tomorrow's good governance forum

Progress in investor stewardship & the accountability of directors

2nd July 2015

tomorrow's company

Agenda

- Welcome
- Introduction
- Investor stewardship
- Plenary discussion
- Accountability of directors

GOOD GOVERNANCE FORUM AGENDA
2ND JULY 2015

Welcome and apologies
Barrie Collins, Tomorrow's Company

Investor Stewardship
Introduction: Mark Goyder, Tomorrow's Company
A chairman's view: Peter Swabey, ICSA
A company secretary's perspective: Liz Murrall, The IA

Dinner discussion: the accountability of directors

WELCOME


Barrie Collins
Tomorrow's Company

Barrie welcomed Forum members and invited guests to the Good Governance Forum and thanked Korn Ferry for kindly hosting the meeting.

He explained the agenda of the meeting would focus on progress in investor stewardship since the introduction of the FRC's Stewardship Code and that over diner we would discuss the accountability of non-executive directors particularly in the light of recent legislative developments.

Barrie asked that any members with specific questions about any of the issues discussed at the Forum, or who would like to get more involved in the work, get in touch with Alexander Cowie (Alexander@tomorrowscompany.com).

INTRODUCTION

Mark Goyder, Tomorrow's Company

Mark Goyder
Tomorrow's Company

Mark introduced the session on progress in investor stewardship by talking about the work Tomorrow's Company has been doing on investor stewardship through their 2020 Stewardship Working Group..

Mark then talked about Tomorrow's Company's plans to instigate a Stewardship Forum, which would run along similar lines to the Good Governance Forum and be complimentary to its work. Mark explained that the whole point of this Forum, as with other Tomorrow's Company Forums, was to be a melting pot of ideas where people can come to grapple with the difficult issues with which they are faced in their own organisations and make sense of the obstacles in a way that allows them to move things forward.

Mark recounted that 6 years before he had done a piece of work on the responsibilities of investors, that built on work Tomorrow's Company had done on unpacking value across the investment chain and conceptualised Tomorrow's Company's idea of what stewardship really meant, that on the day it launched RBS and Lloyds had to be nationalised by the government. Since then the Stewardship Code has been developed and launched, which has provoked Tomorrow's Company to revisit and refine its own definition of stewardship - that you are entrusted with resources, assets and relationships and that you nurture them so that you pass them on in better condition – that applies right across the investment chain.

Mark explained that the 2020 Stewardship Group had been working over the past few months with both ICSA and the Investment Association to assess progress in stewardship since the introduction of the Code. Mark spoke about how positive the spirit of these working relationships and discussions had been and how this understanding of how stewardship has progressed has facilitated a better understanding of where it may go in the future.

Mark then introduced Peter and Liz, welcoming them to the Forum.

PROGRESS IN INVESTOR STEWARDSHIP: THE IA PERSPECTIVE

Liz Murrall
The Investment Association

Liz introduced herself and thanked Mark for inviting her to speak. Liz described the work of the Investment Association as the representative body for the investment management industry (in all its guises) in the UK. Liz also noted that as of last year the investment affairs arm at the ABI joined with the Investment Management Association to form the Investment Association.

Liz then described the history of the development of the Stewardship Code and how she would, today, be focusing on an exercise performed by the Investment Association to monitor the Code. Liz outlined how the Investment Association took their 32 largest members and surveyed them to ask what they were doing in practice about the principles that were the precursor to the Code. This was pre-financial crisis and the subsequent reviews that led to the introduction of a formal stewardship code. Following the introduction of the Code the Investment Association decided to continue with its monitoring exercise and to publish the anonymised results.

Liz then moved into a description of the results of the latest survey, which considers issues such as: how policy statements are implemented; how investors structure and resource their stewardship; how they monitor their investee companies; how they escalate issues; voting patterns; and, ultimately, how they report back to their clients on the discharge of their stewardship duties. One of the key questions the IA asked were what investors wanted to focus on in their engagement with companies and what actually took up most of their time. The majority said that the things they really wanted to focus on were issues around performance, culture and strategy and making sure the companies had the governance structures to deliver that strategy. However, what they ended up spending most of their time on was remuneration.

Another key finding was that the human resource responsible for stewardship increased by 19% over the course of 2014, and over 80% of that resource was represented by portfolio managers and analysts, which may indicate that it is being integrated into mainstream decision-making. Feedback from investors also stated that they felt the best way for them to discharge their stewardship duties was through direct contact with companies.

Overall trends indicated greater levels of engagement, although fewer investors gave advanced notice of intention to vote against resolutions and fewer attended AGMs as a matter of policy. Case studies showed that where there were issues the main point of contact within the company varied according to the situation.

n.b. the full report referenced by Liz is available on The IA website here.

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PROGRESS IN INVESTOR STEWARDSHIP: ICSA PERSPECTIVE

Peter Swabey
ICSA

Peter opened by thanking Liz and noting with interest the way that some of the things drawn out by the survey of investors were also drawn out by the ICSA survey of companies, and that in some areas the feedback was very much the opposite. For example, companies said that they wanted to talk about strategy but investors wanted to talk about remuneration. So the signs are neither side wants to be talking about remuneration, but they both are.

The ICSA survey tested Mark's excellent definition of stewardship and asked what people thought stewardship was and the answer that most people gave was that it is about building a mutual understanding of trust between company and institutional investors. The responses also showed that since the introduction of the Code that companies had seen an increase in the quantity of investor stewardship – although this did not necessarily translate into an increase in the quality of stewardship.

Another interesting difference is the view of what constitutes a large holding – companies see it as a percentage of their capital whilst investors view it as the percentage of their portfolio. A majority of companies (71%) viewed those with a large holding as having special duties when it comes to stewardship. The majority of companies thought that there should not be penalties for those who fail to comply with the Code and of those that do 'naming and shaming' was by far the most popular proposed penalty – most companies felt that those who perform to a high standard should be rewarded or recognized in some way.

Responses on whether the ability to consult or engage with investors has improved since the introduction of the code is split evenly (although some of the negative responses may be attributable to existing engagement being viewed as sufficient). Overwhelmingly most companies preferred method of communication with investors was through face to face contact.

A lot of the feedback on whether stewardship was good or bad depended on the investors willingness to listen to the company's version of what they were doing. The danger with this is a conflation of the idea that good stewardship is just the investor agreeing with what is being said rather than listening and then deciding that they don't agree. Positively, 90% of companies said that they made better decisions as a result of engagement with investors.

Overall 50% of companies rated the quality of engagement with their institutional investors as good or excellent and only 10% as poor or very poor.

INITIAL RESPONSES

FROM A REGULATOR

The statistics we have heard are very interesting and it seems that the message we are getting from both surveys is positive. We have to think about where we are with the Code after five years and compare progress to the Governance Code for perspective – the Stewardship Code is a relative youngster and we do have to be slightly patient in terms of its progression. The Governance Code has developed well through responding to feedback from practitioners operating in the marketplace and I think the Stewardship Code will benefit from a similar development. One of the major tools available for improving the quality of stewardship is using the reporting requirement to help practitioners do this better by helping them report better on the quality of their stewardship activities – as what gets reported gets done.

FROM AN INVESTOR

What stood out for me was the feedback on the quality of engagement – 50% were good or excellent but that still leaves 50% that were average or worse. Similarly only 48% have become a little bit better since the introduction of the Stewardship Code, so I think investors still have a lot of work to do. Trust is a big thing too though and if there is a trusting relationship even if we don't fully agree with what a company is doing we will trust the directors and let them get on with it. I therefore worry about the clustering of engagement around the AGM as this doesn't't suggest the kind of on-going dialogue that leads to a trusting relationship. On who should engage from my experience engagement has to be directed around where you have a large enough shareholding that the board will listen to you for reasons of practicality.

FROM A COMPANY SECRETARY

There is a risk that if you just incentivise the quantity of engagement then the quality of assessment of the company's performance will potentially be at risk. Increasingly companies are asking what is their purpose so I think we should ask the same question of stewardship – what is its purpose? There has been a discussion about duties and the duty of stewardship and this can be compared to directors duties. I wonder whether there is any discussion at a professional level for investors as to what the outcome of their professional behaviour with regards to that duty is. If investors continue to be financially driven in over the short-term in their returns should we be surprised that we have the conversations and quality of engagement that we do. What are the consequences for a company or anyone on the investor side for a failure to engage with their stewardship duties? I think the penalties and positive incentives for stewardship would be a powerful tool. The focus of conversation on remuneration isn't something either side enjoy but there are wider pressures driving that dialogue that we have to be aware of. I also sympathise with the comments about the speed of change and wonder whether we are too impatient for change because things do take time.

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PLENARY DISCUSSION

Following the feedback from Peter and Liz from their respective surveys and the initial responses the Governance Forum moved into a plenary discussion reflecting on the themes addressed. Amongst the key points raised were:

- that it would be beneficial if investors relied less on the recommendations of proxy agencies and engaged with companies directly
- that investors could better appreciate the balance companies are trying to make between producing short-term profits and producing goods and services that benefit society
- that a way of recognising and rewarding investors who exercise good stewardship would be a good way of dealing with the free rider problem that is often a defence for inaction. However, it was noted that it would be difficult to do this without focusing on box-ticking measure and would require a great deal of subtlety in approach
- that promoting the quality over the quantity of stewardship was key and inn particular promoting a dialogue that focused on strategy rather than remuneration, although the public concern about remuneration that presently drives this discussion is unlikely to go away
- some engagement actually makes companies more short term. So more stewardship is not necessarily a good thing in terms of promoting a long-term agenda
- not all stewardship is actually dialogue with other people – some of it is involving an alignment and mixture of stakeholders
- getting to the spirit rather than the letter of stewardship and its purpose is crucial to creating good stewardship.

Barrie Collins then closed the meeting thanking Korn Ferry for kindly hosting the Forum.

DINNER DISCUSSION: THE ACCOUNTABILITY OF DIRECTORS

The dinner discussion centred around a provocation that postulated that recent changes affecting directors of financial services organisations are putting a strain on established corporate governance and company law. And asked whether these changes for the better or changes that we need to think about carefully to avoid unintended consequences?

In particular it related to the Financial Services (Banking Reform) Act 2013 was enacted in response to the 2008 financial crisis. And noted that amongst its provisions is a section which introduces new laws which affect the responsibilities and increase the accountability of directors and nominated executives of banks. The discussion then noted that whilst at present these new laws apply only to banks and other financial services institutions, it is noteworthy that the US Securities & Exchange Commission has said it will monitor these laws with interest and that it is possible that similar laws will be introduced more broadly.

These new rules were described as having four main elements, which imposed onerous and prescriptive requirements for board members and in particular certain senior executives, the Chairman of the Board, the senior independent director, and the chairmen of the Audit, Risk, Remuneration and Nominations Committee. It was also seen that this regulation shifts the burden of responsibility onto these senior managers to prove that they have taken reasonable steps to prevent failures and creates a new criminal offence. Concern was expressed that this reverses the fundamental principle of the presumption of innocence. It was suggested that this might have the opposite effect ton that which was intended by the regulator, to improve corporate governance and encourage individuals to behave appropriately and accept responsibility for their actions.

It was observed that under the new regime, certain directors are responsible for the management of a company's activities insofar as those activities are directly carried out through decisions made by the board or board committee in which the director participates. However, this goes against the principle that a director's participation in a board decision is collective and not individual and non-executive directors do not have personal responsibility for management or oversight of any particular aspect of a company's business. A concern was expressed that the new rules would force non-executive directors to take a more executive role that goes against the principles of good governance.

A final problem was raised in that directors are also likely to be concerned that, in view of the new rules, the role of a director presents a level of personal risk that is not worth bearing. Thus the new regime may have the unintended consequence of reducing the availability of willing and able candidates for directorships which would limit the diversity of background and experience that is key to an effective board. And that this is not in the interests of companies, their shareholders, or regulators.