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- Edited Version -

The Main Issues for Active Shareholders – an International Perspective

by

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I. The importance of corporate governance for professional investors

Professional asset managers, while an increasingly important factor in the worldwide capital markets, today have a tough time to maintain the confidence of clients after three years of declining markets. A good way to achieve this is superior performance. A prerequisite to achieve outperformance is the pursuit of good governance, both at the portfolio companies and their own operations.

Empirical research confirms that companies with demanding governance standards show a significantly higher market valuation:

- The well-known study by McKinsey and the World Bank identifies that large international institutions pay a substantial premium for companies with good corporate governance.[1] A fund specializing in continental European companies with governance deficits by the British 'Hermes Pension Fund Group' has outperformed the EuroStoxx-Index by more than 6 % since its launch in February 2002 through August 2003.
- A study by authors of the 'Harvard' and 'Wharton' business schools analysed 24 corporate governance criteria with 1.500 companies during a period of 10 years until 1999. Companies with excellent governance performed on average 8.5 % p.a. better than companies with poor govern-

[*] Germany's and Europe's largest mutual fund group with assets exceeding € 120 billion and some four million individual clients (of which 2.6 million investment account holders).

[1] McKinsey (2002): Global Investor Opinion Survey, in cooperation with the World Bank's Global Corporate Governance Forum. Internet: http://www.gcgf.org /.

ance.[2] The international rating agency 'GovernanceMetrics' reported in March 2003 an average total return difference of 12.3 % for three years between the top and the bottom 10 % U.S. companies.[3]

II. International governance and equity culture developments: The drivers and the resistance

Despite the increasing evidence of the importance of good corporate governance, many companies and investors are still hesitant to actively pursue corporate governance issues.

Driving factors that play an important role are:

- Severe company mistakes and failures, not only Enron and Worldcom in the U.S. but Ahold or ABB in Europe, have created lasting irritations, followed by intensive demands for change.
- This forced reactions from the political arena. The remedial actions have been quite quick and – looking at the examples of the Sarbanes-Oxley Act of 2002 – rather far reaching. In Germany and in the EU, governance developments have been initiated more proactively in the late nineties in line with the publication of the global Governance Principles of the OECD.[4] The recently published action plan on company law and corporate governance of the EU Commission can become a further milestone in these developments.[5]
- Increasing influence on governance matters is exercised by professional investors, mainly investment and pension funds. Due to their aggregate voting power they are in a preferred position to get their views across to the companies.
- Last but not least, the increased participation by retail investors and the interest of other stakeholders (employees, media) in better governance ensure the attention of professional investors and companies alike.

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[2] Gompers / Ishii / Metrick (2003): Corporate Governance and Equity Prices, in: The Quarterly Journal of Economics, Issue 118, No. 1.

[3] GovernanceMetrics International, New York: GMI Statistical Research, March 2003, page 4. Internet: http://www.gmiratings.com/.

[4] OECD Principles of Corporate Governance, May 1999.

[5] EU Commission: Modernising company law and enhancing corporate governance in the European Union – A plan to move forward (Action Plan), Brussels, May 21, 2003 [COM (2003) 284(01) available at http://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm]

Nevertheless, there are also significant resistance factors:

- Companies in Germany and in Europe still show widely differing attitudes. While many companies today publish their commitment to good governance principles, this is often formal and masks a severe lack of governance quality inside the company and vis-à-vis the shareholders. Extensive disregard of important elements can still be observed in the areas of: Board independence, control issues, disclosure and remuneration, showing the necessity for further development efforts by all interested parties.
- Other reasons for comparatively slow equity culture developments in some EU countries are insignificant long term equity investments for retirement provisions or other savings. Consequently, political or investor-induced pressure on governance issues is too modest.
- Finally, at least within Europe, individual country laws and customs inhibit a faster EU-wide progress. The EU action plan is therefore an important step to reduce such impediments in the interest of all European member states.

III. Key governance issues from an international investor's viewpoint including an assessment of the main EU action plan proposals

Board accountability and quality standards

What really determines board quality is the supervisory board's or the non-executive directors' ability to effectively monitor and control the management board or the executives without stifling their entrepreneurial drive.

In line with the importance of the reliability of a company's financial reporting, institutional investors will support the initiative proposed in the EU action plan to introduce the collective responsibility of board members for financial (and key non financial) statements in form of a certification of financial information. This should not be seen as a mere European regulatory response to the Sarbanes-Oxley Act but primarily as normal practice to be equally applied across Europe. Closely connected is the responsibility of the board for efficient and sophisticated internal controls and risk management, another major aspect of the Sarbanes-Oxley Act.

The EU action plan includes several recommendations to enhance the responsibilities of board members. The recommendations comprise special investigation rights in the affairs of the company, a wrongful trading rule making directors more personally accountable for company failures, and the imposition of directors' disqualification across the EU as sanction for misleading financial and non-financial statements and other forms of misconduct. These measures seem appropriate to fulfill investor's demands for the ongoing improvement of board quality but they should be realized in the near future as they are serious problems of today. Other quality improvements include a recommendation for the board to perform a regular self-evaluation, limitations for the number of total board memberships and a maximum number for former management board members (two only) on the supervisory board as well as guidelines to promote efficient board interaction.

Independence and board structure, separation of functions

Central for the effectiveness and the quality of the board is obviously the independence of the non-executive (supervisory) directors. From the investors point of view, it is paramount that independence is not only confirmed by the formal absence of material company relationships but more by the stature of a director:[6] Only (non-executive) directors that stand firm by their well reasoned positions have the potential to be credible business supervisors and respected advisors. Institutional investors therefore want to ensure that truly independent directors are elected. The need to enhance the qualification of board members seems to be evident: Minimum standards for director independence, a limitation of the total number of directorships, and minimum standards for committees are required.

The EU action plan proposed a choice for all listed companies in the European countries between a monistic and a dualistic board structure that is welcomed by investors. The old idea that the one-tiered structure is the role model for boards has changed.

Another important opportunity for establishing good governance standards is the implementation of board committees – among them nomination, remuneration and audit committees, that have at least a majority of independent directors. Member selection should only be on the basis of directors' professional qualifications. For new or complex topics the employment of external advisors should be a regular call.

Transparency / Disclosure

Transparency is the effective means to gauge and influence governance practices: If only, the pressure to openly justify critical decisions should lead to improved decision making processes.

6 See also the definition of independence in the Higgs-Report: 'independence in character and judgement', p. 37.

Recent company attacks on mandatory quarterly financial reporting as proposed in the EU Transparency Directive[7] are opposed to the interests of all, not only the institutional investors: Only with up to date financial information correct investment decisions can be made resp. confirmed.
Whether the effect of the so called 'whistleblower' communication process for accounting and auditing matters now advanced by the Sarbanes-Oxley Act is really positive, is an open question at least for other countries. While this approach might work in particular cases in the U.S., it appears better to have full transparency and sufficient legal remedies in place to achieve corporate sanity. To discover malpractice through a rather clumsy procedure that offers rewards to persons that should understand their general duties to include detecting fraudulent actions early.
Of considerable importance is the publication of company specific corporate governance guidelines and annual governance reporting.[8] Companies should continuously inform (potential) investors about their governance in a comprehensive manner in the annual report and via the Internet. Investors thus gain the opportunity to assess the governance quality. This should improve the quality of the discussion which can then be focused only on critical governance elements.

Remuneration

Investors increasingly see detailed information on executive remuneration as necessary to judge management performance. The compensation structure should reflect the different functions and success factors to ensure that incentives are in line with relevant benchmarks.
Performance oriented, long term incentives like share option plans require a detailed analysis to prevent inadequate compensation. Ex ante disclosure of the compensation structure and the details of share option plans as well as the shareholder approval for new shares have reached the global change agenda.

A short comment on appropriate compensation for non executive directors: The UK approach of fixed pay only for non-executives should be viewed critically since it does not appropriately account for the advisory role of the non-executives and might foster a control attitude only.

[7] Proposal for a Directive on transparency requirements for listed companies, Brussels, March 2003. Internet: http://www.europa.eu.int/comm./internal_market/en/finances/mobil/index.htm.

[8] See i.a. NYSE Committee Recommendations, EU Action Plan and German CG Code requirements.

Shareholder rights

Many companies still do not provide sufficient information to their shareholders for the effective exercise of shareholder rights. Of particular concern are manifold difficulties for the exercise of their rights in the general meeting. Given the general demands for the 'one share - one vote' principle in the U.S., it is remarkable that no satisfactory general solution has yet been found to implement voting procedures for ADR's that allow all shareholders to exercise their rights in full without serious impediments.

Improving and aligning international practices for representation at the general meeting should be high on the reform agenda. A sensible approach to enhanced shareholder rights must provide comprehensive shareholder access to all relevant financial and non-financial information including counter motions. This should be available to all shareholders well before an AGM via electronic communication means, i.e. the Internet. The company's management should answer shareholder requests in writing prior to the AGM. This would enable the meeting to focus on the important agenda items. Voting procedures should allow electronic proxy voting and facilitate cross-border voting without unnecessary blocking periods that deter institutions from voting their shares.

Auditing matters

Exemplified by one of the largest corporate failures (Arthur Andersen / Enron), auditor's conflicts of interest are a major concern of investors. Of the many suggestions offered to rebuild confidence in company financial statements, full independence of the auditor and the prohibition of non-auditing services are important. As a consequence, proof of the auditor's qualifications, the precise definition of prohibited services and pre-approval of non-audit services should be strongly promoted.

Finally, the audit committee should establish clear communication obligations for the auditor if any deviations from stated governance principles are discovered. It should also assume the ultimate responsibility for the resolution of disagreements between the auditor and the management. According to the German CG Code, the auditor has to report (obvious) governance deficits to the supervisory board with similar provisions in the Sarbanes-Oxley Act.

Some critical points on the EU action plan

The generally to be welcomed EU action plan has various shortcomings from an institutional investor's point of view:

- The proposed election of management board members by executives instead of non-executives is a major negative and should be opposed by institutional investors.
- It is conceptually wrong that the systematic exercise of voting rights by institutional investors is not considered desirable by the action plan. This contravenes a major governance obligation of investors.
- The timing of the implementation steps by the EU Commission should be re-considered since implementation has only been suggested as a medium-term requirement. Given the necessities and the many already existing approaches outlined above, the action plan should foresee the implementation of the obligations as a short-term matter.

Enforcement

Although the international framework for good governance practices has been significantly improved since 1999 and developments accelerated in the last two years, <u>much progress is still necessary to enforce good governance</u>. This will need a broad based legal framework that covers the key principles. In this context, much progress has been made or is still underway. However, a good legal framework needs an efficient enforcement system of competent and concentrated bodies of justice. This is still outstanding in many countries like Germany where too many individual state authorities inhibit an appropriate enforcement process.

Most important, the development of corporate governance standards and their enforcement can obviously not only be left with the governments. <u>Institutional investors</u> with their intensive capital market know-how and collective powers <u>should play an active role in the implementation of good governance in companies.</u> Such a pragmatic and widely accepted self-regulation measure with a 'comply or explain' approach should leave enough room and flexibility for companies to follow their business strategies without being too constrained by endless legal stipulations.

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IV. The main tasks for fund managers as active shareholders

Engagement in the long-term company development

The main objective for fund managers as active shareholders is to ensure the preservation and growth of the company's long-term value. This should not lead to interference with day-to-day company management but should focus on longer-term strategy and general governance standards. Demanding full transparency as well as criticising bad practice are the general kinds of engagement, which can take place in different forms like voting, direct company contact, media discussions and co-operation with other investors in specific cases.

Control of board compensation

Due to the well publicized abuses during the past three years there is more than enough reason for a critical evaluation of management remuneration, its direct link to long-term profitability and to the individual success.[9] This includes managers giving up part of their compensation if share-based elements expire worthless, i.e. this remuneration element must be a substantial part of the compensation package rather than just a 'nice extra' on top. Another crucial requirement for share-based compensation should be that the shares and share options are at least partly granted in restricted form with vesting over three years or more.

Compensation for non-executive (supervisory) board members should also contain share-based elements linked to longer-term profitability (and not dividends) but these elements should form only a smaller part of total compensation.

Involvement in the election of board members

As board quality is paramount for the overall governance quality and thus for long-term company performance, participation in board member selection is a crucial task for active shareholders. This should include the definition of key criteria for candidate selection and direct proposals of candidates. With respect to the latter, fund managers should generally not propose their own members due to serious conflicts of interest.

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9 A recent example of the necessity for scrutiny is that of the NYSE CEO and Chairman, Richard Grasso, who resigned after a furore over his $187.5m pay package mainly criticised by pension funds. See Financial Times, Sep. 19, 2003, page 11.

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Ensure level playing field for takeovers

The unending difficulty to achieve a European Takeover Directive reinforces the need to pursue the shareholder interests as owners. The resistance by the management and the supervisory board against third parties is natural but should not hinder a sensible takeover proposal. While an efficient European Takeover Law might pose a competitive threat for European companies, this is not a lasting excuse for better solutions. At the same time, Europeans should do battle against U.S. companies that still have features that significantly limit shareholder rights (e.g. different classes of voting stock like Ford and Reader's Digest).

Institutional investors should therefore let companies' management know that they place a high value on a level playing field behavior.

Quality of voting procedures and proxy committees

Voting at the annual meeting is a core responsibility for institutional shareholders and should be following a clearly defined policy. A necessary prerequisite is the establishment of a proxy voting committee: This committee is responsible for proposing the voting policy and for deciding critical voting decisions and on internal conflicts of interest. It is also important to provide sufficient internal and external resources to ensure qualitative voting, e.g. avoiding automatic voting behaviour. The pursuit of cross-border voting is of special importance for large funds with substantial international asset allocation. In order to control the associated cost, insourcing of technical support is permissible, but the delegation of voting decision to a third party is contradictory to key quality task.

Reporting to fund shareholders (holdings, voting)

Half yearly reporting of holdings is no longer 'state of the art'. Instead, quarterly reporting (as requested from portfolio companies) and monthly 'top ten' positions should be normal practice for publicly held fund portfolios. The governance policy, its implementation and the general voting behaviour should be reported annually. In all critical cases it is appropriate to disclose and explain individual voting behaviour. This is especially true if conflicts of interest exist. They should be disclosed and potential effects on the voting decision should be explained.

Disclosure of own corporate governance resp. proxy voting policy

Accountability to beneficiaries demands disclosure of all activities of the manager's group resp. parent activities. A detailed governance resp. voting

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policy should be publicly available, also via Internet. In addition, the process that ensures effective monitoring of companies in which fund managers invest should be revealed.

V. Existing guidelines regarding 'shareholder activism'

Key examples from Europe and the U.S. document the increasing efforts from regulators and private initiatives to promote activist behaviour of institutions.

Europe

- FEFSI's High Level Principles[10] (Europe): The principles, which were published in February 2002, contain four major fiduciary duties for investment fund managers: exercise of ownership rights, dialogue with companies, adherence to a governance policy, and disclosure of relationship with related companies. They will be expanded and adapted to the latest best practice developments in the near future.
- BVI Code of Conduct[11] (Germany): The German Association of Investment Companies released a Code of Conduct for its members in October 2002. It contains seven main principles for institutional shareholder responsibility: fiduciary duties, transparency and disclosure, conflicts of interest, securities transactions, organisation and administration, outsourcing, and market integrity. The principles contain precise criteria regarding 'shareholder activism': fund managers to act solely in the interest of investment clients; proxy voting to be delegated only with detailed voting instructions; no abuse of minority shareholder positions; and in the case of takeovers the fund management will undertake every legally permissible action.
- ISC Responsibilities of Institutional Shareholders and Agents - Statement of Principles[12] (UK): The British Institutional Shareholders' Committee (ISC) - members are ABI, ITS, NAPF and IMA - has developed best practice standards for institutional shareholders and/or agents in relation to their responsibilities in respect of investee companies. The Principles include: the establishment of a governance policy, monitoring of and communication with investee companies, intervention necessities, impact evaluation, and client reporting.

10 http://www.fefsi.org
11 http://www.bvi.de
12 See press release 'Institutional Shareholders' Committee unveils new statement of principles on shareholder activism', October 21, 2002, available at www.investmentuk.org

U.S.

- Pension fund rules[13] requiring funds to engage in the governance of investee companies have been applied for long with a considerable degree of public attention, e.g. proxy voting contests and other activities by CalPERS and TIAA-CREF. US pension funds are thus widely seen as the pioneers in respect of shareholder activism. However, especially from a European perspective it is equally important to follow the experiences of non-public activities by leading institutions.
- The SEC Proxy Voting Rules[14] have been significantly sharpened by the amendments of March and April 2003. These amendments require investment advisers and registered investment companies to disclose the voting policies and procedures. They also require to file with the SEC and to make available to shareholders the specific proxy votes cast in shareholder meetings.
- NYSE and NASD regulations are mostly related to the investment firms' own operations rather than to their direct fiduciary duties. Nevertheless, as a result of the 2002 Sarbanes-Oxley legislation overall responsibilities for institutional shareholders have been significantly increased.

The International Corporate Governance Network's effort (ICGN)

The ICGN has just released a policy statement that is global in its reach to reflect its international member profile: Its statement on 'Institutional Shareholder Responsibilities'[15] sets out a framework of best practices on the implementation of fiduciary responsibilities. It addresses the entirety of those relations – not just the shareholder's responsibility to vote shares.

VI. The free-riding problem – a real issue in future?

A crucial impediment towards a more active role by institutional shareholders that is frequently mentioned is the free-riding problem: Is it rational for an investor to commit resources on the pursuit of good governance, if all other shareholders seem to benefit equally from improved company performance and ultimately increased share prices?

[13] In 1988 the US Department of Labor explained the opinion that, since proxy voting can add value, voting rights are subject to the same fiduciary standards as other employee retirement plan assets ('Avon' letter). The same standards of trust law also apply for mutual funds, as clarified by the SEC Chairman in a letter dated February 12, 2002.

[14] http://www.sec.org

[15] http://www.icgn.org/documents

While the introduction of laws that oblige institutions to vote could be a solution, it is not the best one to achieve the quality issue.
What really matters is the understanding by the institutional fund manager that only an active governance effort will give him the competitive edge. The discovery of deficits and remedial action by active managers will be followed by the impact on the stock price. Riding along will therefore not be the winning solution as the discovery process will only benefit the active investor when the stock price is low. This issue reminds somewhat of a Russian leader who spoke of punishment for those who come to late. It is therefore high time that this outdated excuse is filed away and the above mentioned recommendations, not only but also from FEFSI, are being followed without reserve.