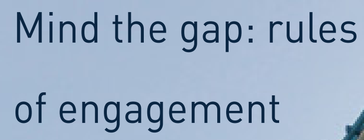
Mind the gap: rules of engagement



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By Simon Mumme

Talk isn't cheap in Peter Butler's line of work. His in-depth discussions with company chairmen, executives and directors about how they can better steer their businesses come at a cost.

"Arranging meetings, preparing and delivering presentations to companies, and discussing their responses all takes time. Companies should consider paying fees to those who attend such meetings," says Butler, founding partner of Governance for Owners (GO), a London-based fund manager.

His clients pay for this work – known as "engagement" or "stewardship" in corporate governance circles – plus an asset management fee for GO's equity funds. The most pragmatic and equitable way to finance more of these discussions on a much larger scale, so that more companies and investors may benefit, is to make companies pay, Butler says.

"If the company pays, the whole share register pays. This solves the free rider issue," Butler says.

True engagement involves ongoing verbal and written dialogue between investors and corporate executives, chairmen and directors. Voting on management proposals at annual general meetings (AGMs) is also crucial and seen as a focal point.

Spring break

In 2012, many European shareholders voted to oppose executive pay resolutions in the so-called "Shareholder Spring". This took place amid the UK government's enquiry into the accountability of companies to shareholders and the public led by economics professor John Kay. Analysis by ISS, a proxy voting advisory firm, shows that more investors participated at the AGMs of Europe's largest 750 companies in 2012 than in the last five years. The number of votes rose to an average of 65.9% in 2012 from 60.4% in 2008. Directives forcing companies to issue proxy statements at least 21 business days before meetings, except for extraordinary general meetings, has fostered voting by improving the flow of information to investors, ISS director of Europe Jean-Nicolas Caprasse says.

European shareholders dissented on 3.78% of votes in 2012 to equal the discontent they expressed in 2009, according to ISS. Investors primarily targeted remuneration proposals, then share plans – bonus incentives involving greater employee stock ownership – particularly if they compromised existing shareholders' pre-emptive rights to reserve stock in future issues, Caprasse says.

UK pension fund the Universities Superannuation Scheme (USS) is currently focusing on the independence of auditors in long-running relationships with FTSE 350 companies.

"Investors rely on the audit to reassure us that accounts provide a reliable, true and fair view of company health," says Daniel Summerfield, co-head of responsible investment at the £35bn fund. "It is vital that the audit is not only technically robust but is demonstrably independent."

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USS will now vote against resolutions from FTSE 350 companies seeking to re-appoint audit firms whose tenure already exceeds 15 years. Such partnerships are "untenable", Summerfield says.

"The lengthy tenures of audit firms, which is prevalent in many FTSE 350 companies, can risk the objectivity and independence of the audit process. We're saying to FTSE 350 companies that there can no longer be an assumption that audit firms can stay in place in perpetuity."

Owners of the movement

"It's chicken-and-egg," says Mike Clark, chair of Russell Investments' global sustainability unit, about the evolution of engagement in the UK.

"We've made a bit of progress, but how far we get depends on the end owners," he says. Pension funds and other institutional investors, in their role as asset owners, are ultimately responsible for entrenching engagement and sustainability risk analysis into investments.

"Asset owners should take responsibility for stewardship and make sure it gets done. Whether fund managers or other service providers do the job is another question," says GO's Butler.

Like businesses, asset owners have varying commitments to improving corporate governance. "I've heard it again and again from company chairmen – that they write letters to their top 20 shareholders and get one or two responses," says Frank Curtiss, head of corporate governance at Railpen, the £20bn UK pension fund.

Embedding sustainability risk analysis and engagement into investment processes, rather than making them a siloed function, is the major governance challenge facing investors, according to Summerfield. Focusing on the quality of engagement instead of the number of meetings held and committing enough people and attention to research and communications is vital.

USS' six-person responsible investment team is tasked with assessing governance and sustainability risks in companies across all markets, including private equity and hedge funds, and briefing portfolio managers at the fund's in-house team.

"Further work can be done to address these factors at the early stages of the investment decision-making process. We are working with the portfolio managers to develop a process which will aim to close this gap," Summerfield says. In 2010 the fund struck a voting alliance with Railpen. Now entering its

fourth AGM season, the partnership shows how pension funds can unite to become more active shareholders.

Votes opposing management proposals are preceded by letters expressing the funds' opinions or seeking more information.

"Not a lot of investors write to management. If they do, it's nine months after the meeting, when the issue is stale," Curtiss says. "We try to contact companies ahead of AGMs to hear what they have to say."

Railpen includes stewardship in the mandates it signs with fund managers hired to manage the scheme's assets. These equity, bond, private-equity and hedge fund managers are at different stages of implementing responsible investment. "Some are good. Some are better. Some have work to do," Curtiss says.

Many take it seriously because they perceive governance and sustainability as part of investment risk.

"Fund managers might not think about it in terms of engagement and ESG, but they do it when investing in companies and holding management to account. We're less worried about the terminology as long as people do the right thing."

Stewards on show

USS, Railpen and GO, as part of the Investor Stewardship Working Party, have helped communicate ways for investors to close the gaps between governance aims and practice.

Asset owners need fund managers to clearly say how steadfastly they will – or will not – engage companies. Each must show "how far, and in what particular areas, it intends to exercise stewardship", according to the group's 2020 Stewardship report, published in March 2012 after discussions with groups including the Financial Reporting Council, which oversees the UK Stewardship Code, and the Investment Management Association, National Association of Pension Funds and the Institute of Directors.

Companies should know what to expect and investors need to compare managers' attitudes to governance.

"There is nothing wrong in NOT signing up to the Stewardship Code when an institutional investor has products that are not suitable, or is too small, or is a non-believer in the benefits of stewardship," the report states. [Emphasis in original.] "There is a place in the market for trading and liquidity and we acknowledge that many investors will not seek in any way to be stewards."

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"Many fund managers have signed up to the Stewardship Code," says Butler of GO. "But I defy you to go to 10 different fund managers' websites and decide which does engagement better. It's not possible."

Proxy voting processes, which do not alert shareholders that their votes have been received or whether resolutions have been adopted or stood down, should also become more transparent.

"There is no accountability. It is an issue that the entire chain of intermediaries – proxy advisers, fund managers, custodians – must look at. There should be automatic confirmation that votes have been lodged," says Caprasse of ISS.

Critical mass

A "critical mass of investor stewards", which have the resources to constructively engage companies and hold boards accountable, is vital, the report states.

Most companies define this as between 25% and 35% of their share registers and say they could have regular dialogues with between

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10 and 20 investors. Companies should proactively seek these investors to form a "core" group to discuss long-term, strategy, risk and corporate governance, and elicit feedback on their performance, the report says. Ongoing meetings, particularly outside the AGM season, could mitigate risks and prevent disputes as investors seeking to defuse a crisis often arrive too late to enter a trusting dialogue, the group says.

"Honest, nuanced, constructive and, as necessary, challenging feedback is best for all parties," reports the Institute of Chartered Securities and Administrators (ICSA) in guidance commissioned by the working group.

"It is easier to discuss challenging issues with an investor, or a company – particularly if such a discussion needs to be held urgently – if a relationship has already been established," states the document, which was published in March.

Meetings should venture beyond the hot-button topic of remuneration, according to the guidance.

"Once a year, a company and its owners should focus on the company's approach to creating value, and protecting that value, looking at issues such as strategy, performance, succession, board effectiveness, culture, risk and reputation," ICSA states. "Individual issues, such as remuneration, should be placed in that context rather than dominating the wider strategy discussion."

Companies and investors should seek engagement on contentious matters, such as pay and director nominations, that may flare up in the voting season.

"With remuneration, companies want to engage well in advance of AGMs to gauge investors' opinions," Curtiss of Railpen says. "No company wants their remuneration report to be voted down."

Publicity generated by AGMs usually overshadows this important work behind the scenes, which usually amounts to a much more productive outcome between the parties involved than if a story is splashed across the national press.

As Curtiss points out: "Voting is the first step. In the UK, it's done from March to mid-summer. Engagement is perennial,"