Corporate Governance and the Effectiveness of Shareholder Engagement

A study of investor, company and adviser perspectives conducted by the JCA Group for the Financial Reporting Council

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SECTION 1

‘Menu’ of Possible Options
for
Consideration
by
Investors and Companies

Suggestions which emerged from
the JCA Group study of
investor, company and adviser perspectives

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1. INTRODUCTION

From our research it is clear that the key task in shareholder engagement is to improve the ongoing quality of the dialogue between shareholders and companies.

Shareholders wish to protect their right not to engage but simply to sell when a problem arises but following the value destruction of the last year, a danger exists that government will press to legislate on shareholder engagement.

In order to preserve the current 'comply or explain' approach, investors may wish to embrace a more proactive approach to engagement.

There is a real debate as to whether there should be a forum for collective engagement. This could have the benefit of ensuring companies hear the range and depth of investor views and also bring economies of time spent for companies. But there is genuine concern and nervousness that collective forums would not allow open and honest dialogue and could simply create another 'box ticking' activity as senior people would not attend.

There is also a perceived need to find a way to encourage dialogue before a vote against, to enable shareholders to register concern and companies to actively acknowledge their views.

Below is a series of tangible suggestions for action drawn from the interviews we have undertaken which could be considered to be included in a new 'checklist' or 'code' of good practice for more systematic on-going high quality shareholder engagement.

However, resource constraints mean it is unrealistic that investors will be able to engage actively with all companies that they hold, nor would companies be resourced to respond. But the embrace by major investment institutions of a more active engagement strategy for their largest holdings by value and proportion, would be likely to deliver a significant improvement in the quality of governance dialogue.

2. POSSIBLE ACTIONS FOR INVESTORS

2.1. Company Stewardship

- Institutions should recognise their role in the UK governance framework for the oversight of companies' compliance with the Combined Code and review their resources and strategy for fulfilling this role.

- Institutions should identify and regularly review their strategy for exercising equity stewardship responsibilities.

2.2. Managing Governance Internally

- Institutions should review how far governance and engagement services do and should form part of their client agreements.

- Institutions should review the calibre of the internal standing of their governance teams to establish whether they are well-placed to represent and deliver the firm's agreed governance approach.

- Institutions should involve those making investment decisions in their governance dialogue with companies as far as appropriate and ensure those involved in governance and fund management are 'joined up'.

- Institutions should review how far their governance and investment teams work together to communicate to companies.

2.3. Quality Dialogue

- Institutions should ensure that they are well represented at all levels of dialogue with investee companies in terms of individuals' calibre and advance preparation.

- Institutions should be ready to give feedback on governance and other issues, explaining their viewpoint, including reasons for increases and reductions in holding.

- Institutions should recognise that governance dialogue can ensure that governance problems do not build in the companies they hold. Institutions should not wait for crises to emerge before initiating their own engagement with companies on governance issues. Mechanisms to allow early conversations should be explored.

- Institutions should look for opportunities to communicate with their clients' engagement with companies.

2.4. Voting Responsibility

- Institutions do 'vote' everyday with their trades but also have a responsibility as a shareholder to vote thoughtfully.

- Institutions should communicate their intention and reasoning for a vote against a general meeting resolution ahead of doing so to provide an opportunity for appropriate dialogue.

2.5. Relationship with Chairmen

- Institutions should review what investment benefits can be derived from dialogue with company Chairmen. Regular, at a minimum annual, meetings with Chairmen of larger holdings should be actively considered by active investors.

2.6. Collective Engagement

- Institutions should explore creating a forum for collective engagement for their most senior people to have private dialogue with each other, but which does not compromise their ability to trade shares and which can alert companies to concerns in a measured and constructive way.

3. POSSIBLE ACTION FOR COMPANIES

3.1. Shareholder Representation

- Companies should ensure Chairmen embrace their role as large shareholders' principal point of contact on governance and other strategic Board issues. This would complement rather than replace the existing contact between CEOs / CFOs and shareholders.

- Companies should review the scope for raising governance issues as part of their regular (management-led) dialogue with shareholders.

- Companies should make an effort to demonstrate how they are responding to specific concerns raised by shareholders over governance and strategy issues.

3.2. Quality Dialogue

- Companies should adopt a more flexible approach to dialogue with shareholders on governance and strategy issues, maximising existing communication opportunities and creatively seeking new ones.

- Large and mid-cap companies should actively review whether they are maximising opportunities for dialogue if Chairmen are not having at least an annual meeting with a significant proportion of the company's top five or top ten shareholders.

- Chairmen should ensure that shareholder concerns, whether on governance, strategy, performance or other issues, are shared and discussed with the whole Board.

3.3. Chairmen

- Companies should aim to increase the exposure of their Chairmen to shareholder views. Simply writing offering a meeting is unlikely to be an adequate communication strategy. Chairmen should consider attending results presentations and some of the subsequent one-on-one meetings with larger shareholders.

3.4. Non-Executives

- Companies should ensure non-executives are able to fulfil their role in representing shareholders. Non-Executive Directors should be given full access to any reports and feedback of shareholder views and encouraged to take an active interest in the effectiveness of shareholder engagement. Opportunities should be sought to give them exposure to the company's dialogue with shareholders.

- Companies should assist Board committee members by providing any necessary training to develop and maintain the expertise required to lead strategic discussions for their committees and fulfil their overall committee Chairmanship responsibilities. This applies in particular to newly appointed committee members and committee Chairmen.

3.5. Board Evaluation

- Companies should make full use of the opportunities presented by Board evaluation. External evaluation is likely to bring new perspectives and benchmarking against good practice elsewhere; companies should consider carefully the use of external evaluation as part of their cycle of Board evaluations.

3.6. Risk Management

- Companies should consider their processes for risk management and consider greater challenge of assumptions, for example whether a regular review of 'what keeps their executives awake at night' could deliver a more rigorous risk review.

3.7. Formal Reporting

- Companies should re-assess their use of governance sections of the annual report as a means of communication. More direct insights into Board and committee thinking and / or sections authored by individual Board members could be considered to improve shareholders' understanding of the company's approach.

- Companies should consider the AGM as an area ripe for review and innovation. The grouping of AGMs in the second quarter is a hindrance to substantive dialogue. Companies invest a great deal of time in AGMs but this 'major piece of structural corporate democracy' is not being used effectively by either companies or shareholders.

SECTION 2

Corporate Governance and the Effectiveness of Shareholder Engagement

A report summarising Investor, Company and Adviser Perspectives

Jan Hall
Thomas O'Malley

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A. KEY FINDINGS

Reality of constraints on investment managers:

- Need to recognise the resource constraints for investment managers, many with hundreds of holdings and little recognition from clients for their engagement activity.

Increased regulation could reduce quality of engagement:

- Risk that further regulation in the governance arena would be counterproductive, leading to more box-ticking and boiler-plate reporting rather than more effective engagement.

Specific areas of interest:

1. Importance of governance to investors

    - Governance remains important to the majority of equity investment management firms although only a few cited it as an important part of their investment process and there is concern about the lack of interest from clients.

2. The engagement experience

    - There are concerns about how well governance is linked to fund managers within investment firms and how far companies act upon engagement messages from investors.

3. Improving engagement effectiveness

    - Larger long-only managers seem ready to enhance their commitment to best practice in company engagement and to take a more overt lead role on this.

    - Companies would welcome improved governance dialogue and need to explore more flexible means of communication. Dialogue with company Chairmen is key; many suggested innovations bypass this reality. Greater effort and understanding on how to improve on this interaction is needed on both sides to make this work.

    - Investors could help by a) being well prepared for meetings, b) giving clarity on investment objectives and c) sharing views on the company's strategy, performance and market.

    - The calibre of people involved in the engagement dialogue is crucial; ideally senior representatives and certainly those commanding fund managers' respect and support.

4. Voting

    - Voting is a valued part of the governance dialogue, although there are concerns about communication and the pressure of the meetings timetable. A renewed emphasis on best practice in engagement and communication around voting should provide sufficient basis for large investors and companies to come together.

5. Remuneration

- Although there is frustration about the time devoted to remuneration and the increasing complexity of some schemes, companies and investors recognise its importance. The publication of examples of schemes that have worked could be considered. As could some kind of training for remuneration committee Chairmen.

6. Annual Elections

- Annual re-election of directors is favoured by some and could usefully be discussed further

7. Non-Executive Directors

- Boards should consider improving reward for Non-Executive Directors who in turn might be expected to commit more time and take on few roles, possibly three to four rather than five to six.

8. Senior Independent Director

- Companies would welcome improved governance dialogue and need to explore more flexible means of communication. Dialogue with company Chairmen is key; many suggested innovations bypass this reality. Greater effort and understanding on how to improve on this interaction is needed on both sides to make this work.

9. Information on the operation of the Board

- Ultimately the quality of the Board members and their interaction is the most important element in effective Boards and the role of the Chairman is crucial in this regard.

- Board evaluation is seen as the most likely way to ensure Boards operate effectively but is not embraced equally at present.

10 – 14. Other

- Risk management should focus on the issues 'keeping management awake' as well as strong risk control and processes.

- A forum to improve informal dialogue between auditors and shareholders would be welcomed by some.

- Greater and common disclosure on risk and committees annual reports could be considered.

B. STUDY PROCESS

Some 35 company Chairmen and CEOs, corporate advisers, investment management heads and governance representatives were interviewed or gave feedback from January to March 2009.

The sample group was selected as representative rather than comprehensive. Most Chairmen and CEOs also had experience as Non-Executive Directors.

Initial interviews of around one quarter of the sample group were broad-ranging discussions of governance issues and shareholder engagement.

The scope of the study was then reviewed and specific questions agreed with the Financial Reporting Council. These questions formed the basis for the remainder of interviews.

The following report draws together the views expressed during both stages. Comments recorded are mainly not *verbatim* but based upon notes taken during the interviews. Participation was on a non-attributable basis; minor amendments have been made for that purpose.

Interviews were mainly conducted by Jan Hall of the JCA Group and Thomas O'Malley, a governance practitioner, and also by Kate Rankine and Alice Perkins of the JCA Group.

Comments were drawn together by Thomas O'Malley.

C. SYNTHESIS OF INTERVIEWS

1. Importance of governance to investors

Investment chiefs retain their belief in the importance of corporate governance to investors.

> *Hugely relevant – corporate governance gives transparency to what's happening; it provides checks & balances to executives and confidence for investors. If corporate governance is not working, it's hard for investors to have confidence.*

> *It's incredibly important – manifesting itself in the long-term performance of companies. Well-run companies tend to have support of shareholders, suffer less volatility at times of maximum stress, with less severe share price falls.*

For some, governance is part of their investment process, albeit within limits.

> *Governance is part of fund managers' view of a company. It's part of our integrated approach that governance should sit with managers. They review companies, and governance is factored in as part of that – especially for small companies.*

> *It is important to long-term investors. It can be a central consideration for us – there are examples of where we have not invested because of governance. We have various controls built into our system where we believe corporate governance to be an issue.*

> *Corporate governance is an integral part of our process of checks & balances. Governance team is responsible for evaluating the governance of companies ... It's not necessarily about exclusion from portfolios; it's about regulating exposure to governance risk.*

Investors believe that their governance activity is of benefit to the whole UK market.

> *Institutions have an interest to work for better governance to enhance the integrity of the London market*

> *The impact is cumulative of the market as a whole. Some just vote with their feet, but if you sell, you have to buy. If you're selling something with poor governance, you're more likely to look to buy something with better.*

> *An important part of our ownership perspective is that institutional investors have a role to make the whole market work better. A lot of our investment work is aimed at adding alpha to client portfolios; the governance work can contribute to that, but it also adds beta to the market and to our client assets.*

But they know that not every investment company takes the same view.

> *Firms that regard governance and stewardship as important could probably be counted on the fingers of two hands; the rest don't feel it justifies the cost.*

> *Some people don't share our view, they believe governance is a waste of time and not effective – and quite reasonably point to the current crisis as evidence.*

> *There are diseconomies of scale – you can't have every investor talking to every company. Some investors don't act like owners and that's no bad thing.*

Although all said it was important, there was little evidence of investment CEOs regarding governance engagement as providing crucial insights for their investment process.

> *There isn't a clear business case for dialogue with investee companies.*

> *The costs of corporate governance are high – both in terms of cash and in terms of time away from the portfolio.*

They feel that their clients have little interest in their governance engagement work.

> *The vast bulk of our clients are not very interested in governance. They appoint us for investment results.*

> *Yes, we feel like owners but that does not put us beyond the brutal reality of client focus on investment performance.*

Investors nonetheless recognise a stewardship role.

> *I think if you own equity, it brings with it stewardship responsibilities.*

They are also conscious that the UK generally has better governance standards than many other markets in which they invest.

> *It definitely matters to us, though in the UK we worry less about companies as they are usually well governed. In other parts of the world we worry about governance a lot more. We always approach UK issues case by case. Where we are comfortable with the individuals and with Board balance, we will give them more flexibility.*

Companies believe that mainstream investors take governance seriously and that it matters to them as institutions even if not always to individual fund managers or all other investors.

> *Investors feel it's very important – it's the process of exercising stewardship.*

> *There's a huge range of investment managers. Hedge funds don't give a damn – they just want to know about short-term share price moves; at the opposite end of the spectrum are the activist firms ... they are in the minority but noisy.*

> *Often the fund managers couldn't care less as long as the price is going up and the business seems well managed.*

2. The engagement experience

Post-results meetings still represent the bulk of the dialogue between shareholders and companies. These are typically attended by the CEO and / or CFO on the company side and a sector analyst with or without fund managers on the shareholder side. The meeting is more focused on the company's performance, though governance issues can arise.

> *We have parallel conversations. Fund managers meet CEOs & CFOs. They focus on financials and on whatever is changing with the company. The corporate governance team is always invited, though we only go if we have something to raise. There's quite a lot of governance in the strategic dialogue that fund managers might have with a company.*

> *In terms of the discussions which the fund managers have, they'll cover governance when they need to – the focus though is more on strategy and direction.*

Meetings between investors and Chairmen are usually a separate channel, with the corporate governance function taking the lead, albeit often with analysts and fund managers present.

The corporate governance team has discussions with the Company Secretary and Chairman (more rarely the CEO & CFO). We discuss the company's governance, including Board performance and composition.

With the Chairman, we're not so worried whether every aspect of the Board arrangements ticks a box. We could cover succession (both Board & executive), strategy, finance & reward. We want to put the 'footwork' in so that we can have appropriate influence and dialogue on the occasions that it is needed.

We meet Chairmen regularly, and sometimes non-executives as well ... We value our relationship with Chairmen, which gives us a perspective on long-term issues and helps us to head off problems at the pass. But another investor might be a boutique without the time or information for engagement. Some very successful fund managers never meet the companies they invest in – so it's hard to say that one approach represents best practice.

Two investors we met have more systematic engagement with Chairmen. One said:

We also have a commitment to routine dialogue with Chairmen of companies in which we are invested similar to the relationship we have with executive directors. Access and the ability to communicate is very important – it doesn't have to be about pure corporate governance per se, though those will be raised if relevant ... [as part of this] ... we hold fairly regular dinners – often with the company Chairman, CEO and SID; CEO, governance head, head of equities and analyst from our side

The division of roles in most investment houses may well enhance the impression of companies that the approach to governance is often disjointed.

From the corporate perspective, there's the question of who to engage with – the separate corporate governance unit or the managers.

The firms with a split between governance and investment have not necessarily been handicapped – what matters is how far the two functions communicate ... Structure doesn't matter, but I think many need to be more joined up in their thinking. There's no point in have corporate governance if it's not joined up.

I get the impression that voting is done in some firms by a separate group of individuals who are influenced more by third parties. I've had examples of investors voting against something where the fund manager didn't even know, and more worryingly, seemed to adopt an air of resignation, saying 'don't worry about it'.

At times it's even worse - the fund manager is almost dismissive of the position taken by his own governance team.

Although this is not a new criticism, only one corporate leader had the impression that the situation was being partly addressed.

Some firms take a holistic view of your company, with governance unit and managers working together. But there are still a number where you see the fund managers and think everything is fine and then you get them voting against you out of the blue. Investors need to learn to speak with a consistent voice.

Companies report a wide range in the quality of dialogue in executive / shareholder post-results meetings.

Many are very perceptive and ask all the right questions, enter a real dialogue. At other firms you get eight people in the room, seven of whom say nothing whilst the analyst goes through the P&L line by line. Shareholders need to get more engaged with the business. If they're going to have the CEO, they could ask deeper questions such as how we look at share buybacks versus other use of money, how do we evaluate investments, how we account for different things, what are our criteria of good returns, what is the process with this product. Our leading shareholders do ask some questions like this but the bulk do not.

More often than not it's a one-way dialogue ... There should be an onus on shareholders to tell companies what they want, why they're holding the stock, whether they have concerns.

The meetings are often focused on quite detailed indicators. The rules mean we have to take care not to give any price sensitive information, so they are looking for nuances.

I am still amazed at the level of preparation by fund managers – it's really just professionalism, which is lacking sometimes. You can either show your frustration or switch into education mode. But really it's a waste of time – you wonder why they asked for the meeting. You'd think that if they say 'yes', they'd do the work required.

We encountered a number of companies that had found it difficult to interest shareholders in meetings with their Chairman.

At the last round two people accepted, both governance people who only talked about remuneration. One fund manager we met later didn't even know the meeting had happened.

I (Chairman) write to investors offering to meet, but it's very rarely taken up. In a sense, that's OK as I am sure it would be taken up if there were issues.

Investors reminded us of the pressures they face, although not all are convinced that Chairmen are trying very hard.

Yes sometimes Chairmen get few, if any, responses to their letter offering a meeting, but shareholders are under time pressure and have holdings in many companies.

I don't feel turning down a meeting means it's more difficult to establish contact if an issue arises – we've got people who've been around long enough to be able to pick up the phone.

Chairmen just sending out letters is not an effective means of communication ... For most of the people that are Chairmen it would be very easy for them to find ways of meeting investors. Plenty of Chairmen who are in London don't make the effort. I recently went to a dinner of FTSE250 Chairmen and in 15 years I had never met any of them – even though we have probably held a reasonable percentage of nearly all of them.

Companies are already exploring other approaches for establishing dialogue with investors, such as this CEO.

I try to get away from the results season. It's hard because people get used to seeing you – but it can deliver better dialogue. For large investors there's no substitute for frequent one on one contact. For smaller investors, we organise dinners, lunches. The dinners were awful so we've stopped them, no-one wanted to be there. Lunches are normally on the back of some event – across the lunches about 20 or 30 investors come; it's just a sandwich and we talk through our recent decisions.

By and large, companies have found that the difficulty of establishing routine governance meetings has not been a barrier when communication has become essential.

At my business, governance has been a major and public issue. We have had a lot of sensible conversations with shareholders.

When we needed our institutional investors to express a view, the majority responded well.

When as a CEO, I phoned up senior fund managers to say I was getting a confused message, we could usually get to the bottom of it ... Companies should follow up more if they're concerned they're not getting the full picture.

However, companies worry that that opportunities to get an early sense of investor concerns or motivation are missed.

> *But we still often don't get to hear of investor concerns – even one of the most plugged in of our large investors sold us to zero without any communication of the reasons.*

> *[After each post-results meeting] I ask whether there's anything shareholders are worried about, but this makes them uncomfortable, so I am not confident that we do hear of concerns.*

> *We get different levels of feedback – trading is the most obvious; though that may because they think we're over or underpriced rather than as a comment on the business – we usually have no idea which.*

> *It's still an effort sometimes to understand how and when institutions express views – particularly the mid range investors – I am not sure that many of these operate effectively for governance / AGM voting, though it works better with major shareholders.*

In a small number of cases, internal constraints prevent investors from giving feedback.

> *We can only express a house view when we have a common view. This is sometimes not very helpful from the perspective of governance dialogue with companies.*

Comments from both investment chiefs and governance representatives imply that shareholders are simply being cautious about where to apply their limited resources.

> *Ownership is a day to day responsibility. But getting involved in an active way can be very time consuming and requires an infrastructure.*

> *It's a big use of our management time but that's a reflection of the fact that it's very important. We don't get any extra fees for this engagement and indeed there's a considerable reputational risk attached.*

> *With a finite resource, you should only use it to make a difference.*

There is also caution about misguided or over-zealous intervention.

> *If investors intervene too much, trying to second guess what companies are doing, it's potentially distracting and / or disempowering. If you're confident companies have a good strategy and manage risk well, you should be able to leave them to get on with it. So the issue then is how do you know whether these conditions apply and how do you find out.*

> *If you do have issues with the CEO, passing these on is really crossing the Rubicon – it's very important not to say you're losing confidence until you're sure ... Even to say that you're nervous is very difficult, in case you're wrong about it. To start asking questions too early is very dangerous as it can be destabilising / self-fulfilling ... Losing confidence in the CEO is a pretty major issue. The upside / downside risk for commenting where we only have a small holding is not worth it. We nearly always talk to others to see if our critical view is shared – and would rarely go into bat if it was not.*

Investors feel that engagement has not been a happy experience in a number of cases over the past two years; we heard many complaints about high profile companies' unresponsiveness on succession, capital raising and breaches of governance principles.

> *Over the past two years we have made our case strongly to a number of companies – the Chairmen and SIDs are often very pompous or don't even want to meet.*

> *We have generally had a bad experience in our engagement with banks.*

The investment industry is very fragmented and companies play shareholders off against one another as an excuse. They should spend more on long-term investors who are their providers of capital.

They could respect us more – on issues like pre-emption rights. 'Stump up and shut up' is their implicit attitude too often. There's not enough alignment with what we're trying to achieve. We want them to deliver over five to ten years but we see little of that in their actions.

It is striking that there isn't better quality 'sell-side' analysis of corporate governance. By and large the big investment banks won't do it because they are afraid of upsetting companies. When there is criticism – especially of governance, companies threaten analysts that they'll withhold access. It's a comment on how far companies are actually open to dialogue on their governance – a sign that something needs to be mended.

Shareholders believe that their comments and concerns are often not reaching Non-Executive Directors or that non-executives are being insufficiently robust in advocating them.

If we feel strongly on an issue we'd write to the Chairman or Company Secretary and insist it gets shown to non-executives but I'm not sure Boards really act – it might get five minutes attention at the end of a Board meeting.

There is a question about how much feedback the CEO gives to the Board on what shareholders have said.

The critical thing from investors' perspective 'at points of stress what is the most effective means of ensuring shareholders' views get aired around the boardroom table'. Recent examples call this into question ... They knew what the views of shareholders would be, who was putting the views of the majority of shareholders to the Board; it was a clear failure.

We need to find a means of getting shareholders' agenda onto the boardroom table in front of the NEDs. Often it's the CEO and CFO who meet investors – how do investors know that their concerns are being included in company thinking? If enough have worries and concerns, how do you make sure that the Board is aware and addresses the issue?

But shareholders and companies still believe in the current governance model and are mainly looking to its better operation as the basis for their response to the current problems.

The system is not broken; it's too easy to say it is and that's the reason for the current problems. There were unique circumstances around what happened to the banks, and everyone has to share the blame.

The vast majority of corporate governance issues are resolved away from the headlights, which is what you want. That you have not had lots of angry shareholders is a success.

There is a sense amongst institutions that they don't say 'no' and vote against often enough. It must be right to presume that the vote will be 'yes', but in future shareholders will vote 'no' more often.

The Code is fine in its coverage of the role of institutions, though it's relatively restricted in what it actually says. Beyond that is the ISC statement. But there are softer issues on why governance isn't working: the number of stocks held, the cost of governance teams, investors' own conflicts of interest.

There are practical challenges, but the Combined Code is working well for many companies.

3. Improving Engagement Effectiveness

Both sides of the corporate / shareholder dialogue recognise that the proportion of the market held by large UK institutions has reduced, but both still look to the major UK institutions to take the lead at the shareholder end of governance dialogue.

Some investment firms already have a stewardship philosophy to their equity investments. Partly in response to recent events, heads of these firms believe that this stewardship duty should be mandated across the industry through peer pressure and / or client agreements.

> *It's part of being equity owners. The cost of doing business should include stewardship. The investment industry through peer group pressure should explain why it's in everyone's interests. If we're not able to find consensus on this, it will become subject to regulation.*
>
> *In terms of how far these things should be encouraged or mandated – it's my strong view that those that are owners should have engagement and governance responsibilities embedded in their mandates, in the investment management agreements.*

This would require greater recognition from clients that governance was an important part of the service they provide.

> *Ideally, the end investors would be interested in what we're investing in rather than in basis points of our performance. We need a change in focus, more resources, with the issue moved up the priority list for clients.*
>
> *These clients are long-term holders but they want you to manage in a short-term way – there's a disconnect. We need the end customer to take more interest in what's happening at the companies they own.*

But there would not be support amongst investment managers for new regulatory duties in the governance field.

> *Attitudes have been changing in the past six months, but I am not at all keen on further regulation or compulsion – it would be more costs without improvement in flexibility.*
>
> *Should there be explicit duties of engagement in the code? No. The code is a list of features you would expect a well-run PLC to have in place. Here we are talking about the behaviour of owners, which is not an issue for the Code.*
>
> *There's no benefit in placing new burdens on the already limited governance resources of investment managers. There's danger that mandating new tasks will create a big bureaucracy that stops people doing important tasks.*

Investment chiefs hope it will be possible to build a new consensus of a more engaged investment industry, although they point out that by itself this would not guarantee the avoidance of future cyclical crashes.

> *It's not inevitable that this new consensus will come about, and even if it does, don't expect investors to automatically prevent disasters.*
>
> *The Government believes that if investors engaged more it would prevent all kinds of catastrophe – for example Company X – if we had engaged, it would have stopped CEO Y; if you intervene, you can save companies from themselves. Of course, the reality is that behind every disaster is a group of investors cheering on the company as it goes down the road to ruin. The only bank that was well positioned before the latest crisis was HSBC and they were being pushed the wrong way by investors. So the Government's premise is unrealistic.*

Our discussions uncovered further questions in the minds of some investors about their role in enforcing governance standards.

> *You can't bet on shareholders to hold companies to account – it's too easy for companies to say that they consulted shareholders. There's too diverse a range of people with different agendas ... How about a governance Czar? Maybe the FSA should be more involved?*

> *The proportion that does act like owners is too small to tip the balance, so you end up with 20-30% against in votes, but no majorities.*

> *But on governance, we can't think of a better solution than turning to the investors – it's certainly better that investors enforce governance standards.*

Raising their game

Investors realise that they will have to increase their engagement activity.

> *There's been a lot of soul searching in the investor community about how to make governance and engagement processes work better. Both investors and Boards need to adopt different practices. Boards need different attitudes to the relations with shareholders.*

> *Institutions could and should have been more effective. We should have done more. We clearly need to use our votes more aggressively; we certainly need to be clearer about our position, both privately and publicly.*

> *Fund managers need to act more like owners. Simple exhortation to do more would not work – can't just change one part of the investment decision-making process.*

In some cases, this will include raising the calibre of those involved in engagement.

> *Also investment management companies have to up the quality of people who speak to Boards on their behalf. The long-term institutions in the UK, such as L&G, Standard Life, Aviva, Schroders and the Prudential all have capable people and engage on an active basis.*

> *The quality of standing of the corporate governance team and those who represent governance views internally is important. It can be a constraint – the governance team needs to be able to look fund managers in the eye and thrash out their issues.*

> *There are resourcing issues for asset management companies that want to take engagement seriously. It's not just about financial resources – you need to have the buy-in of fund managers. Governance people need to be able to establish internal as well as external relationships. You need to ensure that governance teams and thinking are integrated.*

> *You need people with a sufficiently wide knowledge base and the ability to think laterally. Many investors get quite a narrow focus and have sequential thought processes.*

Investors argue it will also require a new attitude to engagement from both sides.

> *There needs to be a change of attitude to engagement – companies have to see it as a good thing and investors have to respond; companies already have sensible conversations with some; the investors need to field serious people. If we want to have a dialogue, Chairmen have to engage. At the moment, a lot of engagement is poor quality. We have changed, dedicating more management time to the issues.*

> *The Big Conclusion is that companies and shareholders must communicate - and urgently if an issue has arisen – problems come from bad communication. People make basic errors; communication solves 99% of problems.*

Another important thing is to change the behaviour of investors – they also need to be more trustworthy / not leak to the press.

Here, the governance team has enjoyed support from the highest levels. In the past that has been soft support but currently there are express messages to see corporate governance function exercising a stronger check and balance. I have an independent reporting line to the CEO. This means there is a level playing field in terms of influence.

How do you shift debate to the longer term, so that financial risk-taking factors in social and environmental risk? It's a question of the subject matter considered by Boards and if Boards have sufficient information and how far they're able to get it. We don't know what Boards don't know. Boards need to get information in order to exercise judgement.

The big question is about the overall relationship between shareholders and companies. We want to make the relationship work better and we have to find ways to identify and address weaknesses. The relationships between shareholders are another important focus, companies often try to divide and rule. The issue is how to have a common purpose without regulatory constraints, how to hold companies to account.

Companies realise that they too will have to improve their attitude towards engagement.

I don't think there's a crisis in communication between companies and shareholders – we just need to be a bit more thorough.

We do see on key occasions that they can play a part in; dismissal of the CEO, contested bids ... That kind of thing has always gone on. I expect it will become more prominent in the future, with increased involvement by the larger investors. The model is not flawed.

Companies would welcome more involvement – a typical comment is that they never get to see the managers themselves. If they find that the climate has changed, there would be scope for really productive discussions, with a mutual change in attitude.

Some shareholders believe it would be helpful to describe engagement best practice.

We would specify good practice – people should only be involved in engagement if they meet quality criteria. If some investors don't want to be part of the engagement dialogue, let them get on with their own approach.

We also need to form a consensus about how the owners of equity in the UK engage, but we are a long way from that consensus.

Companies believe that this can be built upon existing relationships and structures.

We're faced with a catastrophic failure of business models and questions of how to deal with it. Under the old system a smaller number of shareholders held a large proportion of a company's shares and all knew one another better and knew they were in it together. Now we are seeking security and safety once again, but in a different more atomised world it's harder to do anything. We haven't quite reached that point – there is still some concentration of ownership; the top 20 and certainly the top 5 shareholders can make their voice heard.

The AGM is a very important part of the company's calendar, yet the actual meeting never seems to feature in the governance dialogue with institutions. I am not sure I have ever been to an AGM which added anything valuable. Institutions don't turn up because they have the opportunity to speak one to one – they probably think it's not a good use of their time. But the result is that the major structural piece of corporate democracy is not being used.

Investors argue that Boards need to embrace a more active role.

Boards often don't have access to the right information and there is an over-reliance on management. There needs to be a more substantive dialogue with shareholders – shareholders need to be more intrusive in their questions; they need to call executives and NEDs to account more directly.

Specific ideas for improved engagement

There is discussion amongst investors about whether a new forum is required for collective engagement or at least for sharing experiences.

Long-term shareholders need a clear forum in which they can exchange views about companies – possibly with a regulator – and greater regulatory clarity so as to avoid the risk of concert parties. They need to step up to the plate on engagement and they need to get paid for their work.

The big institutions will communicate more frequently between themselves – those that argue for some formal body are wrong. We must not put in place corporatist / union-like meetings.

People have become more reticent about sharing their perspectives, there are concert party concerns and they want to retain discretion to act. The result is less dialogue rather than more in recent years. For example, look at the banks – some tried to engage and effect change but there was no great strength of concern demonstrated in the voting.

We have to be very careful about the information flow and dangers of market abuse. We have to be able to buy and sell so don't want to become insiders.

We need a mechanism to enhance engagement and dialogue but need to avoid establishing a mechanism that creates conflict. Rather, we need to define a mechanism that promotes good dialogue and ensures proactive conversations – a means of getting things done. Maybe it's a statement that says 'best practice includes these elements: x, y, and z'.

Companies have identified a new forum as a possibility.

There's a grey middle bit where we might see some change – that is should / could investors come together in informal investor groups, covering the FTSE250 or 100, working together more closely and more informed and involved than previously. There is a tension as to whether that kind of collaboration could be genuinely open because each firm wants to be able to buy or sell more first.

The exception would be the major shareholding companies, whose assets are large to the extent that their stake in every / most companies is between 0.5 and 3-4%. For them the perspective is different. It's hard to sell off their stake without adversely impacting the price, so they must think about what to do instead. They are more 'ripe' for some kind of activism, which could involve engagement. If investors feel stuck with a company for better or worse, they spend more time understanding what it is doing and voicing their opinions.

Some shareholders believe that a tougher line will be required in their engagement.

Fund managers need to sort themselves out; companies are very good at divide and rule.

We need to be tougher in voting Boards down when they don't respond. I don't fancy a 'you're out' approach to shareholder / Board relations but directors should know that shareholders will be firm.

We asked how far outsourcing had a role in this increased engagement.

> *OK, if you manage, let's say, only £400 million in equities. But for a large house like ours, governance and engagement is central to what we do and deeply embedded in our investment process. It needs to be of the highest quality and must be wholly joined up between the fund manager and corporate governance team. So for large perpetuity holders of equity, voting and engagement shouldn't be outsourced.*

There was discussion about what were the best practical opportunities for engagement.

> *I am not sure there needs to be a separate meeting between the Chairman and investors. I'd encourage the Chairman to join some of the post-results meetings with larger shareholders – more to sit and listen – if people put a face to the name, it's easier to pick up the phone.*
>
> *Chairmen could attend CEO meetings with largest shareholders, but would have largely to sit there and observe – it might be a bit odd for some but could work out well. For mid and small caps some Chairmen already come anyway.*
>
> *Chairmen don't always need formal meetings – it amazes me how they don't just pick up the phone. One example that really impressed me was Chairman X – he called saying that he just need ten minutes to talk something through – no-one is going to say 'no' to that – he came round and was indeed out of the door in under 15 minutes having covered his issue perfectly effectively.*
>
> *Chairmen writing letters is not enough – this is about behaviours; the onus is on both sides to make it work. I think some of my colleagues in investment firms need to up their game.*
>
> *I'm all in favour of contact with non-execs, perhaps a pre-AGM supper or lunch. Some companies do it: HSBC has a pre-AGM lunch, they invite investors – the executives and non-executives are available. It works reasonably well.*
>
> *An annual lunch for shareholders is the worst way to communicate as investors won't be open in front of each other.*

Companies also had ideas on the best forms of practical engagement.

> *We have moved away from the Chairman introducing the results presentations – it was a false position as they're not close enough to respond to questions. It was putting people in-between the owners and the executive team. You can go to the Chairman if there's a problem and to the SID if the problem's with the Chairman. I believe we still get to hear if there's an issue. If there was a problem about me (CEO), he'd (Chairman) see them in a shot.*
>
> *For shareholders we run seminars, for example on innovation in the sector – what's happening, how we think about it; or on the BRIC economies; or a one-day seminar on our business in Africa – we had great feedback [non-executives often attend these]. I wonder how much uptake there would be for lessons on how the Board functions?*

Investors did not believe that a formal requirement to meet Chairmen and / or non-executives would be helpful.

> *If there was a formal requirement to meet the Chairman, our fund managers wouldn't regard them as high up their agenda so wouldn't bother with most of them – unless there was an issue; our governance person would have a pleasant but not terribly useful coffee.*
> *It's helpful if governance dialogue takes place as part of a routine. We hold 900 companies and can't do 900 governance meetings – we can only focus.*
>
> *We have 1,800 companies globally and wouldn't have resources to do it, even just in the UK.*

Companies discussed what they felt would work in terms of dialogue with Chairmen.

> *We've been going through the exercise of reaching out – the Chairman and the SID, we'd like to come to see you in line with guidelines – three out of top 15 said 'yes'. But the logistics would be daunting for fund managers if they saw everyone in addition to normal company meetings.*
>
> *What if there's nothing to say? How many would come? On balance though, it would be a useful improvement, even if it's only for 15 minutes with a simple message, such as 'whatever you do, don't lose the CEO'.*
>
> *Chairmen should remember they are principally there to listen; not to be on transmit. By and large, they must listen and ask questions.*
>
> *If you say 'yes' to regular meetings, people need to put something into them, otherwise they'll just be going through the motions. Investors need to feel the need. Sensible investors already do it – they take the view that if they've got 10% they'd better know the people. Better to have had a relationship in case things go wrong later. It's money in the bank, but you can't mandate it. It's more a job for the investment firms' clients and customers to put more effort into probing and checking that they're doing it.*
>
> *It would probably be good practice to have an annual meeting without management present. There's no substitute for hearing the story direct ... But it would be hard to make it obligatory. Chairmen are good at following best practice, so make clear it's best practice. The Chairmen would have to take the lead though; you can't force the institutions to attend.*
>
> *I can't think of anything worse than a group meeting. One-on-one is the best way to communicate. If investors don't even tell you their concerns one-on-one, they're not going to tell a group.*
>
> *Regular interaction with my Chairman? No, the owner is talking to the key people running the business and that's the executive team. The UK process has a Chairman and SID covering particular issues. That's my preferred model.*
>
> *Is it helpful to have an annual meeting with just the Chairman as an early warning mechanism? I don't have a problem with that, but I am less confident that it's a process that would bear a lot of fruit; if you think of all the time it would take, I'm not sure the benefits would justify that. I am not sure how helpful it would be. If worth doing, would focus on top five to ten investors. It might pick up nascent issues. On the Boards that I sit on, they typically seek a view from the top 20 shareholders, offering a visit from the Chairman, but my experience is that 95% of meetings are declined by the fund managers.*

Investors focused on the key role of Chairmen in the dialogue.

> *If the CEO doesn't listen to us, we can't tell whether what we say gets back to the Board. So you must have communication with the Chairman. It should be shareholders' responsibility to get hold of the Chairman.*
>
> *We must have better communication between Chairman and shareholders. People don't understand the weakness of the Chairman / investor relationship and are therefore asking for a larger role for the SID.*
>
> *If investors are going to spend more time on this, they need to think about what they're doing. We need better links between investors and the company Chairman. It's not that usual for fund managers themselves to meet the Chairman and very rare to see the non-executives. Investors should be trying to ensure that Boards are functioning – it's strange that they don't meet the Chairman; non-executives often don't know what shareholders want. We need a greater sense of interconnection with investors.*
>
> *The danger of a mandatory meeting for Chairman and investors is that you drive a wedge between the Chairman and the CEO – it could create an aura of suspicion. The key thing is availability and accessibility and making sure that the Chairman is aware of issues.*

Though some CEOs expressed caution about too much reliance upon Chairmen.

Our Chairman would be reluctant to go into meetings with investors where he might face questions about details of the business that he couldn't answer.

Yes, the Chairmen can have meetings with shareholders, but my experience is that they don't want to do it unless there's a big issue and even if the Chairmen want it, often the shareholders don't. So the FD and CEO will remain the principal communication channel.

There was little enthusiasm beyond this one comment for the suggestion of public feedback from large shareholders.

There might be an argument for a statement in the annual report from shareholders with more than 5%, on what they think of some of the governance issues – a bit like the sort of commentary Warren Buffet gives.

Investors want a more full and open dialogue with Boards.

It should be mandatory after the post results 'dog & pony' show for the CEO and CFO to report back to the Board on investors' views – particularly on strategy. Questions or issues that are filtered through investment banks are not the views of investors, but more often those of sell-side analysts. Non-executives should be regularly informed of the views of the investor community. It's another potential means of taking the temperature.

More important is transparency from investor feedback – brokers' reports should go to the whole Board and not be filtered by executives.

The market is complicated; different participants have different agendas – they may be short one company and long another. So there's a fine balance on how far companies should listen to every investor.

We need better information on, for example, Board evaluation, which should not be too blandly described. Need to remember that UK corporate governance is pretty good – it's frustrating that we're developing rules to catch the 5% where things don't work. It's a bit like being a social worker – you only get to spend time on the problem issues.

If there has been a governance or other failure, that should be made clear. Some do that, others tiptoe around the issue. Governance should feature more in the normal dialogue. There needs to be open and honest discussion, fund managers need to tell companies what they're thinking and be willing to take action to back it up.

Companies also want to see better quality dialogue.

Both the Chairman and CEO need to be involved in building dialogue with shareholders. But communication has to be two-way. I have a lot of respect for some investors, although they are sometimes slow in offering their view.

A good conversation between the Chairman and investors is very different than a good meeting between a CEO and investors. We might discuss the performance of senior management, particularly the CEO, the possibility of a cash call in the medium term, long term disposal / expansion opportunities – these would be useful insights for long-term investors.

We asked investors what should form part of good practice engagement.

For engagement focus – strategy / risk / non-financials / off balance sheet transactions

There are lots of conversations going on; we need to make sure we get concrete action out of all these conversations

Boards need to ensure not only that the voice is heard, but that someone thinks to go and ask questions. Investors are not generally 'tick box' – it's important for companies to try to explain.

We also need to understand, get better acquainted with the degree to which independent non-executives have conducted due diligence. We will have detailed discussions with the Senior Independent Director to explore the degree of conviction / lack of conviction.

Companies also had views on this.

Issues like 'what is your philosophy', balance sheet management, investment criteria, how do you motivate your leadership community?

Board processes – what issues have been taking Board time, what's the thinking on risks to the business? 'Take me through some recent discussions', how do subjects get selected for discussion, what's the philosophy behind your remuneration? Where does the Board drill down in succession planning?

Some changes are already underway in how investors approach engagement and they had further suggestions.

We are reviewing internally whether we should continue to hold ourselves back if there are problems but the lack of a consistent view means we're not communicating.

If you think about what we are required to do, there has to be some disclosure – there's no effective accountability for investors' governance activity. At the moment, it's not working as effectively as it should.

We are learning from the experience of the past 18 months that these parallel dialogues have not been sufficiently joined up – there has been insufficient built-in emphasis on the corporate governance aspect of major corporate decisions.

What would we do differently? Work on the process – we are beginning the implementation. A stronger check and balance by the governance team on fund managers is emerging. There will be a more robust challenge to why we should approve a particular acquisition or disposal.

Institutions need to be more joined up – there are also questions about how far they are looking at longer-term issues. The governance people talk mainly to the Chairman, more than to the CEO. They need to figure out how to better manage their relationships with companies to make them more joined up. The average fund manager would benefit from a meeting every two years with the Chairmen of companies he holds – but there's a question of whether the institutions would be able to staff this.

Alongside 'investor relations', companies should have a 'shareholder relations' process. Chairman should meet the top 5, one could have a small group to cover the next ten; maybe the SID should meet the top three. New non-executives should be expected not only to offer [but actually] to meet the top 5 shareholders

An obligation on managers to disclose their engagement activity would quickly get into a numbers game and not address the quality of engagement. We disclose our engagement to clients; some ask us about it, but we don't disclose publicly – there's a risk that companies would be reluctant to see us; investors and companies should disclose their engagement policy – we should be more meaningful than 'we value engagement'; investors should consider being more explicit. It's the flip side of having power. Companies could have a public policy as well.

Already, fund managers are talking about governance more in their meetings with companies and there is a better quality of conversation, though I suspect that companies are still not being totally open in their dialogue.

One thing fund management firms might consider would be annual or six-monthly reviews of experience on engagement – what trends are being experienced, what are companies doing – it would be better than people huddling around after a crisis. It could highlight best practice ... When we hear that large numbers do not respond to invitations to meet non-executives, there could be industry chastisement.

Both sides emphasised the importance of information reaching non-executives.

There will probably be more information coming to Boards and more dialogue with investors. You get a sense from some non-executives that they didn't really dig at all to know what's going on.

More dialogue between NEDs and investors? As an NED, I need guidance from investors that I represent but this is very hard because investors are too busy

One specific issue that came up from companies was the role of earnings forecasts in the dialogue.

I think companies should just give an earnings forecast for the coming 12 months – it could be a range. It would cut out all the time spent guessing about what will be EPS; getting rid of that waste of time would allow more strategic discussion with shareholders. No one company could start giving their numbers, but if we all had to do it…

There does need to be more clarity of thought on the issue of guidance given to the market. There are lots of companies not giving guidance in the current environment. You're setting yourself up for failure when things move against you, but you're held to your guidance. But it's difficult with major shareholders; they want to tempt you into steering them. This issue has been bubbling for a while – companies need to be squeaky clean.

Other items such as strategy, succession plans, balance sheet efficiency, how to raise capital, fitness for purpose of the Board all get crowded out [by remuneration]. Who you engage with is important – fund managers who've bought the stock talk about the above; not corporate governance people who talk about remuneration and whether a particular director is up to the job.

One shareholder also raised this.

I would argue that companies should come to the market more often than half-yearly. Six months is too long. Such trading statements as one gets in-between are short on detail – need fuller quarterly information.

4. Voting

Investors value the votes that come with shareholding, and most exercise them in a considered way.

We always try to vote our shares, which is another part of being a responsible shareholder.

Voting is a necessary underpin for the dialogue on the long-term governance issues. We also use it as an annual review of the governance of each company.

Investors regard voting as part of the governance dialogue.

Our overview is that good governance is all about dialogue – a 'no' vote is a failure of engagement and very much a last resort.

It's a sanction available to us and part of the fiduciary responsibility of being a shareholder. Sometimes you realise that your votes hold the balance on an issue, at other times companies don't really take notice even if a firm of our size votes against.

95% of time it is routine and we have no issues to raise with companies. I wonder if this is a sign of the system working well or if investors should pick up more. The rest of the time, with an issue of concern, the vote can bring about change if it is used actively.

Voting is a blunt instrument, but a valuable blunt instrument. We value our ability to vote. If a blunt instrument can be positive, we sometimes use it for affirmation.

Companies are more sceptical about how investors regard their votes.

Investors say they value the vote, but their actions don't always match their words. They give a universal 'yes', which is politically correct and often they genuinely mean it, but the substance to those words is some way behind.

In extremis, they value them. But big investors don't exercise their influence by voting; it's the threat of their votes ... They pick up the phone and talk to one another and quickly they've gathered 20 or 30% and then you have to respond – that's the way things happen.

They can vote every day with their trades. Why wait a year to vote on an issue when you can do it today?

As part of the dialogue, investors recognise that reasons for votes against should be communicated to companies.

If you're investing in a company you should be expected to vote, and to communicate before a vote against. We have to remember that around 40% of the market is now held by foreign investors – you need to communicate to them what is expected of investors; if they don't want to do these things, they don't have to invest in London.

There must be an onus on shareholders to talk to management before they vote 'no'. If management / Boards don't come to shareholders (which they should) then shareholders should go to management / Boards.

Some companies understand that communication can be a challenge for larger investors.

On a typical agenda there might be 18 voting items but only one that requires focus. We need to ensure that stock owners focus on the important votes. It's not practical to expect communication on all votes against – maybe above a minimum size of holding it should be the expectation.

There is concern on the part of investors that voting can dominate, particularly during the busy second quarter. Some suggest staggering annual meetings throughout the year.

Voting is important. But there's a danger that it can come to dominate governance activity. There's a problem of seasonality with bunched AGMs. Governance people spend all their time in the voting season casting votes, to the exclusion of governance consideration, even if they now have the support of monitoring services. Phasing AGMs would probably help and would also improve consideration of vote issues.

Staggering company year ends would be beneficial. In terms of overall economic effect, it should improve the quality of: audit, reporting, voting and engagement ... I recognise that there are some downsides, but from a governance perspective it would be beneficial.

There are concerns amongst investors that the current problems will result in mandatory disclosure of voting or even compulsory voting

The Government has reserve powers to compel vote disclosure, but this must be resisted. We disclose our votes on the website but we have never had a single hit. Only the TUC (which has its own agenda) is interested... I am very concerned that the government might use the power, which would just add to costs for no benefit.

The flexibility of 'comply or explain' should remain. Compulsory voting would not help this.

Investors find no great interest from their clients in voting.

Clients are most interested in voting because that enables them to tick a box. They ask for information, but not in any great detail.

Most of the investors we spoke to have well-resourced governance units. They are cautious about the outsourcing of voting and / or engagement.

I have concerns about separating the vote from the investment decision-makers. One loses the consistency of the dialogue with companies.

We discourage our clients from outsourcing their votes. It means that voting decisions may only be partially informed ... There are limits to how far professional judgement can be brought to bear with outsourcing.

Remember that institutional ownership is falling, so it's a more diverse electorate. The influence of the voting agencies is a concern, with an abnormal sway.

That caution was shared by one of the company directors, we interviewed.

One shareholder had outsourced their voting to an external source – the fund manager was completely divorced from the process; I found that extraordinary – how can you ever have a holistic view? Even some firms with large holdings do it.

5. Remuneration

We asked whether there was too much focus on executive remuneration, whether there should be fewer votes, and whether changes should be made.

One shareholder felt that part of the problem was too much transparency.

You should get rid of the remuneration information in annual reports – it just feeds the remuneration consultants ... the problem is that everyone compares themselves with everyone else – we could have salary bands disclosed instead.

Some people called for greater simplicity. This investment chief was typical of such an approach.

We need a more standard form for remuneration – plain vanilla options at a fixed multiple of salary on a regular basis should be explored, not dictated to Boards.

But others disagreed, including another investment chief and a company boss.

I am not sure we should standardise more – there's a vast difference between an international corporation and a straight forward UK business ... Remuneration must be fit for purpose in a global market ... The quanta have got ridiculous – it's been too much for the remuneration consultants and not enough for the investors.

Even if 'one size fits all' were desirable, I'm not sure it works. It's OK to have reasonable consistency and minimal standards for reporting. But standardisation would be a different issue – motivation and returns are so diverse; it's not the right mindset or a better outcome.

Investors discussed some of the aspects that they would change in terms of the focus of debate.

There could be more focus on remuneration outside the Board.

There's too much focus on quanta rather than on underlying principles and incentives. It's critical because incentives drive behaviours and it's those that we need to get to the bottom of. It's become a massively tangled web.

It's not our role to have views on absolute levels of pay or short term split – I am more interested in performance criteria and long-term incentives. There should be more disclosure of remuneration at the next level down of financial companies after this crisis. Pay is not THE factor in the demise of the banks but it's one of the factors.

The attention given to remuneration is a frustration to investors.

I think that the governance dialogue can get blown off course. There's lots of discussion of remuneration.

Remuneration is hugely important to our investors. I am not certain that all the focus has been good. There is more public focus on this but it's not one of our key investment drivers.

The remuneration industry is a huge frustration. It eats up resources devoted to governance, but basically brings no added value to anyone except the remuneration consultants. They make things more and more complicated.

There's too much focus on remuneration, compared to audit, risk and Board composition.

Companies have similar concerns.

It is right that remuneration should be a focal point, but too often it has been the subject that has captured most of the attention, at the expense of strategy. This is frustrating for companies – they think the fund managers are applying a double standard; When SID and Chairman go round, remuneration shouldn't always be the first thing you talk about – but too often it is. Remuneration is important but it dominates too much.

There's probably not too much attention on remuneration in the governance debate. Thinking about our top ten shareholders, 95% of the dialogue is about the business. If called in by the governance folk, it would be because they think we've done something wrong. It's usually about remuneration or Board composition, though composition is now pretty well regimented so it's not an issue very often.

I think there's been far too much focus on remuneration and not enough on how Boards are working.

Investors are concerned by the potential for undesired consequences from remuneration structures

The only real contribution investors could have made to holding back the banks might have been to hold back the riskiness of their remuneration.

Remuneration is the main thing than can damage habits of good management. There are inherent contradictions and conflicts which create structural risks. Share-based remuneration encourages behaviours that in the end get found out. For example, one leading, but now failed bank, where they wanted to grow earnings – share-based remuneration also meant they wanted to grow the P&L. They were trying to achieve outsize returns, which they could only sustain by increasing the riskiness of the bank. In fact, share schemes just play on the cycle – the lucky ones get in at the bottom of the cycle, the unlucky ones do not.

I am unusual in favouring the removal of share-based remuneration and its replacement with cash-based, with a focus on the sustainability of earnings. Many long term plans encourage risk taking through use of comparators – emphasis on top quartile merely heightens the risk. One of the failed bank's remuneration may have supported its strategic plan but it only paid out if they kept growing. What we saw in the market was simply the effect of gearing but as fund managers learn, the true challenge is to outperform through the cycle – in down years as well as up years.

Philosophically, we favour variable pay – it can be a powerful tool to motivate and incentivise, but we are concerned that the application has become dysfunctional.

If management contribute to delivering exceptional returns for us, we have no objection to them sharing in those. But along with sharing upside goes sharing downside.

Companies need to adapt the remuneration to a radically different environment. Shareholders will be increasingly focused on the discipline of a link with performance.

As investors we missed how banks could pay so much to some of their staff and what impact that might have on their behaviours. The Myners Review focused on commission, but that's trivial compared with the money banks made from M&A. We should have asked ourselves more whether this was a sustainable business model.

Company bosses have concerns about how the dialogue around remuneration is conducted.

The banks had lots of people incentivised to write mortgages; it's no surprise that they did what they were incentivised to do. There's a balance around compensation on how much you want to incentivise people. If you incentivise to drive volumes, you'll generally get a lot of volume, but maybe not the right volume. If you have large amounts of money linked to short term performance, be careful what you ask for.... I worry that we have created a cottage industry.

When you have fund managers talking about remuneration, they see incentives as just that, as a means to an end. They may not like this or that emphasis on the performance criteria, but they value an incentive. The governance group are more likely to be discouraging. You never have people pressing for more; it's more checking and balancing. Interestingly, in the UK it's the governance people that are more interested in remuneration, whereas in the US it's the fund managers who want to know about managers' incentivisation.

If fund managers are doing well they're happy with remuneration going up; if they're being crucified, they want to see management feel the pain.

Governance people say that because the share price is deflated, grants in shares should be less – perhaps 1x salary. But they don't say it should be 3x as opposed to 2x when prices are high. It's a policing attitude that's different from fund managers who are more pragmatic.

I believe remuneration is important and should be properly used. It should be tailored to get the behaviour you want and to get alignment. Different nature / different stages / different types of business all need different types of incentivisation. Remuneration people get their money because of the governance people reviewing the schemes. The agitation over TSR v. EPS can be huge; some investors have strong views.

Focus would be fine but it's from an angle of envy and suspicion. It should be relatively straightforward – what are you incentivising your top 1,000 staff to do – how do those payments break down – is there appropriate focus?

You mainly see that it's governance people who look at remuneration, which can result in less effective scrutiny ... You need to ensure that the drivers for executive pay are the same as the drivers for the industry.

Fund managers' priority is really money, so governance always takes second place. They're hired and fired on their performance and we have seen examples of where companies with weak governance have helped managers' performance for a long time. It was the institutions that pushed many companies to gear up. But if I am going to put money into the hands of a fund manager, all I care about is the returns he achieves.

It's the wrong people in fund management companies that look at remuneration. Investors should be central to forming that view, people who know what's going on in the company's business. The onus is on shareholders to be much clearer on what they are trying to achieve in the remuneration debate.

Investors are concerned about the upward pressure on executive remuneration.

Being head of a remuneration committee is a terrible job. CEOs are like footballers and investment bankers – with a mindset that the only recognition worth anything is a large pay packet. There used to be other forms of recognition. I hope we can return to days when people are not just measured by the money they make – too much money blocks out other intrinsic motivations. Japan has been successful without such a reliance on money.

Yes, there is too much focus on remuneration but that's where the directors are focused. The result has been an upwards ratchet with no relationship for value creation. Time is devoted to it because there's a vote on the issue.

If there was a vote on the audit committee that would be subject to more attention. But we should not reduce say on pay accountability.

The big problem is that executives themselves are pushing a lot of the remuneration proposals that we see. We are continually being consulted by companies trying to increase executive pay. Remuneration Chairmen tell us that they get push back from executives. One often wonders whether remuneration is their only motivation.

We are being told that executives need motivation because their options are underwater. Our clients would love to be bailed out from their investment on the terms that executives are receiving. It's just pay without performance. If CEOs are threatening to leave, remuneration committees should call their bluff, and some of them probably should be going anyway. We are going to be much more militant over remuneration.

There are not enough people saying it – pay is no longer about performance; it's about 'I want; I will get'. This is a destructive trend, executives believing they have some divine right to huge salaries – it's bad for our clients and it's bad for UK plc.

The idea that everyone should be at the median is a vicious circle – appropriate benchmarking is a problem. The whole thing takes up a disproportionate amount of time.

Company bosses made two suggestions relating to how executive remuneration is handled.

There's anecdotal evidence about schemes that have worked or not, but no authoritative report on this or how some schemes have gone disastrously wrong. Maybe the ABI or NAPF should write a report on schemes that have worked well and those that have not.

I would send every new Chairman of a remuneration committee on a two-day course on how to do it. I'd get some consultants, some experienced remuneration Chairman and some investors to train them. I have seen about half a dozen remuneration Chairmen, and they have largely been ineffective, unable to get the agenda focused on a philosophy and to make judgements on that basis. It would be well worth the time to get it right; if they wander off into the long grass, you just get problems.

Fund managers' remuneration

Shareholders were largely opposed to the publication of details of their remuneration.

There's no evidence of anything other than alignment with long-term performance, already we'll now have to meet FSA criteria ... The mainstream investors who'd get picked up by any disclosure regime are not offenders.

I believe that there's already a pretty strong correlation between performance & remuneration, well aligned with clients.

You have to ask to whom we are accountable? We are accountable to our clients and should be judged on our achievement of the targets we agree with them. These should be aligned with their investment objectives – we typically have three-year performance pay. Rating agencies' normal question to fund management companies is whether managers are appropriately rewarded – i.e. are they paid enough to stay.

There were conflicting views amongst the company chiefs as to whether this was reasonable.

The information would not impact how I run my business. I know what my shareholders want ... Maybe their performance targets being transparent would make them more long-termist.

More transparency would be good – to understand the motives of investors, makes them clear to us at the company.

Definitely equal transparency would be a good thing. It's outrageous that fund managers can rant about CEO salaries and keep their own private. It would be very healthy to have what fund managers earn exposed to public scrutiny and debate, because they too are agents of the underlying owner. We enquire broadly and do get answers in general terms. In future, there'll be much more interest in fund manager remuneration, which will lead to longer-term packages, more fund-based and more deferred. Culturally it will be a big change. It should be done in US, Europe and the rest of world as well, but that will only come with serious guidelines mutually endorsed by governments.

Shareholders argued that for privately-owned fund managers, there was no justification for requiring publication.

If it is not a publicly-traded company, why should information be shared? .... In a privately-held company it's up to the owners.

There is no logic to it, especially in private companies. There is no argument as to why it has to be symmetrical. If our clients asked, we would show what the performance drivers are. Listed fund managers already disclose.

It would be fine to disclose the main incentivisation measures – but not for private investment companies. Details for fund managers are better kept private – our only asset is our people; it would be very tough to have the details in the public domain – it would certainly push the cost up.

Disclosure – public companies have to disclose. But we're a private company – I don't see what public purpose would be served by publishing fund managers' remuneration. Our managers are incentivised to maximise the performance of their funds.

I would not be against greater transparency – one already has it for CEOs of investment managers that are listed or subsidiaries of listed.

Disclosure would not be informative due to the complexity and variety of remuneration arrangements across the investment industry

Disclosure? I don't see why. Investors are a vastly diverse group. 30 years ago there was a small group of fund managers that had almost a controlling stake in the bulk of UK companies. Now it's a much wider group. But more transparency for the responsible investors who do engage, and would disclose, would make it even harder for us to compete with the hedge funds, who do not.

Fully transparent remuneration would be meaningless as it's such a diverse group – e.g. local authority managers, traditional insurance firms, boutiques, big US firms and hedge funds. It would set up criticism to no effect. What is visible is the income that managers generate for clients – the issue then is how that is divided between client and manager.

For the quoted fund managers, or subsidiaries of quoted, remuneration is disclosed. But in different firms, it would be different people driving the risk appetite – our most senior fund manager has no management responsibility but has the most influence over our investment outlook.

6. Annual elections

Shareholders expect that the annual re-election of directors will be introduced at some point; on balance, they are supportive of the idea.

> *Annual re-elections will come. Some say it will make companies more short-termist. I believe that's wrong. Shareholders can distinguish between short term and long term loss of confidence; they won't vote people out 'willy-nilly' – they will be responsible. On balance, despite the arguments against, it is manageable and will focus Boards.*

> *I now support that, though I didn't three months ago – what's changed has been our inability to get traction with Boards and their divide and rule mentality. Nobody wants to vote out all the directors but if the option is there, I believe it will force people to talk about things when taking decisions. Will it change behaviour? I hope so.*

> *On balance, I would favour that – how often do you actually see someone voted off. Only when shareholders are banging on the doors do we see changes. It would encourage directors to take their responsibilities more seriously and would enhance dialogue.*

Some shareholders would limit annual elections to the key Board governance roles.

> *It looks like this is what we're going to get. All the time one would have the nuclear option of voting off all the directors – I am not sure that's tremendously constructive. What would you do if you voted them all off? Maybe we should vote for the Chairman annually; the Chairman and the CEO seems reasonable – it would focus minds a bit.*

> *Annual elections seem pretty painless for those companies that go through it. Of course there's the potential anomaly of everyone being voted down but one could address that ... My preference would be for the middle ground – the Chairman, SID and Chairmen of committees could face annual election, the rest every three years; the Chairman and CEO would be an alternative.*

> *That would be fine going forward; it would keep the Board focused. Only big shareholders would swing results so it couldn't be abused by troublemakers. It would certainly be feasible for the Chairman and CEO and maybe also for the SID and Finance Director.*

Some hope that annual elections for directors would take some of the focus off the remuneration vote and provide a general fillip to governance.

> *If you had annual re-election of directors, you wouldn't need a remuneration report. Instead of the remuneration vote, you could vote on the Chairman of the remuneration committee.*

> *It wouldn't be transformational but would improve accountability and empower the AGM. When people say that the whole Board might be voted off and the company paralysed, I just don't think shareholders would behave like that ... If you really felt very strongly about remuneration, you might vote against the Chairman of the remuneration committee as well as the remuneration report. It would certainly be an enhancement to accountability and would help at the margin without throwing the baby out with the bathwater. We need to find ideas to make the system function better and avoid going down the Sarbanes Oxley route.*

Companies were generally less supportive, although they were not vehemently opposed.

> *It's just a knee-jerk response that doesn't really get to the heart of the issue. It's very rare for a director to stand down because of the result of a vote.*

> *It would do no harm. In some circumstances it could be valuable – on a few occasions, it's an opportunity for shareholders to make feelings known. If you're going to do it, it needs to be the whole Board. I don't think it would be destabilising; the days have gone where directors got 100% support.*

I don't think it would make much difference and would just be another piece of bureaucracy. Maybe after someone's been on the Board for six years, or maybe every two years instead of every three. But how do investors know whether a director is good?

Shareholders already have the ability to express their views through voting – on issues like the remuneration report. I am not sure there's an obvious benefit in annual voting. Already, there's not enough focus on some important resolutions.

Speaking personally, I wouldn't fear it – three months' notice is fine for me. It could be right if a company's in difficulty or if you have dissenting shareholders. Otherwise, rotating elections are fine.

I am not sure it would go far enough for shareholders seeking change. If they're at the wrong end of the period, they won't want to wait for another nine months ... When shareholders want to make a change, they go to the Chairman, next to the SID and then the launch a press campaign – this destabilises the company. It can be survived – look at a number of prominent CEOs. Annual elections would probably reduce the mucky politics but would leave more inherent instability.

More voting would enhance short-term accountability and power but you could lose stability. For companies that need change it could be very helpful, but it could damage companies that don't need it .... could contribute to creeping control. Working together, a small number of shareholders could reshape a Board and pack it with their own people. I think there a quite a lot of control issues here – which is probably why we have rotational elections.

Some shareholders already feel that more information is required for 'normal' Board elections.

When it comes to re-appointing directors, often one doesn't know anything about the people beyond what's in the annual report. The shareholder relations process should focus on the Chairman and CEO but could also include the SID and committee Chairmen under comply or explain discussions, with opportunities to meet the whole Board systematically.

Our ability to assess the contribution of individuals is limited. We can evaluate their terms of service and how often they have shown up for meetings.

7. Non-Executive Directors

Shareholders believed that non-executives should have fewer roles and be paid more for spending more time on each of them.

NEDs should only have two or three roles, spending a lot more time on each and being better rewarded.

There's no problem with non-execs being paid more. There needs to be enough compensation for the risks they take.

NED compensation should be increased and be more tied to performance.

I am happy to see higher levels of pay in order to get the best people. We have had a culture of holding down non-executive reward. They should have fewer roles – a maximum of three or four, not five or six.

NEDs should spend more time and be paid more. We need the right people – there's a market out there and we need to pay appropriate levels. Some should always be in stock to bind with investors. The days of the serial NED / serial SID may well be over. The Chairman of Audit at a major bank or insurance company should probably have only one other role; if it's a smaller plain vanilla company; they could probably have two or three. NEDs need to spend more time and be paid more. It's about the time that needs to be taken to understand the key drivers of the business and the complexity behind the P&L and balance sheet. There's a totally different time commitment between a brewer and a complex financial institution.

For complex businesses, all non-executives will have to spend more time with the business and this needs to be part of Board evaluation – and they will need to be paid more for it.

Some shareholders favour formal training for non-executives.

Training for non-execs? Independent Audit run an event. They need to understand there are different types of investors. It's amazing that NEDs usually don't understand a company's top 15 investors. Investors could easily be sellers for reasons that the NEDs don't understand.

We'd favour an institute of non-executives. Independent directors are the first line of defence and they need to be given some resource. They would have to qualify & receive some basic training. All independent directors would have to have a kind of licence, which could be taken away. This would give the government / regulator a window into governance standards.

Maybe they should be subject to some kind of approved persons regime or even an exam .... We need a training mechanism / an education process, not just a series of lectures – maybe an interview at the FSA. It's important that investors play their part.

It's not just technical skills, but also the ability to ask the 'daft laddie' question and to work within a unitary Board. One thing that must not be lost in all this is the unitary Board – we must not drive a wedge between executives and non-executives.

Company bosses also feel that non-executives could be paid more for a greater time commitment, although some are cautious that the amounts involved should not undermine independence.

We want the level to allow NEDs to do the job shareholders want done ... It's amazing there never seems to be a shortage of NEDs but really they should be paid more like £70,000 for a FTSE250 and people should spend more time and only do two of them. Fewer roles are better than four or five at £35,000.

It's fine as it is. By and large non-execs don't do it for the fees. We need to guard against moving too far in either direction ... Time commitment is about individuals – some want to spend a lot more time; some of those are helpful, some a nuisance.

These days the NED position is taken seriously with all the reading and meetings it takes a lot of time. For those with executive roles elsewhere, it ends up encroaching into private time, a few hours on a Sunday – I signed up and I'm not complaining. It's an important job and the pay has to reflect that.

In the UK, we shy away from awarding stock options to NEDs – it's seen as too blunt an instrument. On US Boards they often get modest grants, not massive but at worst it's symbolic, at best it's great value. Or one could pay fees in restricted stock but some of this doesn't go down so well with investors.

We don't want NED remuneration too high so that it becomes too important to people and they lose their independence. I do worry about them seeming to be employed.

There was also discussion with companies about the oversight role of non-executives.

Companies already have non-executives. As their role is to represent shareholders, the non-executives should listen to what shareholders are saying. But now they would really have to do investor roadshows – they are already a big chunk out of the diary but just something you have to do. Given the time and effort taken to prepare, very little comes out of it – other than the occasional chance of making a conversion. This ritual, at least for a while, should become more important. Both sides understand that it's become more important. It could become a rather more fruitful exercise. At the moment, they are nice to have, but these discussions will become more important in aggregate.

The third group in all this is the non-executives – there's more scope for change here than anywhere else. In the last ten years, people have come to understand that non-executives play an important role – the model has changed dramatically, with more time spent but also more riding on them. Yet things went badly wrong – companies had a lousy strategic course and unworkable business models – where were the non-executives?

There were few Boards where the NEDs really felt crucial. Yet much is expected of this link in the chain. How do they go about improving their performance? NEDs will have to be more intensive, managements will have to be humbler and more willing to listen. I don't see any other element where there is such room for improvement, in terms of availability of time, etc. If a fund manager holds at least 30 companies, NEDs only have four or five.

Are NEDs up to it? We all thought they had improved a lot when they committed more time and better questioning. Now they're being asked to do even more, in terms of time and in terms of being demanding and insistent. They are going to have to have all the information that they need to form a genuinely independent view of what's going on in the company.

There was a time when non-executives of a bank really didn't have a clue. It's not enough to know how many mortgages a bank has sold, you need to know what proportion are 100% of property value or 5x salary. In the past it would have been said that these were operational details. In future, it will not be acceptable for NEDs not to have the information.

8. Senior Independent Director

We asked about the role of the Senior Independent Director (SID). Shareholders were cautious about enhancing this role, believing instead that efforts to improve governance engagement should focus firstly on improving relations between shareholders and the Chairman.

Very concerned not to strengthen role of SID. Three-way leadership is not a good idea and would be a recipe for trouble.

Enhancing the SID would undermine the Chairman. We need to build up the role of the Chairman with institutions – you only meet the Chairman infrequently.

The role of the SID is especially important when you have an executive Chairman. But extra powers for the SID would complicate things.

People have raised the relationship between the SID and the Chairman and what happens at points of stress. At that time, the Chairman should be treated as an executive ... how do shareholders know then that their views are represented?

The institutions see the SID as the route of last resort – they don't like to go to the SID so that they don't undermine the Chairman or executives. But they need to have some route to them, it needs to be someone who will respond and who knows them a bit.

That does not mean that they believe the role of SID is working as it should in all cases.

Maybe some fresh thinking is required. SIDs didn't feature / help investors in the situations that went wrong – why was that? What should the expectations of the SID from investors be? This needs thinking through more.

Investors want full access when something has gone wrong. In their model, they can't go to every company to talk about governance – so they typically don't engage when everything is fine. But it does mean that the SID has to take a more senior role in the Board because shareholders won't always be there to push.

Nor did companies favour changes to the role, focusing instead on how individuals operate.

> *If SIDs have more duties, you'll end up needing someone to watch over the SID. In the end you have to believe that the person appointed as Chairman is competent and sensible. You need to tread carefully otherwise the Chairman will be neutered. If the SID does his job and talks to the non-executives then it works.*
>
> *Formalising the role of the SID has been a good move – it's up to individuals to exercise the role. Where it's not working is down to the individuals involved.*
>
> *The SID should be active. Our SID has lunch with me (CEO) every six weeks. If anything important is happening, I make him aware and get his views alongside those of the Chairman – last week, we discussed the tax position of the company. CEOs should use their SID.*

9. Information on the operation of the Board

We asked what information would enable shareholders to judge the quality of debate on the Board. All agreed it would be difficult to write anything useful on this in the annual report. The question elicited some broader comments on Board effectiveness.

> *There's not enough information in the public domain to judge. We don't want private information and it's a bigger question to see what could go into the public domain.*
>
> *People worry about the cosiness of Boards – how far the non-executives dig down. The Chairman and NEDs must dig down and meet the people below the Board and dig down to the level below that – they've got to do more than they're doing. We feel there's not enough challenge of CEOs by Boards .... Companies need to use their Boards and NEDs better – so that they can pick up early on potential problems.*
>
> *Key focus should be quality of strategy. The CEO needs to face robust and appropriate questioning – especially on risk reporting. There needs to be an environment of robust but collegiate challenge. It's important to be able to challenge and have debate within the Board confines, so that any decision is unitary.*
>
> *All the expertise in the world won't help if you don't have the ability or courage to say stop. I am not sure you need expertise to say that. Everyone knew the music was going to stop but no-one was able to call time.*
>
> *It's about group thinking and the dynamic around the Board table. There's a tendency to want to work together. If you have a strong CEO or Chairman, people find it difficult to challenge – they save their challenge for areas where they feel on strong ground.*

Corporate leaders had some suggestions for shareholders assessing Board quality.

> *They way to do it is to look at the non-executives, at what type of Board it is. Investors should meet the Chairman and discuss who is on the Board and why; the quality of input; the quality of challenge to executives. You have to engage; you get out what you put in, it's not about box-ticking or four more pages of annual report.*
>
> *The only way to judge would be by sitting in the room. All you can do is ensure the quality of participants, which should lead to good quality debate if the governance structures are right.*
>
> *We do an in-depth internal Board review with a detailed questionnaire on how Board and committees are working. There's lots of good activity. There is commentary in the annual report but it's pretty sparse – it could be a weak / strong process and investors would not be able to tell which. The only way they could know would be to get the Chairman to talk them through the process, actions that had been decided, updates from previous years, elements that had surprised.*

Persuading investors that there is sufficient debate and challenge to executives is part of the job of the Chairman (& SID).

Active use of Board appraisal was seen by shareholders as the best way for Boards to benchmark the quality of their debate

Companies should themselves be making more use of Board appraisal, but it's very difficult to publish meaningful information out of that process. It's really about the quality of people on the Board.

It's sensible to look again in complex sectors such as financial companies and to re-emphasise the recommendations in the code – for Board evaluation with independent input group dynamics need to be part of that review.

The company bosses also reflected more broadly on Board composition.

I worry about executives other than the CEO becoming second class citizens, and then we end up with just the CEO on the Board, which would be an end to the unitary Board ... Already many only speak at Board meetings when they're spoken to, but you have to have access to information and access to the executives .... Most Boards like the divisional head to present to them, though if they're on the Board they don't challenge each other. They need to be in the room even if they're not on the Board. There must be opportunities to meet informally, opportunities for interaction.

The quality of the CEO, Chairman and SID are critical – that's 70% of the battle. Their personalities are key to the way Boards work and you can't legislate for that.

Governance is down to qualitative matters – people won't write those down; in fact the issues are not things you can write down.

10. Intermediaries

On the shareholder side, there is no consensus view on brokers.

Yes, they / brokers have a duty to give feedback if asked for. A Broker can play a constructive role in this, though if you don't give your view direct, companies can take it less seriously.

Brokers can be useful for reinforcing difficult messages. But we don't want to be disintermediated by them. Generally there's far too much attention paid by companies to opinions on the sell-side; sometimes brokers give messages that could only have originated from a sell-side perspective.

Are brokers any use? No. They get in the way – we don't use them ... Brokers don't seem to understand where we're coming from – it washes over their heads.

Brokers are quite important, they're unique to the UK and do have a good role to play. If you're a big holder, you have direct contact, but a broker can aggregate the views of lots of smaller holders.

We don't trust brokers – too often they just tell management what it wants to hear.

Brokers are generally additive, though some small cap brokers are prisoners of the companies they advise.

The company representatives we spoke to do not place great reliance upon brokers.

Brokers focus more on financials and share price; their focus on broader governance is relatively limited. They generally don't see corporate governance as an area for them.

Brokers have become less useful in the past five years – it's pretty unusual to hear a wonderful insight these days from a broker, they're not objective and they don't understand our business.

They were divided on whether remuneration consultants serve a useful role.

Remuneration consultants are definitely additive – the bigger ones know what's going on, talk to the governance people and have a good sense of what will play. They give good steers and know which investors have which preferences – all of which we have to navigate.

Remuneration consultants tend to create surveys which push pay up and encourage leap-frogging. It has also led to conformity. Guidelines are manna from heaven for consultants. There's a tendency for remuneration consultants to be more focused on covering their backs than delivering what's best for shareholders.

Shareholders remain suspicious.

Too often, consultants are still effectively engaged by management.

Some committees make good use of remuneration consultants but some are very wet and wimpish in their handling of them.

Remuneration consultants could be useful if they were objective. But they often just do what is in the interests of management, not shareholders, because ultimately they are paid by management.

I believe that remuneration committees place too much reliance on consultants – they sometimes seem driven by consultants, which leads to greater complexity and greater reliance on benchmarking.

We are concerned about the role of remuneration consultants and whether they should have a code of conduct. This might cover their independence – what they're doing and who for. We had a remuneration Chairman in recently who had noticed that the proposal presented to him by the consultants said 'draft nine' on it. He demanded to see drafts one to eight and each one had become more generous to management. Their sales pitch seems to be 'we're expert at getting schemes through shareholders'.

11. Auditors

A couple of shareholders raised a number of points about the role of the auditors.

I don't think there's enough dialogue between investors and auditors or regulators and auditors. Of course, if that was formalised, there's a danger there'd be too much boilerplate reporting but we need mechanisms for occasional dialogue. If one had a technical question to the head of the audit committee, it might be referred to the auditor ... It would be good to have an ability to have generic conversations with the auditors; it would have to be through a third-party body, such as the ABI, ISC or IMA ... Some of this is set out in the enhanced disclosure principles that have been drawn up

I would give auditors a bigger role in looking after shareholders. There are major shortcomings to the audit process, which is not effective. It has become process driven. Interest is only in acting in accordance with standards. We need to hear more about the auditors' professional opinion. The going concern statement has to be subject to closer attention by them.

Auditors need much more active communication with shareholders. In the run-up to the Companies Act, we were looking for a mechanism for shareholders to put questions to the auditor, but the changes that came through were meaningless – it's a comment on the force of the Big Four lobby.

The audit committee needs to report more visibly to shareholders. There should be a vote on the audit report. It would be advisory but needs to have regulatory bite. If shareholders don't get a greater role, there'll be more regulation.

12. Annual Reports

Shareholders made the following suggestions for improvement to annual reports.

That's the question I am asked most – do investors read the report; if they don't, why don't they? Accounting statements are pretty historic. We would respond to more clarity in committee reports – such as from the audit committee - and more detail on why non-executives had been appointed

One area that's not effective is the reporting on audit committees. There's currently no common benchmark on audit and risk disclosure. We've been involved in developing guidelines through the enhanced disclosure group. They provide a useful benchmark on how to disclose and bolster confidence of investors to engage companies on these matters. In my experience most investors are not accountants, and are uncomfortable in this space.

If the annual report was improved, engagement could be improved. The Financial Reporting Council should call itself the Corporate Reporting Council. Narrative reporting is very important.

There needs to be a review into the complexity of financial statements. I'd prefer the annual report to be shorter. I'd also like to see the Chairmen of the governance committees more actively involved in writing the reports – where they do already, it comes with much more conviction.

Corporate leaders also had suggestions.

It's a shame that the changes to the OFR were not compulsory. More generally, we should revisit what should and should not be in the report. The best are models and highly informative. The issue is that the standard and contents are pretty variable – I'd like to discuss how to raise standards and establish a concept of best practice. The information you get and the level of disclosure varies enormously from company to company – not just on the financials but also on risk, strategy and CSR. I'd want to explore what we can do to get all companies to similar standards.

They've become more standardised. No one sets out to write an unhelpful report – but it's just a bloody great chore. People feel the more stuff that gets put in the better – everyone has their pet item. But does any of it make much difference to investors? I rather doubt it.

13. Other suggestions and issues for focus

We asked shareholders whether any governance issues deserved more attention either in light of the problems faced by banks, or because they had been crowded out by the focus on remuneration in recent years.

<u>Audit committees</u> will come under greater scrutiny.

The whole issue of <u>pre-emption</u>. Companies should accept that the long-term investors are their providers of capital; they've displayed an almost cavalier attitude to shareholders. Advisers need to focus more on shareholder concerns.

<u>Risk management</u> – including consideration of whether this is handled well under the audit committee; again, how far they dig down ... How do you challenge CEOs unless you speak to the people a level down to find out what's going on.

Discussion of <u>strategy and Board composition</u> has been crowded out. We only discover that a Board was dysfunctional when issues blow up.

<u>Risk focus</u> – reports were totally meaningless – abstract reports are no help; they should be about the business and management, covering the soft stuff.

Companies had similar suggestions, focused on risk and succession.

The work of the <u>nomination committee</u>, succession planning – it doesn't get any focus until there's a problem – it's just criminal. We must insist that it gets the attention it needs.

On well-run Boards an extraordinary amount of work goes into the mix and <u>membership of the Board</u> – it's often invisible and could be made more visible.

The <u>risk management</u> focus has been given a boost – it had become a bit 'processy'. There will be renewed focus on the risk profile of the company. There is an issue of how to share some of the insights with investors without expressing commercially sensitive information.

An '<u>insomnia report</u>' – what keeps you awake at night? We've been thinking about our risk reporting. The things that are on my mind are in that report. We have been guilty though in the past of allowing it to languish / gather dust a bit as a process.

Other issues that arose included:

<u>Investment trusts</u>. Investment trust Boards are mainly non-executive, yet they spend 90% of their time on admin – maybe they should have different regime that frees them up to think more about investment.

<u>Accounting standards.</u> I worry that the accounting profession has confused people massively. IAS21 and IAS29 covering non-cash items. The raw accounts are often confused by these technicalities. One can fall foul of the regulators. Rules sometimes prevent us from sharing data we'd like to – people can't see the wood for the trees.

<u>Common Global Reporting Standards</u>. There is a lot of debate about the extent to which internal reporting standards should be reinterpreted relating to the classification of financial assets. Also the inadequacy of IFRS as a common language of accounting across the world has not happened, as the Americans have not played ball. The mismatch and the controversy on market to market and fair value accounting must be addressed. For the financial services industry it is crucial to get this right. It is frustrating to investors to have US GAAP different with America not adopting IFRS. This is a big one for banking.

D. QUESTIONS POSED TO MAIN ROUND OF INTERVIEWEES

1. Do you believe corporate governance of investee companies is relevant consideration for investment managers? How is this manifest? If it is not relevant, why not?

2. Does the dialogue between investors and executives focus too much on financials? Is company performance of interest in itself, or only as it affects the share price?

3. Should investors act more like owners? In what ways could they do this? What constraints hold them back? Is too much expected of them in policing governance standards?

4. What subjects should be covered in any governance dialogue? How often should it take place? Between whom? What would characterise effective engagement?

5. Do investors value the ability to vote and, in particular, to assist in changing the Board? Why do voting resources exceed engagement resources? Should voting be outsourced?

6. Should larger shareholders give feedback to the Chairman / non-executives on business performance and expectations for their investment? In the annual report?

7. Would there be benefit in a regular meeting between non-executives (with the Chairman) and larger shareholders?

8. How far do resource constraints result in a different approach to governance analysis / dialogue for smaller companies? Do all companies or just smaller ones (below FTSE30) struggle to get shareholder engagement beyond the CEO and CFO? If so, why?

9. How could companies use their shareholders more effectively?

10. Is there too much focus on remuneration? Should there be less frequent votes on it? Are specific changes to current remuneration practices required?

11. Should other governance issues be subject to more focus in the dialogue / specific votes?

12. Would annual elections for all directors improve the governance dialogue?

13. Do investors receive enough information to judge the quality of a Board and the quality of boardroom debate? If not, what else would give a better insight?

14. Should the nomination committee or Chairman report annually on the overall Board profile, including comment on the skills and experience brought by each director?

15. Do brokers and other intermediaries – remuneration consultants – assist / hinder dialogue?

16. Is remuneration in investment management companies in need of review? If so, how?

17. Has the banking crisis highlighted issues for governance that apply across other sectors? Or, if banks are different, why?

18. What other changes would you advocate to enhance company / shareholder engagement?

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