

An invited audience of business and investment leaders recently took part in a lively debate on the theme of “Board dialogue with investors: what next?” at The Plaisterers’ Hall. Our Chairman, Lord Currie, invited contributions from our panel before opening the debate to the audience. We are grateful to the panel: Baroness Hogg (Chairman of 3i), Keith Jones (then CEO of Morley Fund Management) and Anthony Hilton (City Editor of The Evening Standard).

This paper tries to capture the flavour of the many points contributed by our panel and from the floor.

The key themes

- The changing investment scene means that it’s getting increasingly hard to know who your shareholders are, and without this there’s no sound basis for effective engagement. If this isn’t addressed with active involvement from investors and regulators, there’s a danger that a decline in engagement could lead to more rules. No-one seemed to think this would be a good idea...
- Directors of publicly-owned companies, speaking of governance in doom-laden tones, often say they envy the way private equity companies are not burdened by it. But in fact private equity firms, though they may be free from the attentions of external, process-driven commentators, take governance very seriously. They provide an important lesson for the rest of us: the need to make governance – and shareholder engagement – drive shareholder value by aligning owner and manager interests and ensuring accountability.
- Apart from the odd tweak, the Combined Code can be left alone. What matters is making “comply or explain” work. But remuneration committees need more focus – they have an increasingly vital role to play, but often are ill-equipped for it.

Moving the governance debate forward

Shareholder engagement has improved markedly in the last few years. But changes in the investor landscape mean that we need to move on from focusing so much on the relationship between institutional investors and boards.

The role of hedge funds has increased dramatically - and will continue to increase, in part driven by pension funds moving out of equities (“a barking mad situation”). The **trend to absolute return and the use of derivatives** in the fund management industry means that the distinction between active and hedge fund investors is blurring. There’s also been a huge **growth in the position and influence of private equity**, with levels of liquidity reaching a point where it’s a real threat to public markets. And massive **growth in the derivatives market** means that a lot of economic interest is now held in, for example, contracts for differences.

As a result, perspectives on investor relations are shifting, but at the same time companies have decreasing visibility of who the owners actually are.

Companies might put more effort into analysing their share registers, but even so **transparency of ownership will need to be tackled**. The market won’t do it as the different parties involved have different interests, so the FSA will have to make sure this issue, and the implications for shareholder voting rights, are prominent on their agenda.

The various parts of the increasingly diverse investment community need to ask themselves where this leaves them, individually and collectively, on what’s needed for and from engagement. Views will differ and it’s not easy to predict approaches based on labels. Some hedge funds resemble activist investors in how they engage, while others are fully disengaged. Some passive fund managers are, in fact, highly engaged on governance matters. And many private equity investors follow their own model of governance through direct involvement and full alignment, but it’s not uniform and the level of pre-acquisition due diligence can vary enormously.



So there's not going to be – and shouldn't be – any single answer. Diversity will still be the order of the day. But all **those involved in the capital markets will need to play a role in the engagement debate**. Why? Because knowing who your shareholders are is essential for a sensible dialogue and meaningful debate. If there's no channel for discussion and explanation of how principles are being applied, there's a real risk that we will regress towards a rules-based prescriptive approach.

Learning from private equity

There's sometimes a perception that private equity is a governance-free zone, but it isn't so. Private equity investors are, in fact, highly engaged in what they regard as **"real" governance**, which is something quite different from "corporate governance" in the compliance-driven sense. Governance is crucial to the value-added process of private equity; investors are highly engaged, know a lot about the company, and work hard on aligning management and shareholder interests in practice.

For some, this is the best form of board-investor dialogue. Of course, the interests of short-term private equity investors are not necessarily the same as those of longer-term investors, and publicly-owned companies have to work within their own constraints. But what we can learn from the private equity approach is the vital importance of basing the dialogue **on the real intent of governance – helping make sure that owner and management interests are aligned and management properly accountable. That's what stops governance being a burden and turns it into something useful.**

Other points made

The breadth of the discussion meant that a number of interesting points were made on other issues.

- The remuneration committee is increasingly important in the face of growing controversy over senior executive pay, with investors starting to wonder whether levels are running too far ahead of the sorts of returns that the ultimate owners of capital can expect. **It's becoming crucial that remuneration committees have strong chairmen and that they receive good support.** They must have reliable, independently-sourced data, providing good comparative evidence to get the balance right between the risk of losing a key executive and not protecting shareholder interests through misalignment of reward and performance. Both the effectiveness of remuneration committees and the independence of the remuneration consultants need a rigorous examination.
- There has been a considerable degree of coalescence around the Combined Code's principles, but **some tidying up at the edges may still be needed.** For example, some questioned whether the principle of having a *majority* of independent non-executives on the board is helpful – it can lead either to large boards or, in apparent contradiction with another recommendation of the code, a small number of executive directors. But the more important thing is to **reinforce "comply or explain" through an emphasis on the Code as a set of principles not rules.**
- And maybe **the institutional investor community needs to get its own governance thinking straighter.** At times it appears to some that, for the institutions, governance is about de-risking rather than performance. Also, it was suggested, they don't behave as owners and so can be a dysfunctional part of the principal-agent issue, often failing to recognise that they too behave as an agent. This could imply that what's needed is **less but better quality engagement**, learning from the private equity, ownership-driven approach.

So, what next?

The main message that emerged was a clear one. Companies, regulators and investors need to move on to a different debate: how to preserve the benefits of engagement and a principles-based governance approach in the context of increasingly diverse and less transparent share ownership.
