the power of “voice”. In the former case, institutions have typically used their power to dispose of shares or withhold capital to indicate displeasure or disappointment with their investee companies.

But Kay notes that the dispersal of investors in the global economy and the de-equitisation of the company balance sheet that has taken place on both sides of the Atlantic have blunted this particular method of corporate control. For example, the USA has retired nearly $300bn of equity in the last decade alone. He also questions whether the mere trading of shares will ever be an effective mechanism for the development of successful companies that can deliver returns to their investors over the longer term. As a solution, Kay proposes greater use of “voice” (by which he means engagement and voting) as a way of ensuring that companies take the sort of risks that are commensurate with the generation of sustainable success. In his analysis, Kay has reminded institutional investors that the company is a joint enterprise between those that run it and those that own it.

But while there is a great deal of commonality between investors in the USA and UK as to their understanding as to what is the proper purpose of a company, the rights accorded to these investors varies. In the UK, shareholder rights are comprised in company law and regulation, incorporation rights and the rights of pre-emption over the issuance of shares. This last is perhaps one of the major differences between the USA and UK and protects investors from dilution or a transfer of control consequent to the raising of additional equity capital. Pre-emption is not unknown in the USA and indeed the listing rules of a number of US exchanges preclude the issuance of additional shares above a certain amount without the permission of existing shareholders. But the practice is not common.

The primary mechanism for holding companies to account is through the voting process. Here practise in the UK is arguably better developed in favour of the shareholder than it is in the USA. While the boards of both UK and US companies have the power of appointment, UK shareholders have greater power in so far as directors, at the moment of appointment, or, who submit themselves for re-election, are subject to a majority vote that is binding.

But institutional investors also need to be assured of the manner in which the board seeks to re-new itself and ensures that the company has the right blend of talent and expertise in the key positions of leadership. Board evaluations and succession planning are both areas where companies need to communicate the effectiveness of their processes.

One of the main mechanisms of holding companies to account in both the UK and USA is through the audit process; indeed, shareholders get a vote on the appointment of the auditor. In the UK however, shareholders have very little information upon which to base a meaningful voting decision. In the wake of the financial crisis, the spotlight fell on the seeming inability of the auditors to spot the impending catastrophe, particularly at financial institutions. The usefulness and validity of the standard audit report has been called into question as has the independence of an auditor whose longevity of relationship with the audited company goes beyond 10 years.
It is worth mentioning that it is not the role of the auditor to pass judgement on the riskiness of the business model; their job is to verify that the economic transactions of the company (and other matters subject to audit) are properly accounted for. But the engaged institutional investor needs to pay more attention to this part of the governance process and, by engagement with the Audit Committee, get assurance that the auditor has behaved with the right degree of professional scepticism.

The control of executive compensation also provides some points of difference. The growth of executive compensation in both the UK and USA over the past decade has been unfavourably compared to the more pedestrian growth in shareholder value over the same period, particularly where this value is taken as a reasonable proxy for executive productivity.

The lengthy period over which shareholders have had to endure disappointment has turned executive compensation from a mundane matter of ordinary-course governance into a red-hot subject of public debate and shareholder ire. While the so-called “Shareholder Spring” perhaps demeans the more vital efforts on behalf of democracy in the Arab world, it neatly captures the passions that have been aroused. Arguably, the debate about executive compensation bares many similarities to the argument about “welfarism” – they are both sides of the same coin that is the issue of social solidarity and the contribution of the individual to the wider public good.

For institutional investors, the key issue is the incentive provided by compensation packages for executives to behave in certain ways. The review into the workings of the UK equity market conducted by Professor John Kay identified executive pay as one of the issues that explains short-termism in the stewardship of public companies. The economist Andrew Smithers has gone further and makes a direct link between the rise of corporate margins and the weakness of investment to changes in the way that executives are paid. He argues that the so-called “bonus culture” is based upon measures of financial and share price performance where the performance period is far too short. This discourages behaviours, such as investment in human and physical capital, that generate sustainable benefits for the longer term. For institutional investors, the length of whose investment horizons are determined by the liabilities of their clients, these are highly pertinent matters.

In the USA, Dodd-Frank has spawned the “Say-on-Pay” movement which mandates companies to hold an advisory vote on compensation at a frequency determined by the stock holders. In the UK, the dis-satisfaction of policy makers with the advisory approach has led to a shift away from “Comply-or-Explain” for this particular part of corporate governance. The UK coalition is introducing a bill which will provide investors with two votes: one binding vote on pay policy and an advisory vote on the application of that policy.

The UK government’s proposals on executive pay and Professor Kay’s call for a strengthening of accountability in the investment chain have provided a wake up call to institutional investors. In his 1992 report Financial Aspects of Corporate Governance, Sir Adrian Cadbury pointed out that the success of an enabling approach to regulation depended on the degree to which investors were prepared to use their influence in support of governance recommendations. In the wake of the 2007-2008 financial crisis, there is much greater appetite on the part of policy makers to use all-encompassing laws to address the perceived shortcomings of the free market in setting the governance arrangements of companies. The statutory intention is to reduce systemic risk by eliminating sources of risk. The inevitable consequence will be the steady erosion of choices available to companies and their investors. Share owners, and the institutional investors who act on their behalves need to rise to the challenge.