SHAREHOLDER ACTIVISM

With their ability to change whole boards, slap down fat cat pay deals, and put the brakes on overly ambitious and risky business strategies, institutional investors have become the scourge of corporate UK over the past few years, writes **Neil Hodge**

Ever quick to remind directors that it is shareholders that own companies and not the boards that run them, institutional investors are becoming increasingly vocal about executives not delivering shareholder value yet still awarding themselves huge remuneration packages on the back of lacklustre performance.

So far this year, institutional investors have claimed the scalp of Michael Eisner at entertainment giant Disney and have put a block on Sir Ian Prosser's appointment as chairman designate of supermarket chain J Sainsbury. Institutional investors are also pushing oil major Royal Dutch/Shell to look at unifying its board structure in the wake of former chairman Sir Philip Watt's resignation.

Responsible investment

This fresh impetus for institutional investors to take a more active role in corporate governance has arisen in the wake of the Enron and WorldCom collapses. The Institutional Shareholder Committee (ISC) is the UK's most powerful shareholder body, comprising the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF), the Association of Investment Trust Companies, and the Investment Management Association (IMA), together representing more than £3 trillion in funds. At the end of 2003, it issued its 'Statement of Principles on the Responsibilities of Institutional Shareholders and Agents' to encourage – but not force – institutional investors to vote at annual general meetings.

The ISC said that institutional shareholders and fund managers should publish their policies for engaging with the companies in which they invest. They should monitor their performance, maintain an appropriate dialogue with them, intervene where necessary, evaluate the impact of their policies, and report back to clients where appropriate.

The ISC's principles are there to protect the interests of shareholders and not those of other stakeholders, such as an investee company's employees. Michael McKersie, manager of investment affairs at the ABI, whose members collectively own around one-fifth of all shares traded on the UK stock market, says that the ISC's focus on shareholder rights is correct. While he admits that the focus of shareholders is primarily financial, he adds that corporate governance concerns are also important because "a profitable company is a well-run company".

"Responsible investment is about judging what needs to be done now for the long term security of the company. That means thinking about what effect potentially unethical conduct might have on the future standing of the company, or what the dangers are of not having enough non-executive directors on the board. Just because shareholders want to protect their financial stake in the company does not mean that their focus is solely on the balance sheet," says McKersie.

He adds that the top five issues that institutional investors usually raise with investee companies are share price and company performance, the composition and independence of the audit committee, executive remuneration, the effectiveness of the board, and the joint role of chairman and chief executive.

Last year the ABI criticised over 200 investee companies for non-compliance with the UK's Combined Code on Corporate Governance. Through its Institutional Voting Information Service (IVIS), the ABI monitored 686 companies to see how well they complied with the Combined Code. Of these, 86 were given a red-topped report, indicating serious concern, mainly regarding the independence of non-executive directors, the composition of remuneration and audit committees, or executive remuneration. One-fifth received an amber top, indicating a 'significant breach' of best practice. The remaining two-thirds received a blue-topped report, indicating that the ABI had no concerns over their corporate governance.

Corporate governance adviser Pensions & Investment Research Consultants (PIRC) has also spoken out against companies that have not embraced the spirit of good corporate governance as outlined in the Combined Code. Alan MacDougall, PIRC's managing director, believes that "a considerable gulf between company responses and shareholders' expectations is still to be bridged". He adds that "the approach of some companies is not so much to 'comply or explain' as 'avoid and complain'". In its 2003 annual report, PIRC found that only one in three UK listed companies fully complied with the Combined Code.

In its governance principles, PIRC states that it wants companies to separate the roles of chairman and chief executive, and that half the boardrooms of corporate UK should be filled with independent directors. PIRC also wants more transparency on boardroom pay, saying that 'too many incentive schemes offer an excessive multiple of annual salary for less than superior performance'. PIRC is also wary of external auditors carrying out non-audit services to audit clients. It says that in 2003, the average FTSE100 company paid its auditor 2.2 times as much for other work as for external audit.

The NAPF has revised its policy on corporate governance to take into account changes in the Combined Code. In its new policy issued this year, the NAPF says that it 'expects boards to show that they accept the terms of the Combined Code by observing its requirements wherever appropriate'. It adds that 'non-compliance must be accompanied by clear and valid explanation'. Its policy is 'to recommend to its members whenever appropriate that they should not accept 'boiler-plate' explanations which provide no valid insights into the reason for a board choosing to ignore the clearly argued case for the provisions of the Code'. If the NAPF does not accept the reasons for non-compliance, it will recommend members to vote against the company's policy at the AGM.

However, the NAPF adds that it 'recognises that special circumstances dictate special actions, and we will go to great lengths to listen to boards which believe it is appropriate not to comply'. It says that 'good corporate governance is a matter of principle and nuance, not dogma'. But it gives no indication of what might be a 'boiler-plate statement' nor any examples of where it might be appropriate for a company not to comply with the Combined Code.

Prem Sikka, professor of accounting at the University of Essex, dismisses such policies as 'get out of jail free' clauses. "UK business has consistently lobbied against regulation or legislation, preferring 'principles' to 'rules'. But if companies and fund managers are not even prepared to stand by those principles, then what safeguards are there?" he asks. He also discounts shareholder activism "because there are so few people actually doing it." Indeed, Sikka blames institutional investors for contributing to corporate collapses because of the pressure they put on companies to constantly outperform. "It is a fallacy that institutional investors promote good corporate governance by putting pressure on boards to attain shareholder value," he says. "In many ways big investors are part of the problem that causes companies to mis-state their results, liabilities and expectations. By pressuring directors to increase shareholder value above all other considerations, such as corporate social responsibility and the effects on customers or the wider community,

boards are terrified to report bad news. This means that potential risks to the business are either underplayed or left unreported," he says.

Investors' powers

The main weapon in an institutional investor's armoury is the vote at the AGM. But Co-Operative Insurance Services (CIS), itself an institutional investor, has often argued that too many institutional investors still do not participate in the AGMs of the companies that they invest in. CIS, whose own policy is to vote at the AGM of every company it invests in, believes that the AGM represents a rare opportunity to see a board of directors together as a group and hold them accountable. It has often publicly encouraged other investors to vote.

Lindsay Tomlinson, chairman of the ISC and IMA, says that "institutional investors are as active as they can be". He also says that he does not believe that the percentage of shareholders casting votes at AGMs is likely to increase too much over the next five or ten years. "If you look at the percentage of shareholder votes cast at AGMs, it averages out at around 50%-60%, and this comes mainly from institutional investors. Of the 40%-50% of shareholders that do not vote, around 30% are foreign shareholders and the remainder are individual shareholders who, for various reasons, either cannot vote or else choose not to."

Apart from voting against board recommendations at the AGM, other sanctions available to institutional investors include selling shares and publicising their governance concerns. But both options are limited in their effectiveness. Institutional investors believe that they need to maintain good relations with investee companies over the long-term, and so choose not to divest funds. Stanley Dubiel, senior vice president and director of global research services at Institutional Shareholder Services, says that "engagement, rather than confrontation, is the approach that most investors take." As a result, Dubiel – like others – is against naming and shaming companies into compliance, unless it is a last resort. Other investors are even more candid. Mary Francis, director general of the ABI, told delegates at a conference in January that "we won't get anywhere if we approach corporate governance with a bossy-boots mindset that is determined to tell companies to behave in ways we personally have decided is good for them."

Tomlinson admits that the powers of institutional investors are limited. "We can remove a board and we can replace a chairman or chief executive, but essentially we are looking at the proposals made by boards and, through our voting rights, we make a judgment on whether these proposals make sense or not," he says.

While large investors have the clout to influence governance changes and promote good business practice, institutional investors are quick to point out that it is not their responsibility to run companies, nor is it their fault if those companies underperform or go bust. "We are not micromanaging these businesses and we are not validating the information on which business strategies are founded. It is therefore unreasonable to lay the blame at the door of institutional investors for governance failings or corporate malfeasance," says Tomlinson.

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