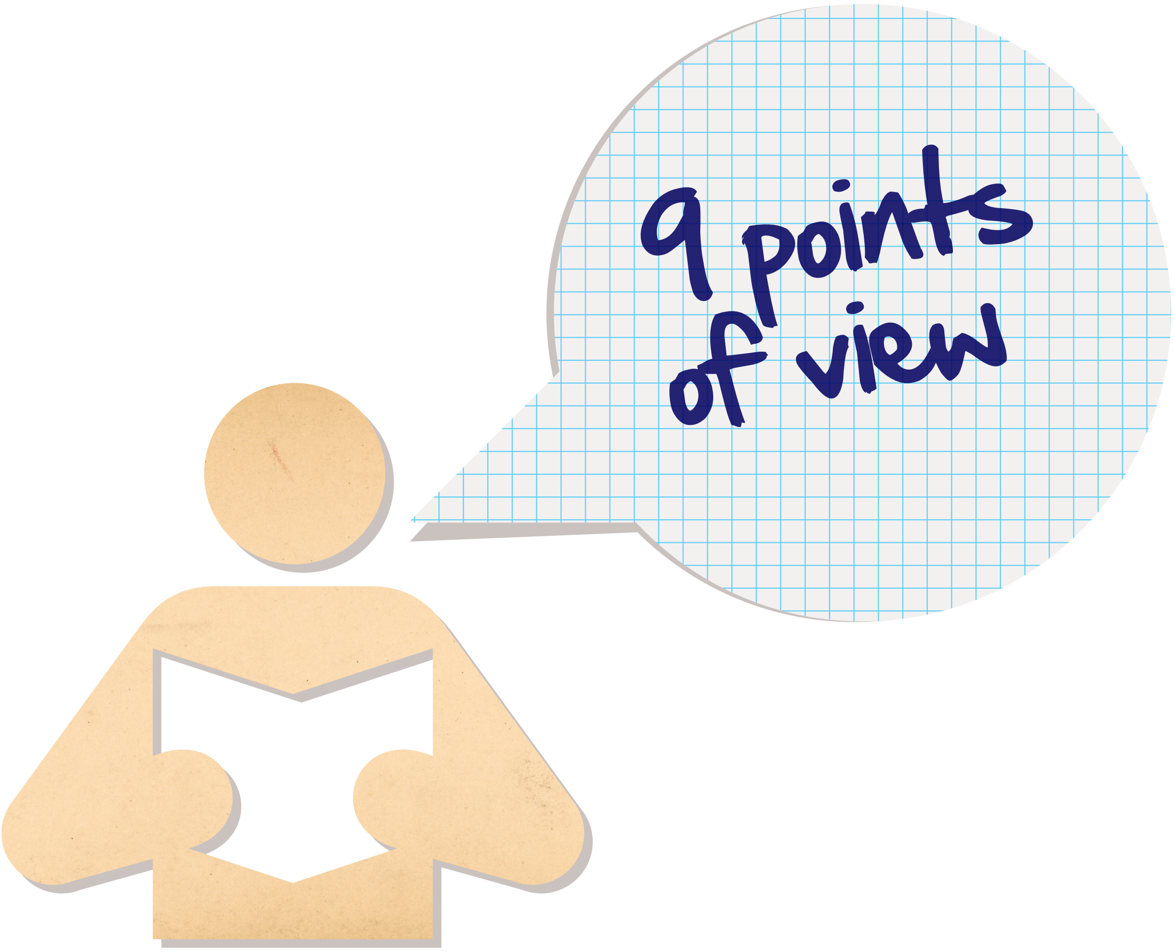
Stewardship and the stakeholder economy

PERSPECTIVES ON THE ROLE OF SHAREHOLDER ENGAGEMENT IN THE UK ECONOMY



PIRC

The idea behind this publication came from a roundtable meeting organised earlier this year by Chris Leslie MP which pulled together people from the investment community to talk about shareholder engagement, or stewardship. At that meeting it was apparent that whilst the UK has again broken new ground in governance with the publication of the Stewardship Code, there were significant differences in opinion on what should be expected as a result.

Inspired by this event, we worked with Chris to commission some of the roundtable attendees, and others with an interest in this area, to put some thoughts down on paper about stewardship, and what could be expected from it. This publication pulls together eight/nine perspectives on the topic from a variety of authors.

One clear message to draw from the essays included here is that there is significant support for the concept of 'stewardship' and a welcoming of the Stewardship Code itself. For a number of contributors, it is taken as self-evident that institutional shareholders should be active as stewards of investee companies, because it is in their long-term financial interest to do so. The important point is also made that stewardship is not simply something shareholders do to companies, but rather it is a relationship that involves both parties, and, hopefully, generates benefits for both too. As such both investors and companies are enjoined to make stewardship work.

On the other hand, an obvious tension emerging from the articles relates to expectations of change. There is a fear that if too much weight is put on the role of shareholders to prevent future company failures, policymakers may find themselves disappointed, and investors may find themselves blamed. Similarly there is a degree a scepticism on the part of some contributors about the ability of mainstream institutional investors to play the role of steward effectively, and a concern about investors' time horizons. Do we have the right shareholders to make the system work?

Importantly, therefore, this is an area where carefully calibrated public policy intervention could play a useful role. It is notable that a number of contributors believe that further intervention may be necessary if the stewardship function is to be properly embedded in the behaviour of investing institutions. If long-term investors are to be able to play a positive role in the economy perhaps the playing field needs to be tilted slightly in their favour.

We concur, and leave the challenge open to Chris and his colleague Chuka Ummuna MP to work with the investment community to think through what the policy options might be. I hope you enjoy the publication.

Alan MacDougall
Managing Director
PIRC

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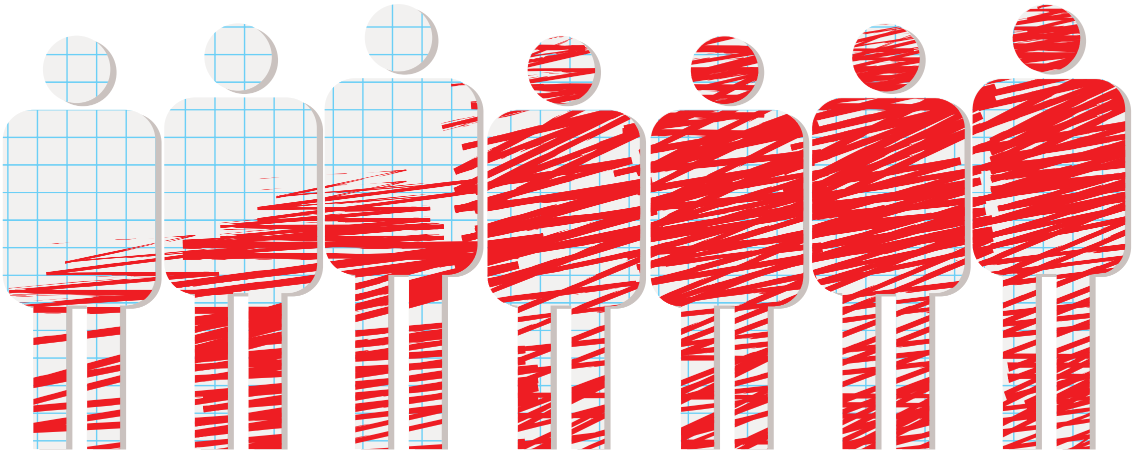


In his speech to Labour Party conference this September, Ed Miliband talked of the new model for growth we must embrace for Britain's long term economic success in the 21st century. *"Producers train, invest, invent, sell"*, he said. *"Things Britain does brilliantly. Predators are just interested in the fast buck, taking what they can out of the business. This isn't about one industry that's good and another that isn't. Or one firm always destined to be a predator and another to be a producer. It's about different ways of doing business, ways that the rules of our economy can favour or discourage."*

The time has come for a serious exploration of how these rules of our economy can spread the best of British business practice. If the global financial crisis has taught us anything, it is that the decisions and risks of large multi-national corporations can have major ramifications for everyone in society – and not just their shareholders or managers. But if we are to avoid taxpayer bailouts, heavy regulation and proscribing legislation in the future, we need to create a stronger and more sustainable system of corporate governance so that crises can be avoided in the first place. Company law has evolved much since the eighteenth century, creating legal entities which can trade freely, turn a profit and limit the liabilities of their owners. But with these privileges come a set of responsibilities to register corporate purposes, set out internal decision-making processes and publish accounts publicly. The last Labour Government did much to promote the stakeholder economy and stronger corporate stewardship – but there remains much more to be done. So what might be at the heart of this debate?

First, we need to encourage shareholders to contribute to the long-term success of the companies they own through better engagement in corporate governance mechanisms. Whether they take the 'stay and fix' approach or choose to govern through exit rather than voice, shareholders must take a leading role in constructively holding companies and executives to account. It is important to recognise that shareholders differ in their attitude towards the stock, their approach to engagement and activism, and their investment horizons[1]. Some shareholders are 'walkers', who act on their dissatisfaction at the company's direction by walking away in search of a better alternative. Others seek

> ***We need to encourage shareholders to contribute to the long-term success of the companies they own through better engagement in corporate governance mechanisms.***

to influence the direction of the companies in which they invest: Hermes UK Focus Fund, for example, has famously pursued an activist agenda and succeeded in delivering sustainable change at the companies in which it holds a stake and achieving abnormally high returns on its investment portfolio. Shareholder engagement, through voice as much as exit, is an important pillar of the future economy we envisage.

We should seriously consider whether sufficient incentives exist to encourage constructive engagement on behalf of shareholders. We should commend institutional shareholders who have committed to constructively engaging in the companies in which they have invested by publishing (and adhering to) active investment management mandates and policies. Recognition for constructive and practical engagement is incredibly important. While the 2010 Stewardship Code sets out a virtuous set of principles, the wiggle room for institutional investors to merely nod in the direction of these ideals is very broad indeed.

Second, we need to help shareholders overcome the democratic deficit of company elections and ensure that their legitimate concerns are heard. The dilemmas involved in the "principal / agent" dynamic are well known and deeply engrained in blue chip Britain, and complaints about management intransigence in the face of shareholder dissatisfaction are on the rise. In recent years, shareholders have increasingly used AGMs to object in areas such as executive remuneration plans and director re-elections. There has been a worrying tendency for some companies and executives to see shareholder votes as just elections rather than an opportunity for shareholders to express wider concerns. Good businesses have talented management who welcome constructive challenge from shareholders. But too often even large institutional investors are rebuffed by company executives who seek nothing more than a majority in the vote. It is vital that this democratic deficit is resolved.

PIRC, the ABI and other shareholder organisations work hard to represent their members and facilitate the constructive engagement of shareholders. Such open and transparent collaboration is necessary to reduce the shareholder's democratic deficit. The market abuse regime does rightly require shareholders to be disciplined in how they conduct themselves when working together, particularly when it comes more 'behind the scenes' engagement. However, they do not entirely prevent constructive public discourse between organisations and shareholder groups, nor (as the Hermes example proves) does it restrict shareholder collaboration to formal representation at votes. Whilst it is not uncommon for shareholders to act in unison on some matters, there are exceptionally few examples of investors working together to influence the direction of the companies in which they have an inherent interest. We should review whether the 'acting in concert' rules are fit for purpose

We need to help shareholders overcome the democratic deficit of company elections and ensure that their legitimate concerns are heard.

Third, we need companies to welcome constructive shareholder engagement rather than spurn it. Transparent access to basic management information is a pretty obvious prerequisite here. Recent moves by BIS to encourage greater disclosure of management remuneration are welcome, though the Government's refusal to implement the 2010 Financial Services Act provisions on disclosure of bonuses is a glaring error. That is why Ed Miliband has called for worker representation on remuneration panels and for companies to publish more information on top pay.

And merely imploring greater diversity on the Boards of UK plc, for example, will not work. We should take steps to open up the closed circles involved in the nomination processes for new Directors and encourage shareholder involvement in that nominating procedure. But good governance goes beyond the personalities who run a company – it must also encourage shareholder involvement in corporate policies and objectives. Take EasyJet as an example. A few years ago, Aviva, a major investor, voted against the Directors at their AGM because they had refused to report non-financial fleet emission information in their annual accounts. Having suffered this major embarrassment, EasyJet – thanks to the constructive engagement of its shareholders - came to recognise the long-term marketing and commercial value of making this additional disclosure. Through transparent disclosure and management being receptive to shareholder concerns, key pillars to a strong corporate governance regime, the company succeeded in building long term value. This is surely a lesson for others to follow.

In an ideal world those of us who own shares through our pensions or life insurance funds could actively engage in the corporations we own. However, the practicalities of modern savings and investment make this extremely difficult – although investors purchasing a basket of equities can increasingly choose an ethical or environmental approach should they so wish. Because we rely on professional asset managers to act as stewards on our behalf, we need strong rules to ensure they can assert the rights of ordinary shareholders when most people would expect them to do so. We need to build a framework which roots out the bad habits which everyone knows cause harm in the long run and enhances best practices.. This is a pro-business agenda and we need a Government which recognises the need for change.

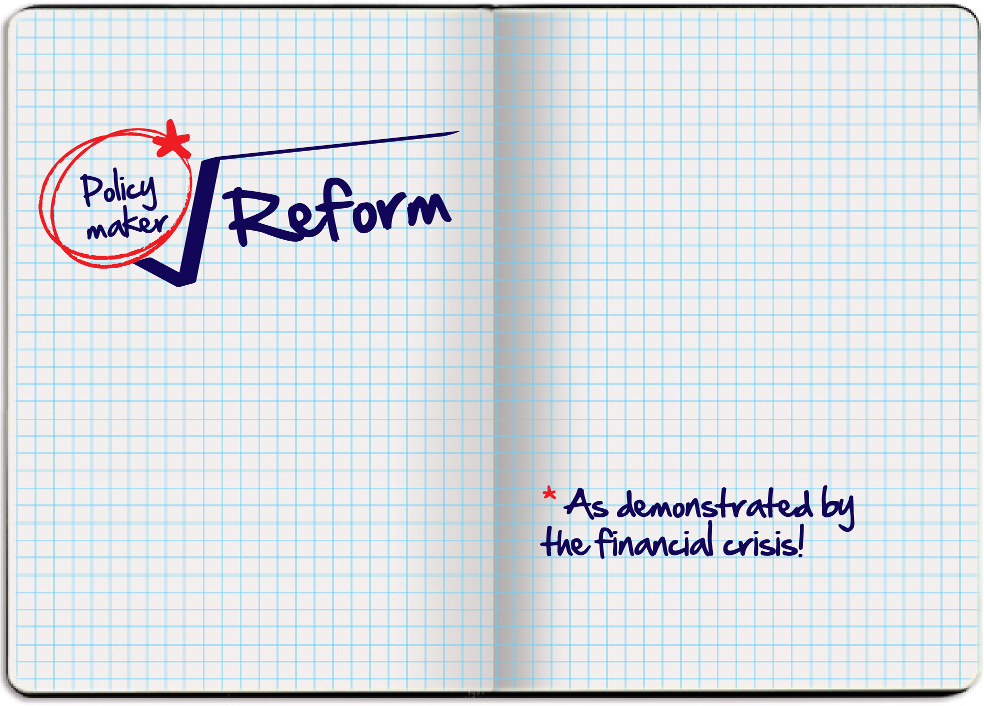
We need companies to welcome constructive shareholder engagement rather than spurn it.

Chuka Umunna is Labour MP for Streatham and Shadow Secretary of State for Business
Chris Leslie is Labour MP for Nottingham East and Shadow Financial Secretary to the Treasury

1. Nordberg, David 'The Politics of Shareholder Activism', June 2009.

Alan MacDougall and Tom Powdrill – PIRC

Investors and public policy



To read some recent commentary, you could be forgiven for believing that the role of shareholders in the governance of companies faces a new and serious challenge. As politicians in various markets react to the failures of the financial crisis, some have warned that a market-oriented approach to governance may be under threat. Quite often the threat is portrayed as coming from Europe, whose policymakers are characterised as not grasping the subtle merits of the UK's flexible, market-driven approach. According to such critics, the future could be an unattractive mixture of political and regulatory meddling, with the likelihood of unintended consequences arising from such intervention never knowingly undersold.

But to characterise the UK as a purely market-driven approach to governance, and to defend it solely in such terms, is to misunderstand both its history and to undermine its potential future. Of course shareholders do not want to lose the role in governance that is afforded to them. Of course they should be aware of how well-meant policy intervention can backfire. But, we believe, they also need to recognise that policymakers often legitimise the role that shareholders play, and that often working with policymakers can be very productive for both parties.

To illustrate the first of these points consider the recent policy background in corporate governance. Has the environment ever been as pro-shareholder? Clearly the UK stands towards the more shareholder-oriented end of the spectrum, but, prior to the financial crisis, if there was any move towards convergence across Europe then that shift was in the UK's direction. Hence, for example, former European Commissioner Charlie McCreevey's enthusiasm for promoting governance principles based on shareholder primacy, such as 'one share one vote'.

In the UK in particular it was the state that essentially re-established the role and enshrined the rights of shareholders that had for a long, post-war period been essentially regarded as rather irrelevant. Looking back to the 1960s and 1970s debates about corporate governance often focused much more on the

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role of employees, rather than that of shareholders.

Compare that with the 1990s and 2000s when the primacy of shareholders in corporate governance was affirmed through the increasing requirements for company disclosure, alongside the introduction of new rights, like shareholder approval of political donations and executive remuneration policies. And, importantly, these new powers were granted by the state because shareholders were unable to achieve such accountability from companies on their own. Only a minority of public companies previously allowed shareholders a vote on remuneration policy, for instance.

More recently the events of the financial crisis have demonstrated that policymakers can sometimes achieve fundamental change far more quickly than shareholders. It was the state that removed board directors who ran the UK's banks into crisis, when shareholders had failed to do so. It was the state that in a number of cases recapitalised the banks, and by doing so prevented a much more severe crisis. And it was the dreaded bureaucrats and regulators who brought about swift changes in remuneration policies at financial institutions that was felt to incentivise excessive risk-taking, policies that shareholders had failed to effectively challenge in the preceding years. Too often, even as reform has unfolded, shareholders and their representative bodies have been unengaged, as demonstrated, for example, by the failure of asset managers to even respond to the FSA consultation on its Remuneration Code.

Yet to hear some representatives of the investment community talk sometimes one would assume that public policy was the problem. Political and regulatory intervention is regularly characterised as a choice between the ineffective and the actively problematic. As the economist Albert Hirschman demonstrated, arguments against intervention can vary dramatically in content, but rarely do in form[1]. It is striking that the positions of the investment community in respect of public policy intervention often fall into the three categories of Hirschman's simple taxonomy of anti-reform arguments. Too often opposition to the intervention of policymakers or regulators seems to be an unthinking knee-jerk reaction, rather than a well-considered challenge.

Aside from representing a misunderstanding of the past, such a characterisation of public policy may not assist shareholders in achieving their aims in the future. We believe that emerging issues that require attention will necessitate co-operation between shareholders and policymakers. To take one example, the current approach to executive remuneration puts a significant weight on the role of shareholders. Reforms are essentially focused 'downstream' facilitating a reaction to decisions already taken by companies. As such most initiatives have looked to improve the disclosure of the details of decisions already taken, and to empower shareholders to challenge them if necessary. This has at best been only partially effective, as the ever growing gap between executive reward and that of the rest of the working population demonstrates.

Therefore there is an increasing consensus that attention should paid to 'upstream' reform, focused on how companies make the decisions on remuneration that shareholders respond to. We have made clear previously that we believe that a widening of remuneration committee membership, for example by including employee and/or shareholder representation, could improve decision-making. But such a reform would surely be impossible for investors to achieve across the board on their own. It would require some sort of political intervention.

Similarly there are significant concerns about the suitability of international financial reporting standards (IFRS) for investors' needs, and there is a growing view that they must be reformed. Yet such a change can only be achieved across the market through engagement with standard setters, regulators and so on. Again, it will not be achieved through normal shareholder engagement.

The point is a simple one. Investors sometimes require the intervention of non-shareholder bodies to bring about the change they wish to see in companies.

If shareholders and policymakers are going to work together effectively, we believe a change in tone is also required. Investors often make the valid point that to maintain a productive ongoing relationship with the companies in which they invest they must be temperate in their words and actions. Similarly we believe that in engaging in public policy investors need to think about the way they talk. Too often it is easy to form the impression that investors and their representatives hold policymakers in low regard, seeing them as uninformed meddlers. This seems to us to be self-defeating. Policymakers may in turn decide that investors are unco-operative and averse to change. This is unlikely to result in a productive relationship.

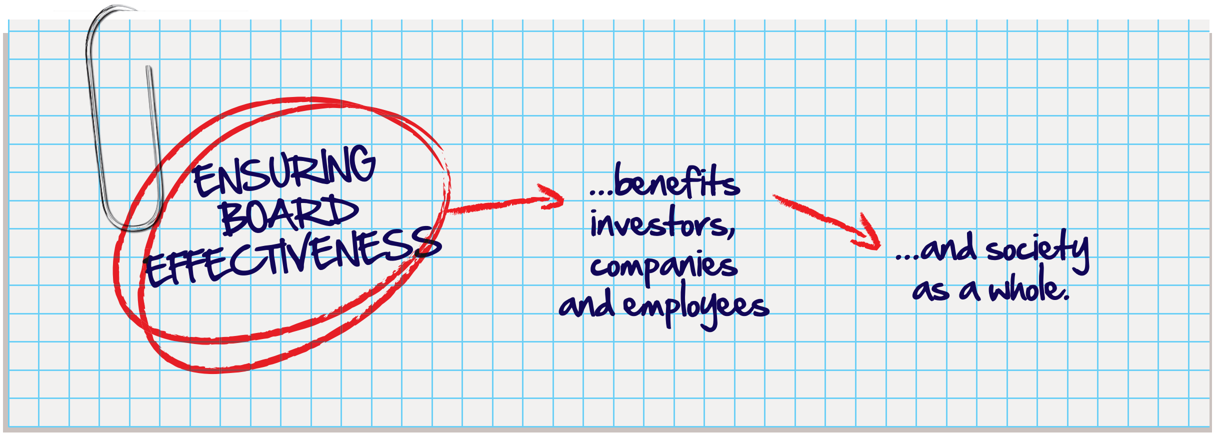
Given that corporate governance, as with all forms of governance, is in essence concerned with how power is exercised, there will always be a tension between competing sources of power. It is inevitable that sometimes policymakers might exhibit overreach, and that, conversely, sometimes shareholders might be too passive. But the current stance of some in the investment community towards policy intervention is, in our view, both misinformed and unhelpful. Engaging in public policy work can deliver benefits that shareholders cannot achieve on their own. In addition shareholder primacy in governance in the UK is, ultimately underwritten by the state. Perversely, a failure to recognise and respect the role that public policy plays in meeting shareholders' needs may contribute to bringing about exactly the loss of shareholder voice that some investors fear.

Engaging in public policy work can deliver benefits that shareholders cannot achieve on their own.

1. The Rhetoric of Reaction: Perversity, Futility, Jeopardy - Albert Hirschman, 1991

Stewards of the company

FROM CADBURY TO CODE



Stewardship is an idea that has gained resonance over the last few years in the wake of the financial crisis, in particular in relation to the stewardship of companies. A prime example of this is the UK FRC's Stewardship Code for Institutional Investors. However, the concept of Stewardship can mean different things to different people. In this paper we will seek to set out briefly:

– the recent origins of the idea from the Cadbury Report onwards;
– what it means today for investors; and
– finally, we set out our views on one of the most important aspect of Stewardship – ensuring board effectiveness.

The financial crisis that began in 2007 raised questions regarding the actions and responsibilities of many concerned, including governments and central banks, regulators and supervisors, financial institutions and their management, boards of directors and ultimately shareholders.

The focus on directors and shareholders shone the light again on the standards of corporate governance. This renewed interest in governance included questions around "Stewardship" and what were the responsibilities of the two groups, boards and investors. Concerns around corporate governance standards are of course not new, and neither is the concept of stewardship. The Cadbury Report, which forms the basis of modern standards of corporate governance, provides us with the classic definition:

'Corporate Governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors.'[1]

The Cadbury Report early on deals directly with Stewardship when it states that 'directors are responsible for the stewardship of the company's assets'[2] and few would contest its later conclusions that 'Every public company should be headed by an effective board.'[3] Finally Cadbury concludes axiomatically:

'Shareholders are responsible for electing board members and it is in their interests to see that the boards of their companies are properly constituted.'[4]

Naturally these necessary truths were not the end of the debate, and many over the years have asked – what makes an effective board?

Clearly there are numerous answers to this question, too many indeed to consider in this short space. So we will focus on three key areas that we identified in our recent Board Effectiveness Report.[5] These are:

– Diversity of perspective
– Board Evaluation
– Succession planning

The need for diversity of perspective was perhaps expressed in its earliest form by the creation of the concept of the non-executive director, or a director not involved in the day-to-day management of the business. This concept gradually evolved into the idea of the independent or outside director, who was tasked with scrutinising the behaviour of management. One of the earliest examples of this was the New York Stock Exchange rule put in place in 1978 that required that Audit Committees be made up only of independent directors. By 1999 the UK's Cadbury Report's Code of Best Practice recommended that the majority of non-executives should be independent[6]; with the concept of independence refined by Sir Derek Higgs in

The concept of Stewardship can mean different things to different people.

his 2003 Review.[7] The concept of diversity has of course progressed further than simply one of being an outsider or independent. This year the Davies Review into Women on Boards [8] brought to the fore the issue of gender diversity in the light of the current low levels of representation of women and the moves in some countries to introduce quotas.

The question of what makes an effective board also led to people to ask the question, how do we measure that effectiveness. Sir Derek Higgs also took on this challenge and recommended that:

'The performance of the board, its committees and its individual members, should be evaluated at least once a year. The annual report should state whether such performance reviews are taking place and how they are conducted'[9]

Higgs recommended on succession planning that:

'A planned programme of recruitment & retirement amongst board member can be of significant benefit. It is an important part of the board's work to ensure that there is adequate management development and succession' [10]

Higgs' recommendations were all included in the UK Corporate Governance.

In all these areas there was a clear understanding that they would only be effective if, as stated in the Cadbury Report, they were underpinned by clear and transparent reporting to shareholders by directors on their stewardship activities.

These developments led to a gradual evolution and improvement in corporate governance standards. However, as the financial crisis demonstrated there was still work to be done and this task was given to Sir David Walker. Sir David, on behalf of the Her Majesty's Treasury, produced his seminal review in November 2009[11] and concluded:

'Improvement in corporate governance will require behavioural change in an array of closely related areas in which prescribed standards play a necessary but insufficient part'[12]

In brief, we had the form but not always the substance of good governance. He goes on to say:

'The behavioural changes that may be needed are unlikely to be fostered by regulatory fiat, which in any event risks provoking unintended consequences. Behavioural improvement is more likely to be achieved through clearer identification of best practice and more effective but, in most areas, non-statutory routes to implementation so that boards and their major shareholders feels "ownership" of good governance'[13]

He also concludes that the shareholders need to play a more active role, echoing a point made in the Cadbury Report – 'Shareholders have delegated, many of their responsibilities as owners to the directors who act as Stewards. It is for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use this power.'[14] Walker therefore endorsed in his interim report[15] the Institutional Shareholders' Committees ('ISC') proposal to draw up a Code on the Responsibilities of Institutional Investors.[16]

The ISC published its Code for Institutional Investors in November 2009,[17] this was endorsed by Sir David's Final Report later that month. He also recommended that to increase the Code's authority and legitimacy it should be given to the UK's Financial Reporting Council, the guardians of the UK's Corporate Governance Code, and renamed the UK Stewardship Code. The primary aim of the Code was to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. It also provided greater transparency to the end client, asset owners such as pension funds.[18]

Board effectiveness is clearly a key issue for investors and one that needs more focus.

To date over 150 asset managers, assets owners and service providers have signed up to the Stewardship Code and its core principles and approach are being used in many other countries to form the basis of their own Code for Institutional Investors.

Board effectiveness is clearly a key issue for investors and one that needs more focus. In our recent Board Effectiveness Report we sought to help companies by looking at the issues around board diversity, succession planning and board evaluation and highlighted examples of existing best practice. We also made recommendations to companies on how to improve in these areas and, perhaps most importantly in relation to investor stewardship, made commitments ourselves, along with our members, to continue to engage, monitor and press for further improvement.

We found many examples of existing good practice by companies in all the areas, many of these are included in our report. However, we also found that some companies continue to address these issues and engage in "boilerplate" reporting that does not create understanding or encourage engagement. We therefore made a number of key recommendations including:

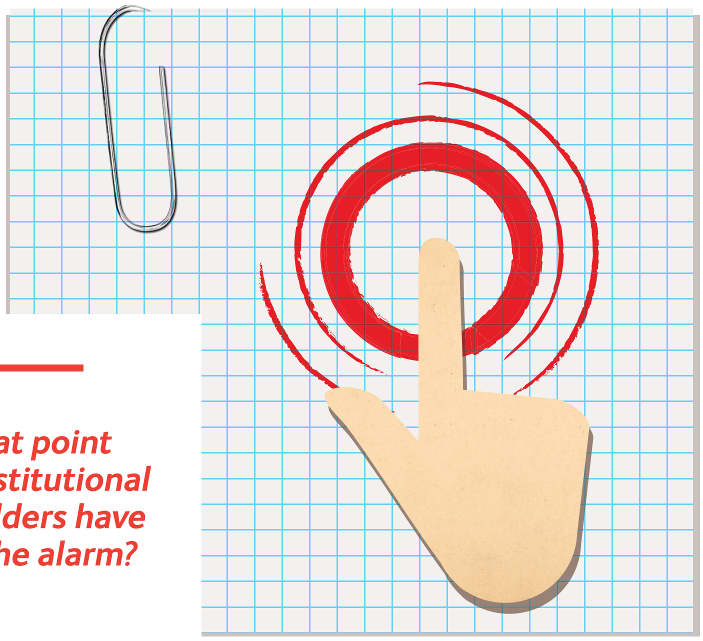
- Companies should ensure that achieving board diversity of perspective is a key objective
- Companies should set and report on measurable objectives to promote gender and other diversity in their organisations, particularly at senior management level
- Companies should ensure that they actively engage in succession planning, particularly at senior levels
- Companies should explain how board evaluations are conducted and report on the outcomes and any remedial action

In all these areas companies should provide meaningful statements that provide genuine insights.

We believe that by companies taking these steps and with investors monitoring and engaging, the overall effectiveness of boards will be increased and the stewardship of companies will improve for the benefit of investors, companies, employees and ultimately society as a whole.

1. The Financial Aspects of Corporate Governance [Cadbury Report], paragraph 2.5 (1992)
2. Cadbury Report, paragraph 1.8
3. Ibid, paragraph 4.1
4. Ibid, paragraph 4.2
5. Report on Board Effectiveness – Highlighting Best Practice: Encouraging Progress, ABI 2011, http://www.ivis.co.uk/PDF/ABI_1684_v6_CS4.pdf
6. Cadbury Code of Best Practice, Provision 2.2
7. Review of the role and effectiveness of non-executive directors, [Higgs Review] 2003, Chapter 9, Independence
8. http://www.bis.gov.uk/assets/biscore/business-law/docs/w/11-745-women-on-boards.pdf
9. Higgs Review, paragraph 11.22
10. Higgs, p.41
11. A review of corporate governance in UK banks and other financial institutions, [Walker Review] 2009
12. Walker Review, p.9
13. Walker Review, p.10
14. Cadbury Report, paragraph 6.8
15. Walker Interim Report, July 2009
16. Improving Institutional Investors' role in governance, An Institutional Shareholders' Committees Paper, June 2009
17. ISC Code, 16th November 2009
18. FRC Stewardship Code, http://www.frc.org.uk/corporate/investorgovernance.cfm

Understanding the crisis



At what point ought institutional shareholders have raised the alarm?

To state that the financial crisis of 2007-2008 expressed a failure of corporate governance in the City of London seems, in comparison with the scale of turmoil and economic destruction that was wrought, like a grotesque understatement. It is rather like saying that the First World War reflected weaknesses in early 20th Century diplomacy – a modest truth dwarfed by events. Something much bigger failed in the credit crunch. Defining what it was is probably the single biggest intellectual challenge facing British politics.

Plainly, shareholders and boards at some of Britain's largest banks failed to scrutinise the business model with sufficient rigour. They might have spotted, for example, the toxicity of assets on the balance sheet, the incentives created by a bonus structure that rewarded risk without punishing failure, the hegemonic power of certain chief executives to requisition large and systemically vital institutions, steering them into commercially ruinous acquisitions motivated above all by the pursuit of personal glory. Sir Fred Goodwin was, it is safe to say, not subjected to adequate checks and balances in his management of the Royal Bank of Scotland.

As with any disaster, part of the response is to sift through the rubble, identify the cause and imagine preventative mechanisms that ought to have been in place. It would certainly be instructive to have a clear account of the moments at which catastrophe might have been averted. This is harder than it sounds. There was no black box flight recorder on the deck of the financial services industry that we can play back to see the point at which crash became inevitable. And if there were, how would it inform policy now?

At which meeting might a chief executive have been confronted? At what point ought institutional shareholders have raised the alarm? What hypothetical model could they have used to demonstrate the hazard when, by definition, the existing model was a proven success? There is ample testimony to show that anyone who tried to warn of excessive risk, whether at board level or on a trading floor, was derided and in some cases punished for disloyalty. This should not be surprising. As the bubble was inflating, those who took the biggest financial risks were also the ones reaping the greatest rewards and so, in the corporate ethic of the industry, the "best" people. It is human nature to assume that things go well because of our superb judgment and go badly because of unforeseeable misfortune. It is also going against the grain of human nature to tell people who are making you rich that they are out of control.

It is possible to overstate the role played by psychology in the collective behaviour of the financial services sector during the boom, but naïve to ignore it. There are, no doubt, regulatory brakes that might have inhibited reckless behaviour. Some practical recommendations – albeit fairly timid ones - were contained in the 2009 Walker Review that looked specifically at corporate governance in the banking sector. These mainly focused on greater transparency around remuneration and aspirations that non-executive directors and shareholders dedicate more time and apply more practical expertise to the scrutiny of risk-taking. That is self-evidently preferable to the opposite. No-one is recommending greater opacity around bonuses and an increase of investor ignorance. But a retrospective critique of governance mechanisms risks ignoring the role that culture and ethical judgment played in the crash. Regulation can create obstacles to reckless behaviour. But if the potential rewards are big enough, the incentive is still there to bypass the rules or find new ways to make money that are not covered by the rules. An essential component of the crisis was the innovation of arcane financial instruments that very few people understood (least of all the agencies that awarded them triple A risk ratings). Ingenuity in gaming the system is not a marginal by-product of the globalised financial system, it is a core competence.

Likewise, it is a simple point of logic the models used to calculate risk are built on data sets that do not include the next unforeseen catastrophe. It is a fundamental principle of economics that models are most useful as academic tools when they are proved wrong by reality. That way economists can better understand what was missing, which is great for the general furthering of human knowledge. It is disastrous when modelling is used, as in the financial services industry, to calculate the odds on multi-billion pound gambles. In other words, regulation and demands to collect more data can easily have the effect of making finance more complicated without making it intrinsically safer.

But since the crash, it has become a political axiom that weak regulation was the problem and that the core of a solution must therefore lie in adjustment to the rules. That view owes much to the political context of a particular period – the run-up to the 2010 election.

From the Conservative point of view, it was vital to pin the crisis on Labour. The Tory intellectual tradition, largely unmodified since Margaret Thatcher's Big Bang reforms to the City in 1986, did not permit profound rejection of the principles of unfettered finance. It was, therefore, necessary to focus on the specific "tripartite" regulatory structure devised by Gordon Brown. David Cameron and George Osborne did not have a macroeconomic critique of the power and volatility of capital markets and were forced to make the debate as parochial as possible: Labour spent too much money and forgot to control the banks.

From the Labour side, there was no escaping the fact that Gordon Brown, as chancellor and then prime minister, had overseen the inflation of the bubble. More problematic still, he had repeatedly declared it not to be a bubble. The claim to have abolished "boom and bust" encapsulated an epic failure of macroeconomic judgement. It hardly needs adding that Brown was unpopular and leading an exhausted and demoralised administration. Whatever his successes in helping coordinate the global response in the immediate aftermath of the crash, they could not be translated into a campaign to have him re-elected as prime minister.

Even if there was a greater readiness on the left to grapple with the intellectual challenges of a global crisis in liberal capitalism (which is clearly what was – and still is - unfolding), Labour had no moral authority to lead the debate. Whether it has more now that it is in opposition is an open question and, arguably, the one on which the next election result depends.

My point here is that given the particular set of political circumstances in the period immediately after the 2008 crash, the parochial account of what went wrong was always going to trump the global one.

As a result we now have a conversation about financial services that focuses on crude questions of domestic regulation. Should banks be broken up? Should they be taxed more? What of their activities should be taxed or banned or subject to a ring fence? These are all important questions but as long as they are debated as a unilateral proposition in a single national jurisdiction they are vulnerable to charge of impossible implementation. How can one government regulate its financial services when, by the very nature of the industry, to do so makes them globally less competitive? But then, how can the current UK government pursue a multilateral agenda for the reform of financial services when its whole analysis of what went wrong in the first place is domestic and parochial? (Besides, the obvious international forum in which to begin building consensus would be the European Union, where the Conservatives find constructive engagement problematic to say the least.) Meanwhile, as the UK economy stagnates, the fear of hobbling a large sector of the economy starts to outweigh the appeal of exacting populist vengeance against bankers for the crash. Doing nothing of substance at all to the City starts to look like an increasingly alluring avenue for George Osborne. Reforms to financial structures and corporate governance could easily be implemented partially and over a long time in such a way as to leave undisturbed the essential component of the industry that was arguably most responsible for the crisis – its culture.

This is a difficult area for policy makers for two reasons. First, it is notoriously tricky to legislate for changes in behaviour. Second, to do so requires a discourse in absolute moral terms – in this case condemning greed, recklessness and irresponsibility – when it is not obvious that UK politicians are invested with any credible public authority to use that kind of language. Bankers are despised and reviled, but not much more so than politicians.

The tendency in any discussion of corporate governance issues has been to look at bad outcomes – a financial crash; a massive oil slick in the Gulf of Mexico; a giant fraud – and imagine that they are unintended consequences of regulatory oversight. That might be the case. But it is also worth considering the possibility that they are the normal and, at a systemic level, routine product of commercial imperatives at work; that the culture and ethos of the organisation has not only permitted the wrongdoing but has made it a necessary part of the process in achieving broader business aims.

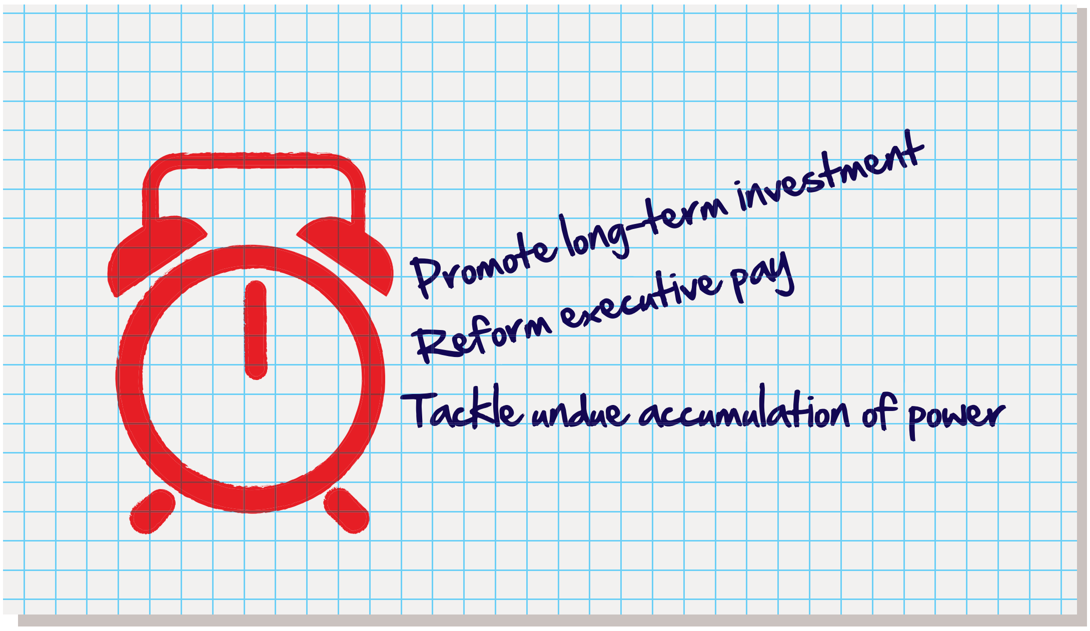
That is not a very comfortable conclusion to draw; it demands a re-imagining of corporate structures more radical than anything currently under consideration in British politics, or indeed under consideration in any global forum. But the parochial domestic response to the crisis has failed. It risks not just reinforcing a sense of widespread ineffective economic management but aggravating also a national mood of disregard for the moral authority of establishment politics as the mechanism for delivering economic security and prosperity. In that context, radicalism is probably less dangerous than continuing to imagine that meaningful change can be achieved by incremental reform.

Radicalism is probably less dangerous than continuing to imagine that meaningful change can be achieved by incremental reform.

5

Stephen Beer – Central Finance Board of the Methodist Church

The moment for reform



Capitalism is still in crisis and the shock waves from the near collapse of the financial system in 2008 are still reverberating around the world. This is the time to be asking fundamental questions about what we want from our market economy and how we can make it work for everyone. That debate must have the City at its heart, for though in this country the City contained the institutions which nearly brought our economy to total collapse; it also has the potential to lead the world in a reformation of finance.

This is the time to be asking fundamental questions about what we want from our market economy.

The financial crisis raised deep, existential questions even in the City. Confidence collapsed in the system on which so many had relied. That brought peoples values and worldviews into the open. Suddenly even traders were asking what it was all for and whether we should be doing things differently. At the same time, a debate about market morality was beginning. The St Paul's Institute, recently the focus of protesters' ire, hosted speeches from UK and Australian Prime Ministers Gordon Brown and Kevin Rudd in 2009 on what values are needed in markets. A few months later, Archbishop Rowan Williams argued for virtue in markets. His speech seemed to have marked the closing of a window of opportunity for reform as banks returned to business as usual and lobbied against regulation. However, the European sovereign and banking crisis has opened that window once more.

The opportunity must be seized by the City, not least because it risks a populist backlash if it does nothing. The 'Occupy' protests and encampments have raised serious questions about how we 'do' markets and they were in financial centres because they identified finance as part of the problem and the solution. Their arguments should be engaged with. Meanwhile, the need for more bright brains in the City to focus on longer term investment horizons remains.

Promoting long term commitment and good management

The City is often criticised for being too short termist but this ignores the long term holdings held by many investment funds, such as pension funds. Some company managements may argue that investment managers are slow to back their long term business projects but the investment managers are not all to blame. Financial forecasting is not very accurate beyond a couple of years and while companies themselves may use forecasting models, even small variations in interest rates or the growth rate can translate into large variations in the net present value of a project today. Forecasts are also subject to trends. For example, during the dotcom boom there was a great deal of 'long term' investment as investors chased companies which barely produced revenues let alone profits. Some of those investments really did become long term as the market for their shares dried up.

The numbers do matter, but investors also need to be able to trust management. Do they believe a company's management is credible? Mature investment managers will have memories of being taken for a ride in the past and should have a healthy scepticism: fund managers are critical capitalists. Deeper relationships between investors and companies can come up against regulatory safeguards but reform in this area must look at how this works in practice. The alternative is for fund managers to take the view, based on behavioural finance findings, that meeting company managements at a peripheral level may in fact lead to poorer investment fund performance, as the management story distracts too much from the numbers themselves.

Good management is important. A good management team will get the basics right, from a close attention to cashflow to investment in people. It will focus on sustainable profits growth. A well-run company is usually an ethical company, with an understanding of its responsibilities in society. If the company is to have the privileges of corporate citizenship, it should be exercising citizenship responsibilities too. The Labour government required pension funds to state their environmental, social, and governance (ESG) policies. Pension funds should be clear about how they will put these into effect and how they assess their performance in this area. Government should promote the Stewardship Code and encourage the production of comparable data on fund managers from organisations such as the UN Principles for Responsible Investment, so large institutions cannot hide behind the approach taken by their relatively small ethical funds.

Many funds index against a benchmark, and some funds are very large, which limits the scope for engagement with a company, because the ultimate sanction of selling the shares has gone. That should be counter-balanced by a higher degree of engagement with company management and a higher propensity to vote against directors and propose new faces to company boards.

Reforming executive pay

An area of poor (and short term) incentives which is ripe for reform is executive pay. People read that directors pay has risen 49% and contrast that with their own falling living standards, as inflation makes a mockery of their own salaries. Yet their pension funds are probably voting for those pay increases. Only in exceptional circumstances do most City institutions vote against pay packages. This is despite the vote being only advisory, retrospective, and having no legal power. Investment institutions also continue to vote for the reappointment of directors who are members of remuneration committees which set excessive pay awards. This is a mystery and suggests a lack of market forces. High director pay rises unrelated to performance, or the cost of living, are taking money from shareholders so why they or their agents should be so content with this arrangement is not clear. Of course, even high directors' salaries represent a small percentage of the profits of most FTSE 100 companies. Furthermore, despite their concerns about pay, investors sometimes become convinced by the star qualities of individual chief executives and so allow them large awards. Yet presumably a CEO who has not ensured the company can survive and prosper without him or her is not such a good business leader after all. The banks meanwhile are in a different dimension; despite the bail-outs and their business models which seem to find new ways to lose money every few years, they continue to pay their executives very high salaries and wonder why the public remains so angry with them.

It is conventional wisdom that pay should be linked to performance and this is a good base level; reasonably stretching performance targets should be set and pay should not appear excessive even if these are hit. Yet CEOs will tell investors they would of course work just as hard for a much lower salary, or a much higher one. We would not want it otherwise. Ask remuneration committee chairs to outline the evidence they use to show that performance-related pay leads to better outcomes for the company and they flee towards generalisations. One would have thought that a bonus structure would be set for an optimal outcome for a company. Perhaps in reality, performance-related pay increases are seen by companies as 'just rewards' rather than designed with shareholders in mind. If that is the case, boards have introduced an ethic into pay (if questionably applied) and it is not too big a step to argue that should be applied throughout the company. This is the approach taken by a report commissioned by the Church Investors Group, which applied theological considerations to company pay. A conclusion was that investors should look at pay levels at the bottom as well as the top, and should look at the ratio between the two.

An outline for reform is becoming clear. Remuneration policies should be based on simple and transparent criteria, and should be subject to a binding shareholder vote before they can be implemented. Both companies and investment institutions should be required to state publicly their reasons when backing pay schemes with a ratio between the highest and the lowest ten percent above a certain point. We could even consider whether shareholders should be able to elect a direct representative to remuneration committees.

Power

Reform should be positive in nature. Its aim should be to make the market work for more people and break up the undue accumulation of power. As economic power is dispersed and experienced more widely, so inequality is tackled and there is a better relationship between the City and the society in which it sits. There may be an opportunity to see this if bank lending to SMEs continues to be poor; the City should be able to find alternative mechanisms and in doing so may become more obviously relevant to the wider nation. It could also experiment with different company models. Ultimately, some sort of national investment bank will be required. This is not to downplay the vital international role played by our financial sector; indeed the City can become an innovator in more productive forms of finance. Virtue in markets is important. It matters who runs trading floors, even with a strict compliance regime. Example needs to be set from the top. Yet ultimately virtue cannot be forced; it can only be encouraged and its absence considered a matter for shame. Concentration of power tends to act against virtuous behaviour; that points to the separation of banking activities at the least, for example.

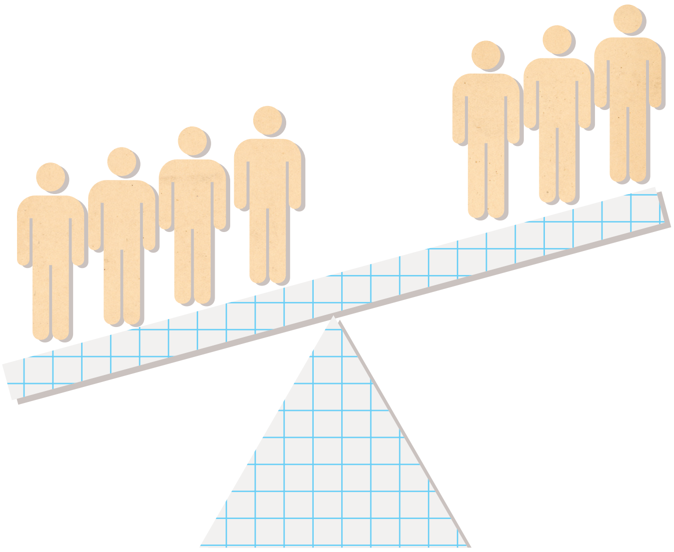
As economies struggle to recover, an important theme will be investment in the future.

As economies struggle to recover, an important theme will be investment in the future. We can help encourage this by strengthening financial relationships throughout the economy. The City can lead the way by being more proactive in promoting good management, discarding outdated executive pay practices, and experimenting with new forms of finance better related to the 'real' economy. Government has an important role to promote transparency, ensure incentives are consistent with these aims, and by standing against any undue concentration of power.

Stephen Beer

Stephen Beer is senior fund manager at the Central Finance Board of the Methodist Church. He has recently written a Fabian Society pamphlet on Labour's economic policy, entitled The Credibility Deficit – how to rebuild Labour's economic reputation. This chapter represents his personal opinion.

Can 'stewardship' save shareholder value?



The financial crisis has shone a spot light onto the previously low-profile world of corporate governance. The near collapse of the banking system and the Government rescue of Northern Rock and RBS dramatically increased the interest of policy makers and commentators in the tools of corporate governance, as the search for answers for why banks had failed combined with the search for ways to stop it happening again. Sir David Walker's review of corporate governance in UK banks and other financial industry entities highlighted weaknesses in shareholder engagement and oversight, and led to the introduction of the Stewardship Code for Institutional Investors, launched by the Financial Reporting Council in July 2010. In the UK, this is the most significant corporate governance reform to come out of the financial crisis.

Is the shareholder value model really working, or is the financial crisis a sign that the model itself needs to change?

Given the central role ascribed to shareholders in our corporate governance system, it is absolutely right and long overdue that some standards should be established in terms of what is expected of shareholders in carrying out their responsibilities towards investee companies. However, there is a more fundamental question that needs to be asked: whether the shareholder value model that the Stewardship Code adorns is really working as it should be, or whether the financial crisis is a potent sign that the model itself needs to change.

At the heart of the UK's corporate governance system is what is termed 'enlightened shareholder value'. Company directors are required by law to serve first and foremost the interests of shareholders, but, in so-doing, are also required to have regard to the interests of employees, suppliers and customers, to community, environmental and reputational impacts and to the long-term consequences of their decisions. Shareholder interests are paramount, but directors are encouraged to serve shareholder interests in a way that also takes account of wider stakeholder interests.

The rationale behind this formulation is that in the long-term there should be a convergence of interests between shareholders and other key company stakeholders, so requiring directors to put shareholder interests first should go hand in hand with generating benefits for all stakeholders. However, creating profit is compatible both with a 'high-road' approach to business based on developing positive stakeholder relationships and investing in R&D and training, and with a 'low-road' approach based on a low-wage, low-skill, low-investment model characterised by poor stakeholder relationships. The aim of requiring directors to take account of employee, supplier, community and customer interests was to push companies towards the 'high-road' approach. The question is whether this has worked.

As well having the right for their interests to be put first within company law, shareholders also have considerable rights in relation to how companies are run. As well as picking up a dividend in exchange for holding company shares, shareholders can:

- elect directors – now annually - at company AGMs;
- vote on remuneration reports, although the vote is only 'advisory';
- vote on shareholder and other resolutions at AGMs; and
- convene Emergency General Meetings.

Ever since the early 1990s, successive reviews of corporate governance, from Cadbury, Greenbury, Hampel, Turnbull, Higgs, and more recently the Walker review of bank governance, have all emphasised the role of shareholders in monitoring and engaging with companies, rather than regulation, as the means of controlling undesirable corporate behaviour. This is particularly notable in the area of executive pay, but is also true more broadly. A common response of successive governments to public concern about corporate behaviour is 'it's a matter for shareholders'. The Stewardship Code sets out standards on how investors should carry out this monitoring and engagement role.

This model of corporate governance - enlightened shareholder value combined with shareholder oversight - is based on number of assumptions about the characteristics and behaviour of shareholders. The first, referred to above, is that there is a convergence of interests between shareholders and the interests not only of other stakeholders but also the company itself. However, this only holds in practice if shareholders are committed to investing in the company on a long-term basis and their prime financial interest in the company is the ability to receive dividend payments over time. If, however, an investor is a short-term share trader whose prime financial interest in the company is to sell their shares at a higher price than they bought them, their interest will be in short-term strategies to raise the share price, rather than long-term strategies to invest in organic growth. In this case, their interests will not coincide with those of company stakeholders such as employees and suppliers, nor, very significantly, of the company itself. If the investor is shorting the stock, their interests will be diametrically opposed to those of the company and its other stakeholders, including long-term shareholders, as they will stand to gain if the company's share prices falls.

In this scenario, it is far from clear why it is shareholders whose interests companies should be required to promote, nor why it is shareholders who should have the ultimate say over how companies are run.

The other assumption at the heart of enlightened shareholder value is that shareholders have the ability and motivation to carry out their monitoring and engagement role effectively.

Share ownership patterns have changed rapidly over recent decades. In the 1960s, the majority of shares in UK companies were owned by individuals, many of whom took a reasonable level of interest in the companies whose shares they owned. By the 1980s, the majority of shares were owned by UK institutional investors such as pension funds and insurance companies. Today, this has changed again, and recent figures from the Investment Managers' Association (IMA) suggest that pension funds and insurance companies now hold around 13% of UK equities each, with an additional 14% held by other UK institutional investors[1]. ONS figures show that at the end of 2008, 41.5 per cent of UK-listed shares were owned by investors from outside the UK, and individuals held just over ten per cent, the lowest percentage since the survey started in 1963[2].

These changes have great significance for the effectiveness of the UK's shareholder-oriented corporate governance system. It will clearly be harder for overseas investors to develop the kind of engaged relationships with UK companies that are envisaged by the UK's corporate governance system. Language, culture, proximity and availability of information all make engagement much more straightforward within a national context in comparison with engaging with companies abroad. This is reflected in responses to the TUC's Fund Manager Voting Survey: in the 2010 Survey, 21 respondents said they voted all their UK shares (with a couple of minor qualifications), while just nine voted all their overseas shares (with a further six saying they voted where practical or in certain markets or a significant proportion of their overseas shares). The UK's corporate governance system was not designed on the basis that the largest single share ownership block would be investors from outside the UK.

Looking at the role of UK institutional investors, there are still major practical barriers to effective investor engagement. Institutional investors hold highly diversified portfolios; the IMA says that the average fund manager holds 450 shareholdings, and for some it will be in the thousands. The TUC's Fund Manager Voting Survey asks each year about how many people fund managers have working on corporate governance and responsibility issues. With five exceptions - two teams of over 30, three teams of between ten and twenty people – all the respondents have less than ten staff working on these issues. However skilled and dedicated such staff may be, it cannot be possible for them to engage effectively with all the companies whose shares they hold over all the issues for which shareholders are ultimately responsible.

A further challenge for effective stewardship is that at present most decisions about voting and engagement are taken by fund managers, whose approach may not be the same as that of the ultimate beneficiaries of those investments. Most of the attention in relation to the role of asset owners has focussed on pension funds and the need for them to give clearer and stronger mandates to their fund managers on stewardship and engagement issues. This is indeed needed, but much more problematic is how to deal with stewardship in relation to beneficiaries with defined contribution pension schemes, personal pensions, insurance-related investment products and so on. This is a vitally important area which has received insufficient attention to date, and which, given the major changes taking place in the pensions landscape, it is increasingly urgent to address.

The TUC believes that it is wrong for short-term share owners to play a significant role in corporate governance.

The TUC supports the Stewardship Code as an important step towards recognising the responsibilities that investors have towards the companies whose shares they own. But we do not believe it is sufficient to make the UK's shareholder-oriented corporate governance system operate effectively. We believe that enlightened shareholder value needs to be revisited, and would like to see directors' duties rewritten so that directors are required to promote the long-term success of the company as their primary aim. In so doing, they should be required to deliver sustainable returns to shareholders, promote the interests of employees, suppliers and customers, and have regard to community, environmental and reputational impacts. This would have the effect of rebalancing the interests of shareholders and others stakeholders, but all their interests would be secondary to those of long-term success of the company itself.

The TUC believes that it is wrong for short-term share owners to play a significant role in corporate governance. We believe that voting and engagement rights should be subject to a minimum period of share ownership, which we suggest should be two years. Strategies to promote collaboration between investors over engagement should be developed, in order to avoid wasteful duplication and make the best possible use of resources available.

The Stewardship Code has given the emperor some new clothes, but underneath the problems with enlightened shareholder value have not gone away.

1. IMA, Asset Management in the UK 2009 – 2010, July 2010
2. Available at http://www.statistics.gov.uk/cci/nugget.asp?id=107

7

Phineas Glover – The Co-operative Asset Management

Building markets for the future

INTERNALISING THE STEWARDSHIP EXTERNALITY

This paper seeks to make the case for stewardship as an imperative for healthy financial markets. In doing so we set out why stewardship is part of The Co-operative Asset Management's (TCAM) investment philosophy and what it means in practice. The barriers faced in asserting a critical mass of investors for effective stewardship are discussed along with an examination of some of the more nebulous structural impediments that sit behind day-to-day engagement efforts. Finally, we outline our perspective on market reforms that may help re-model the investment chain towards a more long-term stewardship approach.

Stewardship is the front-line in protecting against rent extraction and short-termist approaches that jeopardise our economy and environment.

A stewardship mandate

Taking the long-term view is part of TCAM's ethos. Therefore, we see a successful functioning economic system as one that takes account of the sustainability challenge society faces. There is much at stake: investments in the technologies of the future that will help society mitigate resource depletion and damaging climate change requires much longer-term investment horizons. This necessitates a market infrastructure that appreciates 'natural capital' such as the world's aquifers, biodiversity and other resources, in the way that it does traditional 'capital efficiency'.

This is something our members recognise and call on us to tackle via our fully customer mandated Ethical Engagement Policy[1]. As well as this mandate to act as long-term stewards on behalf of our clients, our experience to date indicates a strong business case. By integrating environmental, social and governance (ESG) analysis throughout the investment process we believe we are better able to identify mis-priced companies and serve our clients interests over the long-term.

Therefore stewardship formed a natural responsibility within TCAM long before the Financial Reporting Council formalised the Stewardship Code in the UK. This is reflected by us being the 1st asset manager in the world to issue a comprehensive compliance statement[2].

Stewardship matters

The relationship between principal and agent, the shareholders and the directors, is the cornerstone of the UK market. The system is underpinned by the comply-or-explain framework and is an ownership model that relies on good quality explanations by companies and a fully engaged shareholder base. This stewardship is the front-line in protecting against rent extraction, typically associated with executive excess, and short-termist approaches that jeopardise our economy and environment for future generations.

TCAM believes shareholder engagement is a discipline that should be undertaken through:

- two-way communication, allowing for enhanced understanding beyond the boiler-plate;
- informed scrutiny of systems and practices and how they sit next to the agreed long-term strategic goals;
- transparent reporting from companies and institutional shareholders; and most importantly,
- accountability, so that the whole process is underpinned by the threat of direct stewardship sanctions, providing a tangible reminder to boards their responsibility to create long-term value for shareholders and society.

Key to our engagement strategy is encouraging investee companies to understand and improve how they manage the ESG aspects of their business

Key to our engagement strategy is encouraging investee companies to understand and improve how they manage the ESG aspects of their business. Identifying risks not normally addressed through traditional financial analysis enables us to encourage companies to respond to social and environmental challenges and this can contribute to better long term returns.

Engagement is underpinned by accountability in our proxy voting and such decisions are not taken lightly or in isolation. Our financial analysts, fund managers and chief investment officer are all represented on our Responsible Shareholder Committee that provides counsel on proxy voting.

This all provides a solid foundation for a comprehensive approach to stewardship; however we are only one investor in the maelstrom of UK equity markets.

Practical challenges

The global breadth of holdings by the most influential investors in the UK still presents a barrier to stewardship. Currently global investors are faced with a depth and breadth trade-off in allocating stewardship resources. For instance, if they are more weighted towards a country with a poor corporate governance framework, there may be an argument for targeting these bigger margins of improvement rather than the UK.

The composition of owners in the UK market has undergone major changes over the past 20 years, with ownership of UK equities by UK institutional investors decreasing from around 60% to 40%. Such a shift brings new realities to the principal – agent model and reflects a decline in traditionally engaged institutional investors.

Note also the growth of inflows to passive and exchange traded funds. In theory as passive investing precludes stock bias and seeks broader macro related gains in the market, this should be a positive for attaining a critical mass of stewardship. Despite this natural alignment many big index players pay little visible attention to stewardship. Index fund marketing tends to focus on a low fee model that tries to compensate by accruing stock-lending fees, a clear example of divorced ownership.

While each asset management business will ultimately take a distinctive approach to the way they structure their stewardship activities, many appear vastly under resourced. There are numerous reasons for this apparent void in stewardship; but many relate to more structural impediments that sit behind the day-to-day engagement with companies. They typically relate to the investment chain.

The stewardship chain

While in the UK the expected role of shareholders has now been formalised by the FRC's Stewardship Code for institutional investors, it is important to consider the concept of stewardship across the investment value chain. This forms the financial architecture linking society, from savers at one end to investment in companies at the other, and has a huge bearing on the way markets operate.

Economic theory suggests that interests are aligned at every juncture in this chain, from beneficiaries (the owners of capital), to trustees, to advisors, to the managers of capital, and the ultimate recipients. Meanwhile, the company responds to the signals from its owners by managing returns to them over the long-term. Hence, an efficient capital market transfers today's savings into tomorrow's investment - long-term growth should prevail.

Unfortunately, complexity in this chain can cause a decoupling of interests. Hence, a number of information asymmetries along the way between the various principals and agents. Understanding this sequence is important to ensuring that long-term stewardship is not diluted and is properly mobilised by fund managers at the end of the chain. In that sense we consider the debate around short-termism and diluted stewardship as interconnected. For stewardship to be effective there needs to be a critical mass of long-term investors and reforming this should start right at the beginning of the chain, with the beneficiaries.

Engage beneficiaries

Most beneficiaries don't make the full circle connection between their pension savings, all the way through the intermediary chain, to how this capital influences the behaviour of companies that in turn influence the economy! It would be fair to say the average retail investor lacks voice and trust in the system and this needs to be overcome. We tackle this issue by surveying directly our members on which ESG issues they see as most critical to progress in our engagements and advocacy. We believe this co-operative mandate is invaluable as, not only does it provide a democratic steer on our activities, but it also invigorates community engagement and social mobility around these issues.

Educate trustees and clarify fiduciary duty

The next actors in the chain, the pension scheme trustees, have a key role in their responsibility to define an investment policy and asset allocation that will meet the pension needs of their beneficiaries over several decades. However, a prescient and necessary focus on deficits and liabilities has unfortunately meant that stewardship has tended to be either widely misunderstood, ignored as a luxury, or even worse as contrary to fiduciary duty!

Long-standing misapprehensions over fiduciary duty must be demystified. It means educating trustees that fiduciary duty requires a focus on long-term considerations and therefore those ESG issues that can impact longer term performance are relevant to the investment process. In this spirit we have emphasised the findings of the Freshfields report that fiduciary duty requires consideration of ESG issues and should therefore be reflected in investment mandates.

Review investment agreements

It is critical that a long-term focus is hardwired into how trustees design investment mandates for their asset managers to follow and this has formed a big focus in our public advocacy. Alignment of interests should be in evidence both in terms of the fee structures and the individual incentives of fund managers. It's easy for beneficiaries and the media to forget that the primary factors driving fund management decisions are largely decided by the architects of investment mandates – the trustees. There is a tendency for mandates to be awarded over a relatively short period of time and for performance to be measured against benchmarks over even shorter time-horizons. These are all things that can cause short-termism and undermine stewardship.

We would advocate further enquiry into the nature of existing agreements and how they could be designed to mitigate short-term pressures down the investment chain. For example, excessive benchmarking can cause momentum trading and mispricing meaning that equity indices may not always represent optimal portfolios for performance appraisal.

We have also called for the extension of performance review time periods and a reduced emphasis on relative returns. One solution that wouldn't entrench asset managers on long fixed term contracts would be to appraise their performance on a rolling basis over three to five years. In terms of fee arrangements, asset owners should consider introducing performance fees that are spread over multiple years.

Explicitly include stewardship obligations

We strongly advocate the formal inclusion of stewardship responsibilities into investment agreements as well as tying a meaningful portion of fees to the quality of stewardship provided by investment managers. Moreover, minimum stewardship requirements should be stipulated in tender selection processes. A simple first step that would significantly improve the status quo would be to require asset owners to review asset managers' stewardship record in-hand with the broader periodic performance evaluation.

The scale of the turnaround cannot be underestimated. The current market infrastructure and characteristics are inimical to the principle of stewardship which compels shareholders to investing for long enough to make it worth their while stewarding rather than trading. As long as the market is strongly influenced by speculative, hyper-frequency trading then adopting a stewardship stance by the few can be a symbolic protest vote with occasional wins. This is why structural reform across the value chain, backed by a mindset change about what it means to be a fiduciary, is required to align a critical mass of the market. We call on the government to take the lead on this agenda.

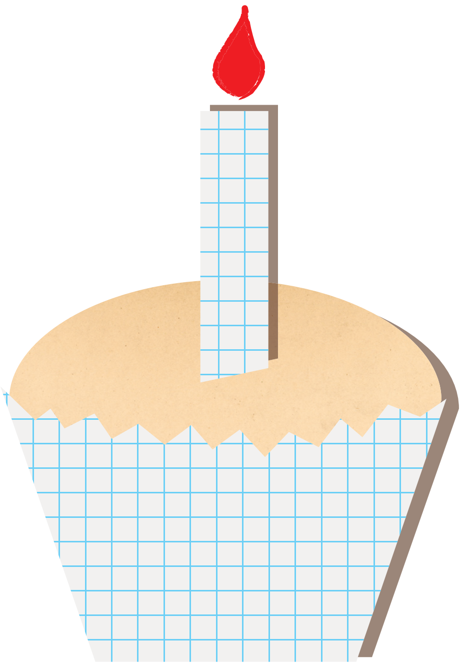
We strongly advocate the formal inclusion of stewardship responsibilities into investment agreements.

Phineas Glover, Corporate Governance Analyst,
The Co-operative Asset Management

1. http://co-operativeassetmanagement.co.uk/advisers/stewardship-code.php
2. http://www.goodwithmoney.co.uk/assets/Uploads/Documents/Responsible_Shareholding.pdf?token=912f499c60893397d91bcd16b9238e6fe818cf88l1320165608#PDFP

Stewardship and engagement

A GLOBAL ASSET MANAGER'S PERSPECTIVE ON MANAGING EXPECTATIONS



Although the concept of stewardship in relation to land ownership has its roots in history, it is relatively new in the context of investment management. With the UK Stewardship Code celebrating its first birthday earlier this year, this collection of essays is a timely reminder that there is still a need to debate and build consensus around the concept of investment stewardship, including how it should be practiced, how it will be assessed and how it might evolve. BlackRock's experience with the evolution of the corporate governance framework suggests that there will be many iterations before practitioners are satisfied that the desired outcome is being achieved.

Clarifying terminology

Writing as a global investor, BlackRock observes that 'stewardship' is not widely understood outside the UK. It is notable that the two other market-specific sets of guidance on stewardship, in the Dutch and South African markets, and the global guidelines published by the International Corporate Governance Network, have adopted terminology around what it means to be an 'actively engaged' or 'responsible' shareholder focusing particularly on shareholders investing on behalf of others. These might be useful reference points for the UK debate.

For our part, we define stewardship as protecting and enhancing the value of the assets entrusted to us by our clients. A subtle but important distinction exists between this and the stewardship responsibilities of board of directors and company executives, namely to protect and enhance the value of the company over time. As shareholders, our stewardship responsibility is to our clients. Yet we perceive a widespread belief that stewardship implies that shareholders have a responsibility to engage with companies and 'make them better'. This confuses the two responsibilities. Sometimes fulfilling our stewardship responsibilities to clients will involve engagement with companies; other times it will necessitate selling or reducing a shareholding if we cannot protect our clients' interests through engagement, which should not be seen as a derogation of our duty, but a fulfillment of it.

This might seem a subtle distinction but in our experience terminology is important. Our concern is that without further clarification about what stewardship entails and where responsibilities lie, we will either not meet expectations or we will create divisions that need not exist. We believe that the corporate governance community did itself a disservice in developing its own terminology without creating a common understanding for what basically boils down to 'good quality leadership' by

With the UK Stewardship Code celebrating its first birthday earlier this year, it is a timely reminder that there is still a need to debate...

the board and 'good quality management' by the executives. Many practitioners will have heard company representatives say that portfolio managers never ask about corporate governance. While portfolio managers may not specifically ask about corporate governance using the technical terms, they regularly consider the quality of company leadership and management at in-person meetings and through various other means.

The term 'engagement' is also a case in point. Engagement is really just another way of saying 'communication', principally between investors and companies. Like stewardship, the practice of engagement would benefit from further debate. Expectations linked to engagement have grown substantially over recent years and have reached a stage where engagement is often seen as a panacea for all wrongs. This is unrealistic. It is essential that commentators understand that engagement is not synonymous with change, telling boards what to do or micro-managing companies. Shareholders in the UK are afforded extensive rights but these are focused on oversight and holding the board and management to account, not on directing execution.

Engagement is really just another way of saying 'communication', principally between investors and companies.

Our engagements with companies just as often aim to on develop mutual understanding and share perspectives. Many companies are not aware that shareholders might be interested to know more about a particular aspect of how the business is managed. Or they might not be aware of their investors' policies or priorities in relation to the company or its industry. Investors asking questions and/or making representations to board members or senior executives might prove to be a catalyst for change or might simply raise awareness which can help preempt situations that could become crises. We suggest that further debate around both the purpose and measures of success of engagement is needed.

Importance of a focused approach

It is also important to recognize that the majority of companies do not need intervention. Shareholders should allow management and boards, to do what they do best, manage and oversee, respectively. We are all resource constrained and therefore need to focus on the issues that matter to our clients and not conduct engagement meetings as a courtesy to companies or to gather statistics to look more 'active' than otherwise. Clients should also be thoughtful about assessing the approach their asset managers take to engagement, including voting. While expressing dissenting views in public may attract attention, it does not always produce outcomes that are in the long-term interests of shareholders or the company.

The challenges of collective engagement

This brings us to the subject of collective engagement by shareholders, and the challenges posed. First it must be recognized that collective engagement or shareholder collaboration is not universally accepted as always a good thing – by investors, companies or regulators. It is certainly a way of sharing workload and potentially engaging with a greater number of companies. We have found it can be very effective on policy issues such as board disclosure on diversity policies. However, engagement focused on value-related matters, such as strategic direction or company leadership, can be much more difficult to achieve collectively. We believe that in those instances collective engagement should be used selectively.

In practice, collective action is difficult to manage given that shareholders tend to have a range of perspectives - it's a characteristic of the market. In BlackRock's experience, even where there is agreement that a problem exists, it can be very difficult to agree a single course of action or timeframe in which it ought to be taken. This diversity of opinion is not a flaw in the system, but a strength as it brings a range of alternative solutions to the situation. Nonetheless, it is not always possible to reach a consensus and in many collective engagements shareholders ultimately take their own stance directly to the company. This is further exacerbated in markets with dispersed ownership. To engage collectively effectively, particularly on sensitive or value-related matters, requires mutual trust amongst the shareholders, respect for the different perspectives and knowledge of one another's motives. This generally takes time and personal contact to establish, although it could be addressed in part by a code of conduct or modus operandi for collective engagement, setting out mutually accepted ground rules on the use of the media, representation of the views of others, competition issues and so on.

Without wanting to labour the point, even if a group of shareholders succeed in agreeing an engagement strategy, it is still only making representations to a board or management team. The company representatives ought to listen to the group's concerns and suggestions, weigh them up and then decide best course of action for the long-term sustainability of the company. That won't always be the outcome that the shareholders were seeking, which will mean a further course of action – including possibly selling – needs to be considered.

Room for improvement across the chain of ownership

In closing, we would warn against over-engineering engagement or stewardship. We believe that transparency, and through it sharing of experience, is the key to improvement in practice. More information in the public domain, and provided to interested parties privately as appropriate, enhances accountability and aids understanding. We are strongly opposed to making engagement mandatory, even in its lightest form of proxy voting. Practitioners need to see value for themselves, their clients or their beneficiaries otherwise there is no incentive to engage well. Not surprisingly, we support the "comply or explain" principle underpinning the UK Stewardship Code and its emphasis on disclosing to clients and potentially other interested parties how stewardship responsibilities are interpreted and implemented. Informed clients can determine whether or not they support the approach taken and if not, move their assets or engage with their asset manager. Clients have a pivotal role to play. Clearer signals from clients as to how they value and assess stewardship activities will help asset managers shape their thinking. All of us in the chain of ownership have room for improvement. This will only be achieved as part of an organic, cooperative effort.

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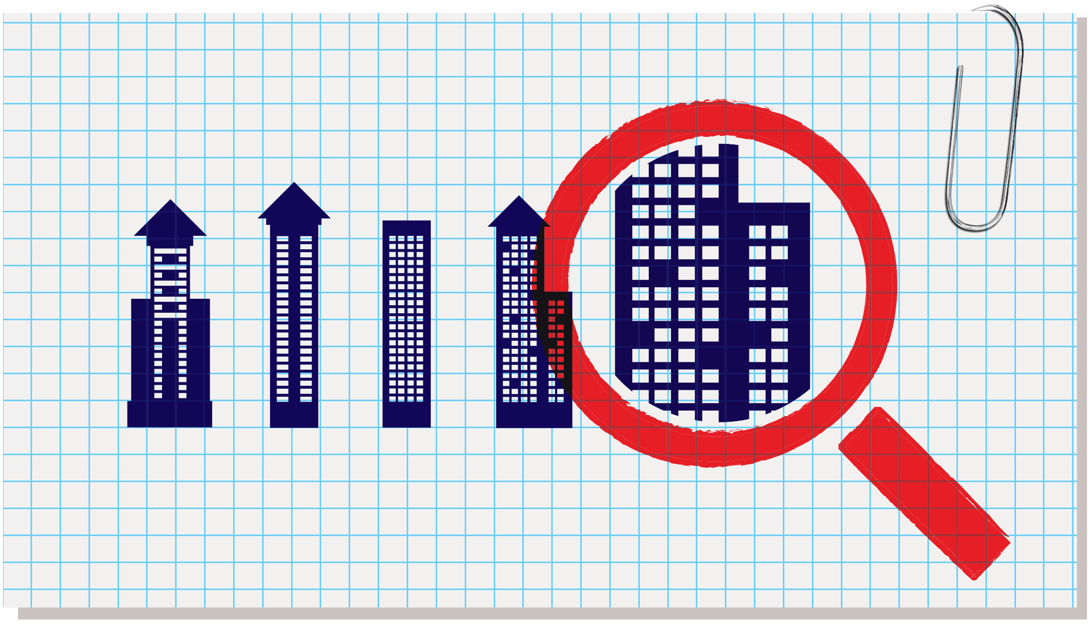
In summary, BlackRock supports:

– A clear explanation of investment stewardship, or rather the responsibilities of those who invest on behalf of others that has widespread acceptance. We define stewardship as seeking to protect and enhancing the value of the assets entrusted to us by our clients.

– A commitment to focus on quality of engagement over quantity, supported by thoughtful measures of shareholder engagement success.
– The establishment of a code of conduct or modus operandi for engaging collaboratively so that all parties have a common understanding of how shareholders and companies need to conduct themselves. Such a code should cover issues such as the rules around confidentiality of views exchanged and the respective roles of various external parties.
– The creation of a European 'Corporate Governance Forum' through which to convene meetings of major institutional investors and asset managers interested in governance and engagement. Experiences and lessons learned could be taken back to domestic markets to advance practices across Europe.
– A consistent standard of disclosure across Europe requiring all companies to provide sufficient information for shareholders and others to assess the merits of the approach taken to corporate governance.
– A consistent standard of disclosure across Europe requiring all those investing on behalf of others (i.e. asset managers, pension funds and other institutional investors) to set out their approach to active shareholder engagement including their:
    - approach to using rights attached to shareholdings (e.g. voting),
    - approach to other shareholder responsibilities (e.g. engagement) and
    - approach to responsibilities to clients (e.g. managing conflicts, reporting on activities).

Experiences and lessons learned could be taken back to domestic markets to advance practices across Europe.

Dedicated active ownership and corporate challenge



While institutional investors are increasingly also "responsible" owners of companies, dedicated active ownership investing is different. A key distinction is that the governance functions of most institutional owners are primarily focused on protecting value by stopping bad things from happening at companies their institutions already own, or addressing bad things that have already happened (for example, inappropriate capital increases, remuneration plans, acquisitions, labour practices and succession processes). By and large they do a very good job at this, mobilising relatively scarce resources to focus on the crises among their large, diversified portfolios.

Shareholders in the UK have largely abdicated the clearest and most powerful tool of ownership – the ability to appoint board directors.

By contrast, dedicated active ownership investors (or "constructive activists") identify companies whose fundamental performance can be improved by active ownership. Engagement is pre-planned and pro-active and the investment decision is predicated, in part, on creating value through engagement (along with an attractive "as-is" case). This is facilitated by a focused portfolio (in Cevian's case, normally only 8-12 full positions) and a long-term investment horizon (in Cevian's case, a 3-year horizon is used for investment decisions).

Operationally-oriented active ownership investors (such as Cevian) look to close the performance gaps between their portfolio companies and leading peers. An example of a target company would be one with good businesses, but which is achieving a 5% EBIT margin – below the (say) 10% level achieved by the peer group leader. An active ownership investor, prior to investing, will typically spend months working to identify the concrete areas of underperformance – typically operational, strategic, structural, financial and governance – and putting together a value-enhancement plan to address them. In Cevian's case, it typically buys shares through the market to become one of the company's largest owners – 5 to 15% - and "have a seat at the table."

Most active ownership investors work to create value for all shareholders and do not do special deals with their companies. Accordingly, they are able to work well with other owners of companies (such as institutional investors), who frequently support the targeted initiatives of the active owners.

In Cevian's case, it typically is prepared to go one step further, by committing an experienced executive to the company's board whose primary objective is to better the interests of the company.

An active ownership investor's approach differs to the vast majority of other public market investors who concentrate their efforts on trying to predict short-term share movements, manage highly diversified portfolios that limit their analytical focus, and accept as given company strategies, structures and governance. In many cases, these are investors who buy market beta through index funds or look to invest in the best companies and best management teams, shunning underperforming companies. The fundamental value of companies are analysed through a short-term focused lens and very little value, if any, is ascribed to improvement potential, either because most investors don't see the potential or because they have no reason to expect that the potential will be realised (i.e. the company will continue to underperform its potential).

In Cevian's experience, the board is a key determinant for the performance of a company. Get the board right, and much else falls into line, e.g: remuneration issues; corporate focus and strategy; M&A policy. Get the board wrong, and underperformance is likely to manifest itself in a number of areas.

We normally see underperforming boards in what Lord Myners (now Chairman of Cevian Capital UK) has repeatedly called "Ownerless Corporations." Because of Ownerless Corporation syndrome, shareholders in the UK have largely abdicated the clearest and most powerful tool of ownership – the ability to appoint board directors. This is evident by the habitual passing through of board candidates with 99% pass rates. Instead, it is largely left to company boards to nominate and appoint their own members.

The result can be boards that are out of touch with their shareholders, operate without a clear mandate, and feel they owe a debt of gratitude to the board chair and other members of the nomination committee who have appointed them. Taken together, it is easy to understand how these factors can inhibit non-executive directors from fulfilling one of their key functions - providing a strong sense of challenge within the board.

At its worst, lack of challenge can be catastrophic – the Walker Review identified this as a major problem area for British banks that suffered in the financial crisis. In less extreme cases, it may lead to poor decision-making in cases where there may be conflicts of interest which the board is supposed to monitor and address (e.g. the setting of targets, remuneration policy, M&A policy).

Creating the right board is not just about getting people with good CV's – companies and their headhunters have become adept at this. As importantly, it is also about ensuring that non-executive directors have the right kind of proactive attitude and feel a real and tangible sense of responsibility to the shareholders who vote for them. They need this to empower them to challenge executive directors – who are much better informed than the non-executives – and board chairs who may be largely responsible for their nomination.

In specific cases, the antidote for Ownerless Corporation malady can be a dedicated active ownership investor. However, looking more broadly, Cevian firmly believes that one of the greatest opportunities we all have in front of us is solving the principal-agency issue that exists between board directors and the shareholders who vote them in.

The antidote for Ownerless Corporation malady can be a dedicated active ownership investor.

In the UK, Cevian has made clear to its companies that it will only vote for new non-executive candidates it has met, interviewed and approved, feeling this role is too important to leave selection entirely in the hands of board chairs. While more diversified investors couldn't do this with every company they own, it would be good to see them doing it when they own large percentages of companies (5%+?) and/or the holdings are significant for them.

Without question, lessons can also be learned from the Swedish and Nordic approach to board nominations, where shareholders participate directly in the companies' nomination committees. Thus, they are directly involved in reviewing the work of the existing board, identifying new candidates who can make a valuable contribution, and proposing directly to the annual general meeting the recommended board (including individual candidates) for the following twelve months. The board candidates are then voted on in the normal way, and acceptance is decided by way of simple majority.

In the Nordics, asset managers feel a high degree of responsibility for ensuring that shareholders elect the right board members – which is most cases has meant asset managers have had to dedicate senior staff to this process. Asset managers say their involvement has made them better owners, more long-term focused, and more understanding when their companies hit bumps in the roads. It also puts key shareholders in one room together, facilitating collective engagement. Owners also say that the involvement of numerous parties in a transparent process has broken-down the old boys network, and resulted in better board diversity.

At the same time, board directors have said this process gives them a more clear mandate, empowers them to challenge, and gives them a high sense of beholdenment to shareholders.

The shareholder-led nomination committee model is not a panacea for corporate governance - there are instances where large shareholders do not effectively utilise their rights (resulting in a sub optimal board composition). Nor could one simply take a model from the Nordics and blindly apply it here in the UK.

However, insights gained from that experience should be incorporated into discussion and debate here in the UK, where investors and society have such a strong interest in raising the bar for board and corporate performance.

Cevian Capital and its team have been dedicated to active ownership investing in Europe since 1996. It is one of a handful of dedicated active ownership funds in Europe, with others including Governance 4 Owners, Hermes Focus, and Knight Vinke. There are differences among them (e.g. operational vs. governance focus, big stakes vs. smaller stakes, joining boards vs. working from the outside, geographic spread). However, at the core of all is a common approach of identifying the potential that often resides within corporate underperformance, and working as an active owner to turn that potential into value for all shareholders.

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