

IMPROVING INSTITUTIONAL INVESTORS' ROLE IN GOVERNANCE

AN INSTITUTIONAL SHAREHOLDERS' COMMITTEE PAPER

1. Introduction

This paper addresses improvements that could be made to corporate governance in the wake of the banking crisis. UK corporate governance arrangements have worked well for much of the time. Successive Codes, together with the comply-or-explain regime, have led to a cumulative improvement. However, recent experience with banks prompts an examination of how governance can be made more effective, particularly at times of stress.

Our purpose through this paper is to enhance the quality of dialogue between institutional investors and all companies, not just banks, to help improve long-term returns and the alignment of interests, reduce the risk of catastrophic outcomes due to bad strategic decisions or poor standards of governance, and help with the efficient exercise of governance responsibilities.

The ISC hopes this will form a useful contribution to the current Walker Review and the Financial Reporting Council's review of the Combined Code both in providing suggestions not only as to how ongoing dialogue with companies might be improved but also, particularly, how to deal with the rare instances when it is failing.

2. Clear mandates

Those responsible for appointing fund managers should specify in their mandates what type of commitment to corporate engagement, if any, they expect. Where shareholders delegate responsibility for such dialogue to third parties, they should agree a policy and, where appropriate, publish that policy and take steps to ensure it is followed.

Beneficiaries are free to choose whether or not to have an engagement policy, but their choice should be a considered one, based on the objectives of their fund. Managers are then responsible for ensuring that they comply with the terms of the mandate as agreed. This is consistent with principle 5 of the revised Myners' Principles published in 2008.



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3. Effective dialogue

Many institutional investors seek regular dialogue with companies on corporate governance matters. Mostly this is conducted on an individual basis, and works well. When it is failing, the ISC believes a collective approach may be useful to ensure that their message is heard. We need to build on existing approaches to enhance investors' ability to ensure that the whole board, led by the chairman, responds to concerns.

A key objective is to establish a simple, non-bureaucratic approach that would enable and encourage more institutions to participate so that there is a critical mass of involvement. A broader network might include foreign investors and sovereign wealth funds with an interest in long-term value. The resulting dialogue should be outcome-focused. The Chairman of the ISC will consult with senior practitioners from the investment industry to develop ways of achieving this.

It is important that there are no regulatory impediments, real or imagined, to the development of collective dialogue. Uncertainty about the rules on acting in concert can be a deterrent to such initiatives. The authorities should make it clear that collective dialogue is permitted. Also the authorities should make it clear that it is possible for individuals to receive price sensitive information in the course of dialogue provided there is appropriate ring-fencing.

Dialogue should be aimed at resolving difficulties. Where, however, dialogue fails to produce an appropriate response, shareholders and/or their agents should be prepared to use the full range of their powers including voting against resolutions and follow-up afterwards. The ISC considers that investors have on occasion been too reluctant to act in this way.

4. Board accountability

On occasion investors are concerned that the matters they raise with the chairman of a company are not reported to or discussed with the full board. All directors must address matters of serious concern.

One means of making boards more accountable would be for the chairs of leading committees to stand for re-election each year. If support for any individual fell below 75 per cent (including abstentions), the chairman of the board should be expected to stand for re-election the following year. This would be a powerful incentive to resolve concerns during the intervening period.



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Indeed, the requirement for chairs of committees to put themselves up for re-election would motivate them to keep abreast of investors' views and ensure that concerns are addressed in a timely way. In practice it should lead to improved dialogue with investors about issues that might be controversial. It would also broaden the agenda beyond the remuneration issues that dominate dialogue at present.

5. Raised standards at institutional investors

The ISC Statement of Principles on the Responsibilities of Institutional Shareholders and their Agents sets out how investors can approach engagement with companies. It is a useful benchmark that commands widespread consensus. We need to do more to promote it.

The ISC will review this statement over the summer and designate it as an ISC Code. Investors will be able to sign up to it and report publicly on how they apply the Code. The ISC will publish a list of signatories. This will help beneficiaries to make informed choices when issuing mandates to fund managers.

The ISC will continue to review the Code periodically and update it as required.

6. Combined Code

The current review of the Combined Code creates an opportunity for a focus on outcomes. It will ensure that the operation of the Code leads to a qualitative assessment of companies' compliance or explanations so that box ticking and boiler plating reporting are reduced to a minimum.

The ISC believes the following suggestions could enhance the quality of the dialogue between companies and investors:

- Chairmen should retain overall responsibility for communication with shareholders and/or their agents, and be encouraged, through amendment to the Code, to inform the whole board of concerns expressed (whether directly or through brokers and advisers). Both the chairman and the rest of the board should ensure that they understand the nature of the concerns and respond formally if appropriate.
- The Senior Independent Director (SID) should intervene when the above does not happen. If warranted by the extent of the concerns, the Code should also encourage the SID to take independent soundings



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with shareholders and/or their agents, and work with the chairman to ensure an appropriate response from the whole board.

- The Code should emphasise succession planning more clearly, perhaps through a provision that encourages chairmen to report annually on the process being followed and progress made.
- The audit committee's terms of reference should be expanded to include oversight of the risk appetite and control framework of the company; in complex groups where this would overload the audit committee, it may be more practical to establish a separate Risk Committee dedicated to this function.
- Board evaluation with external input should be expected of banks given their regulated status and the public interest aspect.
- The Combined Code already gives independent directors the right to seek expert advice. It should encourage them to do so in cases where they feel it may be necessary to their understanding.

<http://www.institutionalshareholderscommittee.org.uk/>

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