Shareholder Power in the Boardroom

Forum

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Chair

Matthew Blagg, CEO, Criticaleye

Speakers:

José Manuel Campa, Professor of Financial Management, IESE Business School

Vanni Treves, Chairman, The Equitable Life Assurance Society

George Dallas, Managing Director, Standard & Poor's

This write-up is based on the proceedings of a recent forum held for members of the Criticaleye community. Participants attended this event to hear a panel of experts discuss shareholder power in the boardroom. Following the short introductory speeches, the panellists were posed questions by the audience of Criticaleye members. Aside from the speakers, no names or companies have been noted to encourage open debate. To watch a video of this event, please sign into the Criticaleye website at http://www.criticaleye.net and click on TV.

Introduction

Criticaleye Members and guests met to discuss whether shareholders have a place in the boardroom. The difference between the percentages of shareholders on boards in different countries was explored. Typically there are fewer shareholders on the board in the US whereas 55 per cent of boards in Italy are made up of shareholders. José Manuel Campa, Vanni Treves and George Dallas spoke at the event.

Speeches

José Manuel Campa got the ball rolling, focusing on a Continental European perspective. Could there be too much shareholder power, he wondered. Surely the best board would have 100 per cent shareholder representation? In fact, the underlying ownership structures were very different, and some

shareholders predominated at the expense of others. Typically from a global perspective, a well identified single shareholder controls the firm, unlike in the UK where 2.4 per cent of shareholders are represented on the board or on the NASDAQ where this figure is less than 2 per cent.

Italian firms, on the other hand, have over 55 per cent shareholder board representation and German firms over 60 per cent. On the continent a family, or sometimes a bank, is likely to hold control. There are conflicts of interest when an independent director sits next to someone who owns 55 per cent of the firm and has appointed all the other board members.

In the UK and the US, executive directors usually exercise power disproportionately: they govern appointments while holding a tiny fraction of the shares. In Europe, however, there are three types of directors: internal directors such as the CEO; external directors that we in the UK might call "nominee" directors; and independent directors. Conflict arises in this scenario when the nominee director (typically representing 30 to 40 per cent of the shares) exercises undue influence by controlling strategy and appointing independent directors to serve their own interests.

In European firms we also see cross-ownership, where friends collude by buying shares in each other's companies – to the detriment of the smaller shareholders. How do we deal with this? Corporate governance codes seem to share ideas of best practice, but these are extrapolated from Anglo-Saxon codes, which may be less appropriate in this very different context. Should a board that represents the majority of shareholders, for example, have a majority of independent directors? Proportional representation might be more appropriate, or limited voting rights regardless of capital. But the situation of having some shareholders profit at the expense of others is very difficult to police. Disclosure and transparency are a big issue, as is the question of remuneration when the executive director has other interests – for example in other parts of the parent corporation. These are the difficulties of the European situation.

Vanni Treves then looked at the balance of shareholder power in the UK boardroom. He thought the simple answer was, 'no, there is no such thing as too much shareholder power in the boardroom,' but he wanted to take a practical stance.

Shareholders in a UK plc are absolutely entitled to exercise their rights – from voting down resolutions to sacking the board – in whatever way they see fit. Shareholders in the UK are mainly large institutions: they own 78 per cent of shares in British companies, and this in a very concentrated way. For example at one large international company of which he was chairman, just twelve institutions owned 51 per cent of the shares. Even companies the size of HSBC or BP have only a few institutions that hold enough shares to have a real voice. If you keep these institutions happy, they can be persuaded not to use their power.

Traditional UK institutions are steady investors, so their chief concern is the long-term value of their shares. They become unhappy if you announce poor results, if your strategy is opaque or if you give them unexpected shocks – and this last point is by far the worst. As Napoleon said leadership is the management of expectation, and that's definitely true in this context. By connecting with your shareholders in every possible legal way you can keep them happy. This can include using your formal quarterly announcements, through analyst meetings, trading statements, road shows, corporate brokers and in briefings to investor relations groups, as well as by contributing to analyst reports.

The outcomes are high levels of understanding, a ready supply of prospective shareholders and a means of cushioning bad news. Above all, you must make the shareholders understand that their rights are paramount.

George Dallas thanked the other speakers and explained his take on the issue – the perspective of an investment analyst with particular insight into the US situation. Standard and Poor's is, essentially, a risk assessor, and is not an investor itself. Its main focus is the ability of a firm to maintain a sustainable operational and financial performance. On this basis, he indicated that S&P is positioned to review the role of investors in the boardroom from an independent perspective. He noted that agency theory is an important starting concept for this discussion: management needs to be held accountable, so shareholders, along with the directors they elect, play an important and legitimate role in this process.

In practice, however, investors can be a source of strength or weakness from a risk perspective. A situational assessment is required on an individual company basis. In a comparative context, the US presents a situation of generally fragmented ownership in which the dispersal of shares among small investors can leave them disenfranchised or with a limited ability to exercise shareholder rights to influence the company's governance. For the average American small shareholder, this can lead to a misalignment of interests with other investor groups – particularly in cases where hedge fund short-termism may not work to the interests of core long term shareholders.

George identified the stage of the company's own life cycle, its country of domicile and ownership structure as key contextual factors that affect its corporate governance profile. Even though the US and UK share many common features and are often put into a common "Anglo American" classification, there are key differences between the two systems.

Firstly there is the division between federal and state jurisdiction to consider. Company law operates at state level. While US shareholder rights in US state law typically are weaker than in the UK, there is more indirect regulation, such as the threat of class action and the litigious culture.

Secondly, the investor base is very different. Almost half of US households own equities, compared with only 15 to 20 per cent of individual ownership in the UK. The US SEC is inclined to regulate more to protect these smaller,

less sophisticated investors. Moreover, institutional investors represent roughly 70 per cent of the market capitalization in the UK as compared with 50 per cent in the US—institutional investors play a less dominant role in the US.

These facts coupled with the large number (over 5000) of listed companies and geographically fragmented share ownership means there is less scope for intimate institutional investor engagement in the US than in the UK. The US, therefore, presents a very different set of challenges to the UK: the UK's noteworthy 'quiet word behind the scene' approach is less practical in the US. As a partial consequence, this helps to explain the different and more prescriptive amount of regulation relating to US corporate governance.

Questions

Professor Campa was asked to comment on the private equity debate in the UK in the light of his assessment of the perils of concentrated ownership in Europe.

The main difference, said Professor Campa, is that with private equity firms you can be sure of their objective function – they have exclusively financial interests, even if this is in relation to their debt rather than their shareholding. With firms in Europe you can't be sure of the main shareholders' agenda – will they act strictly to maximise shareholder value or do they have other goals? Families often do, as do banks. And there's also the question of state intervention in private firms in which the state has a stake.

Vanni Treves added that the common perception is that private equity funding is bad for employment, and it's true that the big private equity firms don't hold back because of employee rights issues: their main issue is taxation.

Is private equity seen in a different light in the US?

Although there is a history of seed funding and venture capital activity in the US, private equity investment is still a worry, partly because of limited transparency and potential conflicts between investors (including both small shareholders and creditors). In the emerging private equity debate, creditors are increasingly important financial stakeholders. Nevertheless, they share many similar interests to a company's core shareholders, these being the long-term viability of the company operationally and financially.

What is the role of the non-executive director in situations of concentrated ownership?

In firms that have formal structures in place, said Professor Campa, these structures can help you deal with conflicts of interest. For example, a firm with 80 per cent majority ownership had an appointment committee mainly composed of independent directors. They rejected a candidate not because he was unqualified, but because they suspected a conflict of interest. If the

independent appointments committee hadn't been extant, the non-executive directors might have been powerless. It's a good idea to set out formal procedures dealing with conflicts of interests.

George Dallas made reference to the Italian companies' code, noting that in cases of controlling shareholders, it may be unrealistic to expect the degree of board independence as we see in the UK or the US. However, even for controlled companies there should be a critical mass of independent directors to allow for independent oversight of key board processes such as audit, related party transactions, executive compensation and management succession. José added that in Europe it's often asked why independent directors are needed in situations where ownership approaches 100 per cent. Should they, in this example, wield the power to fire executives, or should they be more like consultants, instead?

How should a board deal with the conflict between the long-term stewardship of a company and the attractiveness of a large cash offer made by private equity?

The asymmetry between the short-term pressure and the long-term imperatives is growing. There's always pressure in this situation, said José. With private equity specifically the issue arises when the private equity company wishes to change fundamentally the strategy of the firm, and change its risk profile. Otherwise, the conflict a board member faces is no different from in any other bid. The board member should always act in the shareholders' interests – and cash is usually king. Boards were legally bound to take formal advice, and would consult the shareholders through a corporate broker. As a director on the receiving end of an offer you should talk to the shareholders confidentially, to gauge their feeling – although this was difficult if you couldn't be sure who they were. Fund managers and others should have more of a say to help decide what constitutes a good offer.

When does providing a director with the information necessary for him to perform his duties become improper disclosure, if the director is also a shareholder?

Technically, he or she can't pass anything on to a shareholder. But the distinction between the roles is not always clear. Though the director can't pass information on, how the knowledge affects his or her actions is another story.