Time to view corporate governance, stewardship as partners in responsible wealth creation

Common sense needs to be applied to both practices to bring about enduring business performance. BY MARK GOYDER AND ONG BOON HWEE

TRY asking the chairman of a listed company to say what frustrates them much in relation to AGMs (annual general meetings). Chances are that the answer is about voting. "We spend weeks communicating with shareholders about strategy, policies and challenges. And come the AGM, they voted against us without explanation."

How does this happen?

Big institutions seem to have split personalities. CEO and finance director meet the fund managers and analysts. Meanwhile the company secretary and company chairman talk to the corporate governance specialists.

The asset managers and analysts focus on financial performance – often over the quarters and the financial year. The governance specialists bring to the conversation their own assumptions, codes and guidelines. Rarely do they start with the mentality of a steward – thinking about the enterprise and its needs. Some even outsource the thinking to proxy voting advisers, whose voting guidelines may take no account of the company's circumstances and direction.

This is perhaps a reflection of the institutional investment world, where people think the answer to a complex problem is to ask a group of experts for advice. Just as not so long ago, "no-one ever lost their job for buying IBM", so no-one can ever be criticised if they have acted on expert advice – though spending money that might otherwise go to the ultimate saver.

There is nothing wrong with such outsourcing, so long as it does not encourage a generalised commitment to compliance in the place of a localised focus on the core and circumstances of the company. It diminishes the exercise of judgement by the owners of shares. Just as "good is the enemy of great", in this sense, "compliance is the enemy of stewardship".

The chairman of HBOS – a UK bank whose collapse alongside RBS triggered the UK's banking crisis of 2008 – claimed after the crisis that his bank was a leader in good corporate governance.

But what is this "good corporate governance" to which he was trying to conform?

Recent experience suggests that there may be mistaken assumptions, misperceptions, or intent twisted with misapplications.

From an investor's point of view, good stewardship is about getting alongside the company, understanding it and using investor influence through and with the board to promote its long-term success. Bad corporate governance is that which encourages investors to impose rigid templates from outside, having the trappings of the process but not the effect.

As we said in our previous article, "stewardship and corporate governance go hand in hand for the betterment of growing and enduring companies". However, there are some misconceptions about corporate governance which seems to set governance and stewardship at loggerheads. Like a common Chinese saying (*tong chuang yi meng*) which means "sharing the same bed, but having different dreams", such misconceptions have investor stewardship and corporate governance sharing the same intent, but resulting in very different application.

We look at three such common notions.

Experience in the UK and US has showed that the problem in the banking sector was that shareholding was so dispersed that no institution was effectively holding powerful management to account. PHOTO: AFP

1. IT IS BAD TO HAVE A MAJORITY SHAREHOLDER

The Reserve Bank of India – the Indian regulator – required the controlling family of the Kotak Mahindra bank to sell down its holding from its original 43 per cent to no more than 20 per cent by 2018. The stated objective is "to ensure it is a well-established regulated entity, widely held, publicly listed and enjoys good standing in the financial community". A banking consultant, commenting on this, said that the idea to have diversified holding in banks was because "banking is a business associated with the larger public good".

Bank regulators are certainly not alone in having this notion, as we see manifestation of this in various forms, against various entities – family owners, institutional investors, and sovereign wealth funds.

But why? Why does spreading the ownership among different institutions improve the stewardship of the company? How does reducing the size of the interest of the family promote the wider public good? The risk of this notion is that the opposite may happen.

The dispersal of shareholders is the enemy of stewardship. If no-one owns more than one or 2 per cent of a bank, they have no capacity and incentive to be responsible owners. An engaged institutional investor may well ask: "Why should I do the 'heavy lifting' when the benefits of my efforts are spread across a large group of investors who haven't lifted a finger to get involved?" This may well be the classic case of Everybody, Somebody, Nobody and Anybody; where everybody was sure that somebody would do it, and anybody could have done it, but nobody did it. In the meantime, weak or over-ambitious CEOs can continue unchallenged. As experience in the UK and the USA showed in 2008, the problem in the banking sector was that shareholding was so dispersed that no institution was effectively holding the powerful management to account. They do not even need to "divide and rule", as the "divide" part is done for them by the notion "it is bad to have majority shareholders".

It is bad to have a majority shareholder if that shareholder abuses the rights of minorities. The logical response to that is not to get rid of majority shareholding. It is to protect the rights of minorities. And to instil the sense of responsibility and accountability on the majority shareholder – precisely what stewardship is about.

2. COLLABORATION BETWEEN SHAREHOLDERS SHOULD BE DISCOURAGED

In many countries, regulators have sought to avoid collusion between investors. Takeover codes have specific provisions concerning "concert parties". While these rules are understandably needed in takeover situations to avoid hidden action by bidders, the blind application of this leads to the notion that communication between investors or shareholders is bad.

The problem is that such a notion can unintentionally inhibit investors who want to collaborate in order to be better stewards. What is too often missing is any influence in the opposite direction, encouraging dispersed investors to act as joint stewards, including the necessary and legitimate collaboration in engaging with the investee company to support and challenge its board in the interests of long term success. It is encouraging to observe that the industry body for asset managers in some countries, as in the UK and Singapore, has initiated forums which are intended to facilitate this process of communication and collaboration among investors.

3. ALL SHAREHOLDER ACTIVISM IS A GOOD THING

There is a tendency to assume that all shareholder activists are a good influence because they shake up sleepy companies and focus them on shareholder value. This is wrong. Unfortunately, many shareholder activists define shareholder value in anti-stewardship ways – such as demanding share buybacks at the expense of future capital investment. Some activists may be knights on white chargers who have spotted a lazy or greedy management or work to protect minority shareholders. But others may be pirates – opportunists looking for a chance to break up a successful and steady company in order to generate some short-term profits for themselves. Pulitzer prize winning journalist Jesse Eisinger has looked at the career of American activist Carl Icahn and concluded:

"If you look at somebody like Carl Icahn, you see the essential fraudulence of shareholder activism. He has never tried to actually make a corporation better. What he does is issue a bunch of fake pronouncements about sometimes a fake offer to take over a company . . . But, he's not actually helping companies make better products or create sustainable value for their stakeholders, shareholders, debt holders, employees, (or) customers."

Whether Mr Eisinger is right or wrong about Mr Icahn, he has certainly pointed out that the motivations of activists vary. Too many of them look at companies in the way a lion looks at a hyena – attractive prey to be captured and devoured.

For too long, lawmakers and companies have acted on the basis that they should treat all shareholders the same. This seems fair. But is it? In effect, this is becoming increasingly unhelpful to the development of good investor stewardship. Why should a company treat a hedge fund, which intends to profit by betting on a fall of its share price, the same as a responsible long-term institutional investor?

By the same token, it is a mistake to regard every shareholder activist as a champion of better governance. We all want to encourage active engagement by shareholders, but we do need to ask exactly whose interests the activist is serving.

GETTING THE SPIRIT RIGHT WITH BOARD NOMINATION

The pivotal relationship in the stewardship value chain is that between the shareholders and the board of directors. There is one practical change that could help make this relationship work better.

Shareholders, including institutional investors, could become more involved in the nomination of directors. The prevailing practice tends to be that the current board controls the board nomination process. In some places, Sweden for instance, there is a different approach which encourages joint stewardship. The board nominations committee is formed by representatives of the largest investors in the company. The result is that major institutions could come together to work as stewards of a company in that most important task – ensuring that it has the right board.

Here again, an alarm bell may sound from corporate governance "purists" – to have majority shareholders influencing the nomination process would diminish the independence of the board, they say. Others worry that this undermines the authority of the chairman. But think about it. Ultimately it is the shareholders who elect the board. If there is one decision in which it is logical to involve them more thoughtfully surely this is the one. And, why should the largest shareholders not influence the nomination process? By virtue of the size of their stakes, these shareholders are likely to be the ones that have the long-term interest of the company at heart. In any case, since they have the rights at AGMs to endorse or reject the appointment of the board as majority shareholders, it makes sense to enable them to make a more proactive contribution to the nomination process. Ultimately all shareholders, including minority shareholders, would still have the rights and responsibility to endorse the board.

In listed companies, there is at times the need to protect the minority shareholders' rights in the face of a dominant family or private owner. Here the idea of a representative board nomination committee could be adapted. The rules could be framed to ensure that minority shareholders are also fairly represented on the Nominations Committee. This could prove a valuable way of aligning shareholders in a common concern to select the right board. It could also give them the habit of working together to be better stewards of listed companies.

For some time, the world of investment has been seen as a mysterious art practised by highly paid wizards. But the reality is more prosaic. Good investment practice is much about common sense. "Don't put all your eggs in one basket". "Don't invest in something you don't understand". "Don't follow the crowd".

The same common sense needs to be applied to corporate governance and stewardship practices. We should focus on the spirit rather than the letter of good governance, and remember that they are there to underpin enduring business performance, and not get in its way. Governance is about holding the company to account and keeping it honest, starting in the boardroom. Stewardship is about looking after the assets you are entrusted with and nurturing them so that you pass them on in better condition – and that includes a responsibility for the values and relationships in which the future wealth of any company resides. It is time to view board governance and investor stewardship together as partners for responsible and inclusive wealth creation.

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