

Corporate governance issues

1. *Introduction*

This paper is intended as a discussion document for the Methodist Church Joint Advisory Committee on the Ethics of Investment, Epworth itself and its customers. As some readers will be less familiar than others with the subject matter, a section is included on key concepts. There is a need for the Trustees of pension schemes to decide on policy on these subjects and issue instructions to their investment managers.

2. *Key Concepts*

2.1 Corporate Governance

refers to the way that companies (particularly the larger ones in whom pension schemes invest) organise their affairs. It covers such matters as:-

- The constitution of the Board of Directors
- The age at which directors should retire
- The relationship of independent directors (“Non-executive Directors”) with directors employed by the company (“Executive Directors”)
- The remuneration of Directors and Senior Management
- The use (and misuse!) of Company Funds
- The requirements to hold regular Annual General Meetings (AGMs)
- Circumstances requiring Extraordinary General Meetings (EGMs)
- The period of notice required for AGMs and EGMs
- Procedures at AGMs and EGMs
- Voting arrangements for ordinary resolutions and special resolutions (Resolutions deemed non-controversial may be decided by a show of hands while certain resolutions will need a formal vote).
- Possibility of voting by post or through a representative (Proxy), who could be the Company chairman

2.2 Stakeholder

is a concept that means different things to different people. It is political jargon for any person or group of people who have an interest in the progress of the company. As such it could include some or all of the following:

- Shareholders
- Management
- Employees
- Trades Union
- Suppliers
- Local Communities
- Customers
- Environmentalists
- The Government

There is however a school of thought that thinks the term stakeholder is misleading. While all of the above may be interested parties, it is the shareholders that own the company and will benefit from the prosperity and suffer from the adversity experienced by the Company. The shareholders prime concern is that the company should continue to grow and add shareholder value year by year and this is unlikely

to be achieved unless most of the other interested parties are satisfied. Furthermore shareholders may have other concerns such as ethical issues and are entitled to make their views known to the Board who are essentially the shareholders' representatives. This paper will make sparing use of the word stakeholder in order to avoid confusion.

3. *A subject of growing significance*

- 3.1 Corporate governance is attracting increasing attention among those involved in it as directors of companies or as governors or trustees of institutions, and also among those concerned in Government or in public life, as well as among those affected by it, be they shareholders, investors, recipients of the services provided or the general public. Interest has grown rapidly in recent years, with the growth in legislation, regulation and guidance on the responsibilities of office-holders in the private and public sectors, and the standards of behaviour expected of them. Reports from Cadbury, Nolan, Dearing, Greenbury and Hampel have established a set of codes by which conduct is now being judged and commented on publicly. The subject is being given prominence in the media, with the emphasis naturally on scandals of misappropriation or misuse of funds and on alleged shortcomings of misbehaviour of those in positions of responsibility.
- 3.2 Questions are being asked of stakeholders on how they are exercising their powers of scrutiny and voting rights to demand more openness on information and good practice. The new Human Rights powers and the forthcoming Freedom of Information Act will give the general public and the media greater opportunities to require more information and hold people in responsible positions to more public account.
- 3.3 The matter has been given prominence recently because the Pensions Minister has recently issued a press release stating that in future trustees will have to state their policy, if any, on social, environmental and ethical investment matters as part of the disclosure framework laid down in the Pensions Act 1995. This will include the policy of the trustees on exercising their voting rights and will form part of the Statement of Investment Principles.

4. *The development of the present situation*

- 4.1 In a democratic society many would hold the view that one has an obligation to exercise one's vote in the political arena. A similar view can be held in respect of corporate governance. In fact given the fundamental interest in the business it is perhaps surprising that shareholders do not take a greater interest in the assets that they own. Two main reasons for the present situation (where two thirds of shareholders do not normally bother to vote) are historical inertia and administrative inconvenience.
- 4.2 Most of the large companies started their existence as family concerns. The family both owned and managed the business and the owners and the management interests were identical. Furthermore in the best-run businesses the owners recognised other interested parties. When the companies spread the ownership through the mechanism of the stock exchange this was still largely true as the family often continued to have a significant shareholding and interest in management matters. Today the size of companies is much larger through mergers and acquisitions and the original family interest has often disappeared. New companies may still follow a similar pattern.
- 4.3 It should no longer be assumed that the interests of the management and the shareholders are identical. Conflicts of interest are common and include the following:
- Members of management may be more interested in maximising their personal remuneration than optimising shareholder value. Hence the importance of a remuneration committee containing independent directors.
 - Directors may hold multiple directorships and be using one company to the benefit of another and not necessarily to the benefit of the shareholders of the first company.

- Directors may be using shareholder funds for political purposes or other purposes, which the shareholders might not like were they fully aware of what was happening.

- 4.4 Turning to administrative matters the difficulties involved are considerable and the government's objectives may be defeated on grounds practicality. Approximately two thirds of the shares are owned by pension funds and insurance companies (the institutional investors). The investments of Epworth, although large by comparison with the average individual's holding, are relatively modest but the holding contains approximately 200 different equities. In order to participate meaningfully in every vote hundreds of documents would have to be examined every year. In addition the mechanics of registering votes are slow. The process should involve the Registrar at the Company, the Trustees, Epworth and the Custodian, who physically look after the shares on behalf of Epworth. Either to vote or register a proxy has to be achieved against a timetable. Trustees meeting once a quarter cannot hope to examine individual cases and the Pensions Manager rightly concentrates on other concerns. This has been described in terms of Epworth but it is generally true of all major institutions.
- 4.5 The conclusion from this analysis is that shareholders will generally support the management point of view either by not voting or registering a proxy vote with the company chairman. This is not an entirely satisfactory state of affairs and shareholder groups are combining in various ways to take action – particularly where shareholders value is threatened.

5. Action by companies

In response to the growing concern, directors, governors, trustees etc. have been reviewing their past practices in the light of the new and proposed statutory requirements. They have made many changes in the ways they operate and conduct business, and in the ways in which they report on that and respond to public enquiries and queries. There have also been substantial changes in the requirements and reporting standards of the accountancy and actuarial professions, which are now being reflected in the reports and accounts of institutions and pension schemes. The responsibilities of office-holders, and the standards publicly expected of them, have increased significantly as a result of all this, and they are having to demonstrate that they are living up to the higher expectations and to justify public trust and any rewards that they receive for doing their job.

6. Current demands

In these circumstances there are demands that Boards should show not only that they are fulfilling their duties to their shareholders and other interested parties, but also that they are operating in the most effective and efficient manner they can. As explained above shareholders too are being pressed to show that they are exercising their rights in positive and active ways (e.g. by scrutinising available information, demanding more explanations, exercising voting rights etc). They are also being urged by special interest groups to use their powers to forward particular causes (e.g. equal opportunities, environmental issues, ethical investment etc).

7. Present requirements

- 7.1 The result of all the interest and deliberations has been a fair measure of agreement on the principles and practices expected of corporate governors. These have been set out in various documents, such as the Stock Exchange's Principles of Good Governance and Code of Best Practice (the "Combined Code") appended to its Listing Rules. Companies have had to comply with the Listing Rules giving effect to the Code for financial years ending on or after 31 December 1998.
- 7.2 The Combined Code lists 17 Principles of Good Governance and 48 Provisions relating to and elaborating on the various principles. It covers a wide range of principles about effective governance (such as the appointments of executive and non-executive directors and roles, and remuneration, accountability, relations with stakeholders) and detailed requirements (such as lengths of appointments, membership of board committees, disclosure of remuneration, reporting requirements).

- 7.3 The Combined Code contains no statutory provisions. The Stock Exchange is responsible for monitoring companies' compliance with the Listing Rules, but has limited sanctions available apart from the "nuclear deterrent" of de-listing, which is unlikely to be invoked for minor or technical breaches, even if they are numerous or repeated. The emphasis has thus focussed on shareholder and peer group pressure, of the kind that has led to the almost universal acceptance of the Cadbury and Nolan codes. Leading institutional shareholders (pension funds own more than one-third of UK equities) have been urged by the National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI), and by Pensions and Investment Research Consultants (PIRC), to exercise their voting rights in favour of better governance and to demand more information about performance and compliance with good practice. More and more investment managers are setting out their policies on what they expect and the criteria on which they will exercise their voting rights.
- 7.4 PIRC in particular, who have played a leading role for some years in campaigning for more information and placing greater requirements on companies to comply with more stringent rules, continue to press for shareholders and the Government to go further than the Combined Code and demand higher and more detailed standards (e.g on directors' re-election every year, executive remuneration, AGM rules). Their views are set out in the fourth edition of their Shareholder Voting Guidelines 1999. In general, each proposal represents a high standard of good practice, and many companies comply with most of them. In combination, however, they constitute a considerable body of detailed prescriptive rules which tend to focus a board's attention on the formal requirements of governance rather than the substance of policy decisions aimed at the prime responsibility of running a profitable business which maximises the return to shareholders.
- 7.5 Similar concerns are being expressed by board members, governors and trustees of bodies in the public and private sectors such as education, health and pension schemes where the Government and statutory funding and regulatory bodies are laying more and more requirements of accountability and performance on people who are paid relatively modest amounts compared with company directors or who give their services voluntarily for no reward. Those of working age with a career or business of their own to manage are proving less willing to sacrifice their time and shoulder increasing responsibilities which could adversely affect their own prospects and reputation. Excessive centralisation and bureaucratisation of what has been seen as a personal contribution to a worthwhile and individual institution could deter many of the most useful people from providing the benefit of their advice and experience.
- 7.6 In the financial sector in particular, various well-publicised scandals in recent years have led to a radical overhaul of the statutory and regulatory rules and structures. The extent of regulatory detail and the powers of the regulators have increased considerably, which should provide greater comfort to customers and investors, even though the position in the UK is not as stringent as in the US. On the other hand, it look certain to increase the amount of litigation, both from suppliers appealing against rulings that appear to go too far in terms of the rules themselves, or of natural justice, and from the growing predilection of dissatisfied customers to resort to law. Either way, there is little doubt that the previous freedom of those running financial services to return healthy profits is being steadily curtailed.

8. Response of Investors

- 8.1 Institutional investors, individual shareholders and other interested parties, including the Government and other statutory bodies, therefore need to exercise some care in deciding how far they are going to seek information about an institution's performance and use of their voting and other proprietary powers. As explained above, regard must also be had to the time and costs involved in exercising greater accountability. Whatever the position of the individual shareholder, investment managers and trustees have to be able to defend their actions and the monies they expend from the funds entrusted to them on securing the information necessary to support their decisions on buying or selling shares, seeking explanations or exercising voting rights. These actions do not come cheap. Investigating companies

takes time and is expensive. Using the services of specialist advisors like PIRC or EIRIS can cost tens of thousands of pounds every year.

8.2 In these circumstances it is suggested that there are three broad types of question that investment managers and trustees should ask themselves about companies in which they have an interest. In order of importance they are:

8.2.1 Is the company being managed effectively and efficiently, in a way likely to provide a good return for investors?

If the answer is “Yes”, they can proceed to questions (2) and (3). If it is “No”, the normal course should be not to buy the shares and sell any existing holding, unless there are special circumstances (e.g. a likely takeover or merger, or an imminent change of management or policy, that holds out the prospect of a good return). However it would not be defensible to hold shares that are poor value in order to change the company’s stance on moral or green issues, whatever an individual investor might choose to do with his or her own money.

8.2.2 Is the company’s management acting in accordance with the requirements and guidance of good governance and best practice?

This can now be assessed with more confidence from annual reports and comment in the media. Investment managers and trustees will need to assess whether the addition information that comes from subscribing to an organisation such as PIRC is worth the money.

The answers are unlikely to be all affirmatives, given the wide range of topics covered in the guidance. They are even less likely to satisfy all the extra points raised by e.g. PIRC. Investment managers and trustees will have to exercise their judgement in deciding which of the topics rank as the most important in their eyes, which will depend in some cases on the circumstances of individual company’s. They may well decide to focus attention on particular companies in their portfolio, which have had question marks raised against them.

If there are judged to be major shortcomings on significant issues, these are likely to be reflected sooner or later in the share price, unless there are exceptional circumstances that could justify a decision to sell. But minor breaches that are unlikely to affect a good companies performance would seem to call for less drastic action such as taking the matter up with the company or voting on specific resolutions at the AGMs.

8.2.3 Is the company’s management taking sufficient account of other considerations e.g. equal opportunities, ethical or environmental issues?

This is very much a matter for individual investment managers or trustees to judge in the light of their own preferences that they can justify to those whose interests they represent, bearing in mind their fundamental duty to act in the best interests of securing a good return. Such issues have come into much more prominence in the last few years, with rapidly growing interest in ethical investment in particular. More investment funds and even insurance companies are now setting up ethical funds (e.g. Standard Life and the Norwich Union in recent weeks), and the Government’s latest consultation paper on pensions has come out in favour of this development.

Information on these aspects is harder to come by, since company reports usually refer to them in general and bland terms, if at all. Specialist services such as EIRIS provide fuller assessments, but it is not always clear what their ratings are based on; and they are often an indication of points of concern to pursue rather than definitive answers.

If the answers on important points are negative, and the company is otherwise sound and well managed, investment managers and trustees will no doubt try and persuade the company to improve its practices, in conjunction with other investors with similar concerns, at least initially. They may also decide to exercise their voting rights on relevant motions at AGMs to the same

effect. If they have no success, and they feel strongly enough, it is always open to them to sell the shares in question, if they can defend that on grounds of obtaining a similar return from a more acceptable investment.

If there is sufficient concern on these issues from a sufficient number of investors, the effect may be to bring about a change in management policy or to affect the share price in a way that would lead investors to consider selling their shares anyway. All this must be a matter of judgement.

9. Summary of action required

It is suggested that Epworth in conjunction with its customers should carry out a review of current practice in two parts:-

- What steps (if any) should be taken now to increase the interest taken in corporate governance?
- What steps need to be taken over the next nine months to put the pension funds and other customers in a position to cope with the Government's proposed regulations?

This report has skated over the administrative implications of detailed involvement in corporate governance and the review would need to cover this aspect in some detail.

Increased involvement is likely to involve an appreciable increase in expenditure so assuming that the customers are content that they are fulfilling their duties as good citizens, there is no pressing need to incur costs until the Government's intentions are confirmed.

It should however be realised that the Government can introduce these changes through regulation, which is much quicker than through primary legislation and contingency planning is therefore essential.

August 1999