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Response to call for evidence on the effectiveness of the Combined Code.

Dear Chris,

This response refers to matters that concern Section E of the Combined Code and in particular E.1 Dialogue with companies. I write in an academic capacity. The views are solely my own and not those of any organisation I am affiliated with. All errors are my own. I am currently writing-up research on corporate governance. The intended outlet is academic publication. I have drawn on this current writing in order to provide a response to your call for evidence on the Combined Code. I welcome further consultation on the Combined Code. Below, I focus on 3 areas in relation to institutional shareholders' dialogue with companies, and in green boxes suggest areas of potential follow up.

With best wishes,

Paul Cox

Institutional Ownership and Corporate Governance

Within the United Kingdom institutional investors collectively control approximately 70% of the stock in the largest companies (National Statistics, 2007)[1]. The concentration of share holdings puts large institutional shareholders in a position where, either singularly or through collaboration with others, they are potentially well placed to engage with the companies in which they invest.

This is a source of interest because there are likely to be times when an investor will own shares in a company that has a management team that does not have all the skills and vision necessary to maximise the long-term value of the firm for shareholders. In other situations corporate managers may not be representing shareholders best interests. This might be because their financial interests are not well aligned with those of the long-term share holders, or because they are overly focused on other priorities, such as the short-term, mergers and acquisition, financial restructuring, or on a particular strategic partner. It might also be the case that there is shareholder uncertainty because a board has failed to provide investors with the necessary information to judge whether they are acting in investors long-term interest, for example where they have chosen not to follow the Combined Code (FRC, 2009). Finally, shareholders may believe that the effectiveness of the legal, regulatory and accounting framework under which companies operate is not functioning in their best interests.

Institutional shareowners and investment managers are then in a position where their and their clients' interests are likely to be improved by effective use the corporate governance process. The corporate governance process consists of two main elements. Each area has relevance to Section E of the Combined Code:

Firstly, it involves institutional shareholders appointing the board of directors and auditors of the companies in which they invest. This is done through exercising voting rights to help ensure the company has in place appropriate governance, director remuneration, and public reporting and accountability structures.

Secondly, it involves institutional shareholders building a working relationship with the board of directors of the companies in which they invest. This is to help ensure the directors discharge their duties in a manner that benefits shareholders. A small number of institutional shareholders argue this governance process also involves engaging with firms, regulators and standard setters to improve the markets in which corporate securities are listed and traded[2].

In order to be effective, the corporate governance process requires a sufficient number of major shareholders to take a long-term view and to

[1] This includes UK shares held by overseas institutions.
[2] This is developed further under The Portfolio Objective and Fund Objective Interface.

engage constructively with the companies in which they invest through dialogue and the use of their voting and other rights (FRC, 2009).

In recent months the role of institutional shareholders in the corporate governance process has been the subject of attention. For example, the 2009 Turner Review of the financial crisis suggests that "Shareholder influence seems to have been relatively ineffective in the past in constraining risky strategies. There may be ways of improving the effectiveness with which shareholder views are communicated to non-executives (Turner, 2009 p93)" and of achieving "more effective institutional shareholder influence over corporate strategies" (Turner, 2009 p47). Recent criticism of the role of institutional shareholders in the corporate governance process has its origins in three areas:

1. Non- Executive Directors

In its 2007 review of the Combined Code, the Financial Reporting Council (FRC) found that there was concern about the overall quantity and quality of engagement by institutional shareholders with corporate management (FRC, 2009). A number of companies have complained to the FRC that they offer meetings with new and existing non-executive directors (NEDs) to institutional shareholders as recommended in Section A.5.1 of the 2008 Combined Code[3] but that very few ever take them up (FRC, 2008).

NEDs are a cornerstone of the corporate governance process because they are the principal governance agents on the board for shareholders. They represent the interests of shareholders. Effective running of the board requires the NEDs to understand the viewpoint of the body of shareholders.

Yet for the majority of companies and the majority of situations, communication between institutional shareholders and corporate boards involve investment managers meeting the executive directors, in particular the chief executive and the chief finance officers. Usually, a senior independent NED or other independent NED would only be contacted if pursuing a point of difference with the company could not be concluded through behind-the-scenes meetings with executive directors, through an expression of concern to the company's advisors, or through meeting with the company's chairman (ISC, 2007). This lack of involvement makes it difficult for NEDs to gain the necessary understanding to represent the views of shareholders on the board. There is also no obvious way for institutional shareholders to know whether NEDs have been appropriately briefed by executive directors about their concerns. There remains the risk that NEDs receive information from executive directors that is not framed in quite the same way as that with which it was communicated by major shareholders to executives.

Several reasons have been put forward to explain the lack of direct communication between institutional shareholders and NEDs. Fund managers

[3] A.5.1 requires that: The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, the company should offer to major shareholders the opportunity to meet a new non-executive director.

may feel that communicating directly with NEDS might have the appearance of going behind the backs of the executive directors, with whom the principal consensual working relationship is usually struck. Also, fund managers may feel that it would be excessively complicated to directly involve one or more NEDS. This is because NEDs might not have the time or the level of knowledge and understanding of the whole company to act as informational intermediaries between institutional shareholders and corporate management. Furthermore, it may be thought that NEDs lack power when it comes to challenging the chief executive on behalf of shareholders, for example if the chief executive is felt to be pursuing too aggressive a growth strategy.

Possible Follow up for consultation

It would be useful to have a better understanding of why NEDs rarely meet institutional shareholders, and what if any other channels are used by institutional shareholders to ensure NEDs are properly informed.

2. The Portfolio Objective and Fund Objective Interface

The engagement interests of a large, modern institutional owner of shares, for example a pension scheme, are very broad. This is because the investor will usually have a broad spread of investments around the world. Usually this type of owner will have apportioned its total fund across a number of portfolios and appointed external fund managers to manage each portfolio. External fund managers perform engagement on each portfolio to meet portfolio objectives. Portfolio objectives are met by communicating with corporate boards, management teams and other shareholders.

Yet engagement for a large institutional shareholder can mean more than focusing on a few of the companies held in a particular portfolio. There is an interest in wider fund objectives that look beyond matters that attach to a particular firm in a particular portfolio. Fund objectives are met by communicating with firms, regulators and standard setters to bring about better markets, high quality corporate governance, accounting standards and improvements in disclosure where this is in shareowners best interests. This view is summarised by an inhouse fund manager of one large pension fund[4].

“Our interest has moved on towards mega themes. For example corporate governance in the US is important to us because we believe there is a contagion effect, what happens over there comes over here. High executive remuneration in the US raises executive expectations in the UK. We work quite hard in the States talking to the SEC [Securities and Exchange Commission] because structures in the US impact our funds over here. We have really been trying to take a step back and ask ‘what are the different issues which affect all of our funds over the long term?’ It is a lack of information in markets, it is poor governance structures, it is valuation. We want to talk to the organisations in these areas both here and in the US.”

[4] Cox (2009), forthcoming.

This view is also summarised by a large corporate governance engagement specialist[5]:

"There is a whole other area about engaging with policy makers for better markets. We are in this space but no fund manager is. We need to distinguish engagement by a fund manager who is motivated only to make a better trading decision, from our engagement which means talking to companies and standard setters to get a change of some kind. What fund managers do for the purposes of trading is not what we call engagement"

The portfolio objective fund objective interface may be one point of weakness in the corporate governance process. This is because external fund managers limit their governance efforts to portfolio objectives. Moreover, they tend to engage the most those few companies in which their holding is large relative to other managers or where their position in a company is overweight relative to an index. This view is summarised by two external investment management firms:

"Our opportunity lies with companies in which our shareholding is proportionately large compared to other investors. Activity in corporate governance and corporate responsibility focuses on such companies."

"We focus on firms in which we are significantly overweight. We must feel that by being significantly overweight on a stock that we know something about the stock that the market does not know. To seek to influence a company in which we are overweight is a vote of no-confidence when in fact we are confident because we are overweight. It sends an incorrect signal. Any influence is therefore limited to firms in which we are underweight which, by its nature, we will have less, perhaps no, influence over."

Recent interview research finds that engagement on wider fund objectives was pursued by inhouse investment managers, governance experts inhouse to an institutional owner, and dedicated engagement firms but not external fund managers. Little is known whetherlarge institutional shareowners are aware that their externally appointed fund managers may not engage on wider fund objectives. This is a potential problem if institutional shareowners believe that their external fund managers are engaging on fund objectives, or if institutional shareowners have not specified in mandates the breadth of engagement required. The existence of an engagement gap may help to explain why many managers were not engaged on the increasing system-wide risks that contributed to the current financial crisis.

<u>Possible Follow up for consultation</u>

There is very little public information on the portfolio objective fund objective governance interface. It would be useful to have a better idea

[5] Cox (2009), forthcoming.

of the priorities of the various objectives for institutional owners, the channels used to engage on wider fund objectives, as well as the views of external fund managers.

3. Institutional Shareholders as Owners or Traders

As traders of shares and other corporate securities, fund managers have significant investment information needs. Behind-the-scenes meetings with corporate management are an ideal opportunity to obtain this information.

As investment fiduciaries, one duty of fund managers is to act as if they were shareowners. This requires them to engage in constructive dialogue with corporate boards, management teams and other shareholders to ensure the best return for shareholders and the ongoing success of the company. Behind-the-scenes meetings with corporate management are also an ideal opportunity to obtain influence and work with companies to help create change.

The mindset - traders or owners - that fund managers tend to have when they meet with corporate management is a question that several researchers have shed light on.

Stapledon (1996), Gaved (1997), Barker (1998), Marston (1998), Holland (1998a, 1998b, 2001, 2005, 2006) and Holland and Doran (1998) provide theory and evidence that meetings are a key informational channel by which fund managers become better informed. Barker (1998) and Cox (2009) find that investment managers rank meetings with corporate management as the most important source of information available to them. At the meetings fund managers can uncover new facts, confirm and clarify existing knowledge, develop a clearer picture and more detailed understanding of the company, acquire information that is not published elsewhere and acquire information that is non-public. Knowing more means that a fund manager will acquire a competitive advantage relative to other investors, and so should make more profits for themselves and their clients.

Stapledon (1996), Gaved (1997), Barker (1998) and Holland (1998a, 1998b, 2001, 2005, 2006) and Holland and Doran (1998) also provide theory and evidence that the meetings are a vehicle by which fund managers do work with companies to bring about influence and help create a firm that is worth more. It may be that the companies held in a fund manager's portfolio are performing well. In this case the fund manager may not wish to exert any influence. In other situations a fund manager may wish to become more involved. To be effective, this means more than expressing polite reservations to senior management. The aim is not to wait for failure, but to identify the potential for underperformance within a firm as early as possible. Meetings then become a forum of influence. This involves raising issues repeatedly over a period of time with firmness until concerns are addressed. As performance deteriorates, so the purpose of the meetings becomes more formal.

Until recently the conventional view was that meetings achieve both information and influence. Recent research has cast doubt on this however. Roberts, Sanderson, Barker, and Hendry (2006) find that the meetings achieve neither information nor influence. The procedure of meeting is so ritualistic and rehearsed that it is a case of 'going through the motions'. Meetings serve little more than to 'discipline portfolio firm management through the effects of knowing that one is being scrutinised' (p291), and to implicitly confirm 'the norms of acceptable corporate conduct and performance' (291), 'the property rights of their shareholders' (p290) and the 'right to monitor the performance of managers' (p290). For the most part, neither information nor influence tend to result from the meetings because they 'are both so infrequent and so important that the potentials for dialogue – for both informing and being informed – that, in principle, the face-to-face encounter offers, are for the most part foreclosed' (p291).

Different to the above, Hendry, Sanderson, Barker, and Roberts (2006) find that the mindset of fund managers meetings is firmly one of traders. The interests of fund managers are wholly divorced from ownership that accompanies significant shareholdings. 'The conceptualisations in terms of ownership and agency that dominate both academic and popular discourses are marginal to the actors' accounts. Rather, both fund managers and company managers conceptualise institutional investors primarily as financial traders' (p1101). Trading securities inconveniently leads investment managers to control key resources. The fund manager's job as they see it is to outperform benchmarks - and so make money for themselves. The fact that they are perforce shareowners is incidental. If they could have the investment without the ownership they certainly would. (Hendry et al, 2006 p1122). One irony of this result is that it is the role of fund managers as owners that provides the rationale to meet with corporate management in the first place. The finding is able to explain fund managers' reluctance to meet with NEDs. With limited meeting time available, the greatest reward is for fund managers to meet with those who know the most. This means the CEO, CFO and other executive directors.

Cox (2009) provides anecdotal evidence that the tendency for meetings to focus on a trading mindset may be the major rise of specialist mandates and decline of balanced mandates over the past 15 years. Balanced mandates tended to focus on longer term drivers, for they included asset allocation. This longer term emphasis coincided with a longer investment holding period, lower portfolio turnover, and, drawing on Holland's work from the 1990s, a greater mindset of ownership. The recent shift toward specialist mandates in which fund managers are judged only on stock selection has coincided with a period of higher portfolio turnover and evidence of fund managers having f a mindset of traders.

<u>Possible Follow up for consultation</u>

It would be useful to have a better idea if knowledge is the reason why fund managers rarely seek out meetings with NEDs. It would also be

useful to understand more of the priorities between information (trading) and influence (ownership), the degree to which fund management mandates influence the mindset of the meetings, and the individual and collaborative shareholder channels through which influence and change are sought.

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