THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Dialogue in corporate governance

Beyond the myth of Anglo-American corporate governance

Investment dialogue

Shareholder responsibilities and the investing public

Exercising ownership rights through engagement

Dialogue in corporate governance

The globalisation of capital markets and capital flows, corporate scandals and newly developing economies are encouraging demands for consistency in corporate governance practices so as to reduce complexity and confusion. Dialogue can help facilitate a better understanding of different approaches to corporate governance and foster an appreciation of equivalent systems.

Difficulties arise in striving to achieve a single, global approach to corporate governance. There are too many deep-rooted cultural and structural differences for a single approach to work equally well in all countries and for all companies regardless of their stage of development and business. The ICAEW has launched the *Dialogue in corporate governance* initiative to challenge commonly held assumptions, identify fundamental questions, set challenges for future research and generate practical proposals. This will include:

- **Beyond the myth of Anglo-American corporate governance** – Contrasting US and UK securities markets and how they impact national and international policy, investment, business and accounting.
- **EU approaches to corporate governance** – Contrasting models of corporate governance in EU Member States, drawing out potential implications for future convergence.
- **Matching corporate governance to investor needs** – Exploring the different sources of finance as businesses evolve and the implications for corporate governance.

About the ICAEW

The ICAEW is the largest professional accountancy body in Europe and has over 128,000 members in 142 countries worldwide. Since the establishment of the Cadbury Committee in 1991, the ICAEW has played a significant role in the development of corporate governance in the UK.

If you would like to know more about *Dialogue in corporate governance* or *Beyond the myth of Anglo-American corporate governance* and relevant events and publications visit www.icaew.co.uk/dialogueincorpgov

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Scope and use

Corporate governance is a broad discipline and this discussion paper is not intended to cover every aspect of corporate governance. It provides information on issues raised in the *Pressure Points* consultation paper and generally focuses on publicly quoted companies and institutional investors, particularly those operating internationally.

This discussion paper should be read in conjunction with the other papers in the *Beyond the myth of Anglo-American corporate governance* series focused on policy, business and accounting issues and the *Pressure Points* consultation.

Beyond the myth of Anglo-American corporate governance

In June 2005, the Institute of Chartered Accountants in England & Wales (ICAEW) launched the *Beyond the myth of Anglo-American corporate governance* initiative. Its aim is to explore differences between US and UK corporate governance systems and the pressures these differences create for international business and investment. The intention is for this work to help inform policy makers on both sides of the Atlantic.

As part of the initiative the *Pressure Points* consultation paper was published in December 2005 and is relevant to boards, investors, the accountancy profession and policy makers. It highlights 21 questions representing some of the most challenging aspects of cross-border corporate governance and the comparability of US and UK corporate governance systems.

As context for responses to the *Pressure Points* consultation, four discussion papers provide information on the current state of corporate governance in the US and the UK.

- **Policy dialogue:** ***Effective corporate governance frameworks – encouraging enterprise and market confidence***

- **Business dialogue:** ***Board responsibilities and creating value – demonstrating leadership and accountability***

- **Investment dialogue:** ***Shareholder responsibilities and the investing public – exercising ownership rights through engagement***

- **Accounting dialogue:** ***Disclosure responsibilities and building trust – promoting transparent and reliable information***

The initiative also encourages on-going dialogue through face-to-face meetings. At the ICAEW transatlantic roundtable in Washington DC in December 2005, the importance of dialogue around corporate governance for global capital markets was emphasised by SEC Commissioner Cynthia A. Glassman:

'We have much to learn from each other on how to regulate wisely and make global markets efficient... Our analysis of regulatory policy needs to be rigorous, yet flexible. We need to be clear about our goals, but recognize that there is more than one way to achieve them.' [1]

A paper summarising the findings of the *Beyond the myth of Anglo-American corporate governance* initiative is expected to be finalised in late 2006. It will include evidence from responses to the *Pressure Points* consultation and feedback from face-to-face meetings and roundtable events on both sides of the Atlantic.

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[1] Remarks of SEC Commissioner Cynthia A. Glassman at the ICAEW *Beyond the myth of Anglo-American corporate governance* roundtable, Washington DC, 6 December 2005.

Shareholder responsibilities and the investing public

Exercising ownership rights through engagement

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Introduction

A fundamental tenet of capitalism is that a company is an entity of joint enterprise between those who control it (i.e. the directors) and those who own it (i.e. the shareholders). Directors are responsible for acting in the best interests of the company for the benefit of shareholders. Shareholders in turn, empower directors to lead the company in a fiduciary capacity, whilst maintaining a degree of decision-making control through incorporation rights.

Agency theory applies where there is a separation of ownership and control and describes how misalignment can occur resulting in conflicts between the interests of those in control of the company and those who own it.[2] Mitigating these conflicts through legal and regulatory frameworks which define the responsibilities, rights and powers of directors and shareholders, is a key corporate governance objective.[3] However, while the fiduciary duties of directors are generally widely acknowledged, there is still debate around the role and responsibilities of shareholders.

The concepts of share ownership and shareholder responsibilities were described by Mark Anson, CEO of Hermes Pensions Management Ltd (Hermes), at an ICAEW event in Washington DC in December 2005 as follows:

'Share ownership embodies two important principles. First, the term shareowner reminds all interested parties – executives, directors, creditors – who is the ultimate owner of the company. Second, with the acknowledgement of share ownership comes the obligation to continue to exercise ownership rights in a public company.'[4]

Institutional shareholders (such as pension and investment funds) hold the highest proportion of shares in both the US and the UK. In the US, securities owned by institutional shareholders amount to around $8 trillion or 63% of equities and in the UK institutional shareholders hold just over $2 trillion, or more than 80% of equities.[5] There is also a high degree of cross-border investment between the two countries. The value of UK holdings of US equity and debt, as of 30 June 2004, was $488 billion – an increase of $98 billion from the year before.[6] US holdings of UK equity and debt, as of 31 December 2004, amounted to $738 billion, by far the largest amount invested in any country outside the US.[7]

Given the high levels of their investments, institutional shareholders can play a significant role in the governance of companies. The importance of shareholder engagement in corporate governance matters was described in an International Corporate Governance Network discussion paper by Sir Adrian Cadbury and Ira M. Millstein:

'The effectiveness of an enabling approach to regulation depends on the degree to which shareholders, and especially institutional investors, are prepared to use their influence in support of governance recommendations. Codes of good practice gave investors an agenda for their

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[2] 'The Modern Corporation and Private Property,' A. Berle and G. Means, New York, Harcourt Brace & World Inc, 1952.

[3] 'Theory of the firm: Managerial Behaviour, Agency Costs and Ownership Structure', M. Jenson and W. Meckling, *Journal of Financial Economics*, Vol. 3, 1976.

[4] 'Share Ownership: The Foundation of Corporate Governance', Robert Carlson, Charles Valdes and Mark Anson, *Journal of Investment Compliance*, 2004.

[5] 'The New Agenda for ICGN', Adrian Cadbury and Ira M. Millstein, Discussion Paper No.1, p.11, ICGN 10th Anniversary Conference, London, July 2005.

[6] Report on Foreign Portfolio Holdings of US Securities as of June 30, 2004, Department of the Treasury, Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, June 2005.

[7] Report on US Portfolio Holdings of Foreign Securities as of December 31, 2004, Department of the Treasury, Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, December 2005.

dialogues with boards and encouraged them to engage in such dialogues. The ability of the market to bring about changes in corporate governance derived from the changing pattern of ownership. As noted above, the institutions had emerged as the dominant shareholding force. It was in their interests and the interests of their beneficiaries to raise governance standards and they acquired the voting power to do so.'[8]

This discussion paper, *Shareholder responsibilities and the investing public – exercising ownership rights through engagement*, describes the rights, responsibilities and powers accorded to shareholders in the US and the UK. It looks at how institutional shareholders in each jurisdiction engage with companies to influence corporate governance and ultimately the value of their clients' investments. This paper also provides information relevant to the questions in the *Investment dialogue* section of the *Pressure Points* consultation paper. These questions are reproduced below and cross-referenced to the relevant pages in this paper:

	***Pressure Points* questions**	**Page**
Q5.	How does shareholder oversight and engagement actually improve the corporate governance and performance of companies in both markets?	19
Q6.	To what extent should shareholders be empowered to participate directly in fundamental decisions affecting companies and hold directors to account?	6
Q7.	How effective are shareholder proposals as a means of influencing the governance of companies?	19
Q8.	To what extent should shareholders be afforded powers to influence or determine the composition of boards?	15
Q9.	Do pre-emption rights adversely affect competitiveness and are shareholders deterred from investing if a company does not provide such rights?	12

[8] 'The New Agenda for ICGN', by Adrian Cadbury and Ira M. Millstein, Discussion paper No.1, p.11, ICGN 10th Anniversary Conference, London, July 2005.

1. The role of institutional shareholders

In the US and the UK, directors have a fiduciary duty to act in the best interests of the company for the benefit of shareholders, while having regard to other stakeholders. Over the years, share ownership patterns in both countries have evolved. High levels of individual ownership have been replaced by increased concentrated institutional holdings.

This shift in equity ownership has raised the profile of institutional shareholders as guardians of the investing public. Through pension, insurance and savings products, they too have a fiduciary responsibility to act in the best interests of their beneficiaries.

Increased share ownership brings with it increased power to influence good corporate governance. Institutional shareholders have a responsibility to exercise their ownership rights, for example by entering into dialogue with companies based on a mutual understanding of objectives and play a role in corporate governance.

The *Pressure Points* consultation paper raises the following question:

Q6. To what extent should shareholders be empowered to participate directly in fundamental decisions affecting companies and hold directors to account?

In considering this question, the following areas are relevant:

- Shareholder primacy versus the stakeholder approach to corporate governance.
- The responsibilities of institutional shareholders.
- The practical application of the comply-or-explain approach to corporate governance.

1.1 The purpose of companies and shareholder primacy

The US and the UK corporate governance systems have traditionally emphasised that the maximisation of shareholder wealth is the fundamental purpose of companies and as such is the most efficient means of enhancing the wealth of society as a whole. This view was reflected by the UK's Company Law Review Steering Group as follows:

'...the ultimate objective of companies, as currently enshrined in law (i.e. to generate maximum value for shareholders), is in principle the best means of securing overall prosperity and welfare.' [9]

This approach does not entirely disregard the interests of other stakeholders but concurs with the view of Berle and Means[10] that the purposeful behaviour of directors requires the existence of a single objective, namely the maximisation of shareholder wealth. Multiple objectives for a variety of competing stakeholders may prevent directors from making reasoned decisions. This does not preclude companies, in the ordinary course of business, from having regard to a wider group of stakeholders as emphasised below by Professors F. Easterbrook and D. Fischel:

'...maximising profits for equity investors assists the other 'constituencies' automatically. The participants in the venture play complementary rather than antagonistic roles. In a market economy each party to a transaction is better off. A successful firm provides jobs for workers and goods and services for consumers. The more appealing the goods to consumers the more profits

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[9] 'Modern Company Law for a Competitive Economy: the Strategic Framework', para. 5.1.12, (the first consultation document of the Company Law Review Steering Group), Department of Trade & Industry, 1999.

[10] 'Corporation and the Public Investor', A. Berle and G. Means, *The American Economic Review*, 1930.

(and jobs). Prosperity for stockholders, workers and communities goes hand in glove with better products for consumers...'[11]

In contrast to a shareholder primacy approach, many other countries have adopted a stakeholder (or pluralist) approach to corporate governance. In such systems directors are legally obliged to consider the interests of other stakeholders in fulfiling their fiduciary duties to the company. Examples of these differences are described below by Robert C. Pozen, Chairman of MFS Investment Management:

'...under French law, the board of directors represents "the company" and must act in its best interests; French courts have rules that the best interests of the company go beyond and are distinct from the interests of shareholders. Even the President of France once complained that French workers were being asked to sacrifice in order "to safeguard the investment benefits of Scottish widows and Californian pensioners". Similarly, Japanese law does not require the company board to represent the interest of shareholders. Courts have ruled that directors have only an indirect duty to shareholders as the ultimate owners of the company. However, Japanese stock exchanges do provide limited oversight of companies listed on such exchanges. Similarly, directors are supposed to represent multiple constituencies under Brazilian law. Furthermore, under the Brazilian Corporation Law, a "controlling shareholder", as well as a corporate director, owes a duty towards the corporation, other shareholders, corporate employees and the community in which the corporation operates.'[12]

From an economic perspective, shareholders are the residual risk bearers of a company. Their claim is limited to whatever is left after all other contractual claims are paid including employee salaries, taxes to the government and payments to creditors and suppliers. The return to owners of ordinary ('common') shares for their capital investment is not governed by a contract and there are no guaranteed repayments. In the US and the UK therefore, a prime objective for a company is to manage the shareholders' risk and maximise the value of investments after other obligations have been met.

While there are different perspectives on whether a company should follow a shareholder primacy or stakeholder approach to corporate governance, an enlightened shareholder approach may present a hybrid of the two. This approach makes it clear that directors are primarily accountable to shareholders but also takes into account regard for other stakeholders such as employees, suppliers, customers and the environment.

1.2 Institutional shareholder responsibilities

Institutional shareholders in the US and the UK hold a large proportion of shares on behalf of beneficiaries through pension, insurance and savings products. They therefore play a significant role in the governance of companies and are expected to act responsibly in exercising their ownership rights. The importance of this is emphasised by the International Corporate Governance Network, whose members' assets are estimated at around $10 trillion:

'Millions of households worldwide depend on the growth in long-term value of investments made by institutional shareholders, be it for their saving schemes, life insurance, retirement provisions or otherwise. As trustees of these investments, which may include shares in listed companies, institutional shareholders have a general responsibility to use best efforts to preserve and increase this value. Improving the corporate governance of companies is increasingly understood as an important means of enhancing the long-term value of equity investments. As a result, many

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[11] *The Economic Structure of Corporate Law*, F. H. Easterbrook and D. R. Fischel, p. 38, Cambridge, Mass.: Harvard University Press, copyright © 1991 by the President and Fellows of Harvard College.

[12] *The Mutual Fund Business*, Robert C. Pozen, 2nd Edition, Houghton Mifflin, 2001, p. 502, © Houghton Mifflin Company.

institutional shareholders, along with the ICGN itself, have taken steps to outline best practices for the governance of such companies. However, institutional shareholders as a class have an equal responsibility to address their own roles as fiduciaries and owners of equity on behalf of savers.'[13]

In the UK, institutional shareholders owe a duty of care to individuals who have invested in retail funds under company law provisions and regulations from the Financial Services Authority (FSA). Similarly, in the US, investment managers owe a duty of care to individual fund investors under the Investment Advisors Act 1940 which is enforced through Securities and Exchange Commission (SEC) regulations.

US pension fund trustees are obliged by the Employee Retirement Income Security Act of 1974 (ERISA) to recognise the voting rights of their beneficiaries and have a legal duty to vote their shares. Trustees also have a duty to have a policy on voting on proxy issues, and a duty to maintain accurate, company-specific voting records on proxy voting activity. In relation to shareholder voting the US Department of Labor recommends that:

'Where proxy voting decisions may have an effect on the economic value of the plan's underlying investment, plan fiduciaries should make proxy voting decisions with a view to enhancing the value of the shares of the stock, taking into account the period over which the plan expects to hold such shares. Similarly in certain situations it may be appropriate for the fiduciary to engage in activities intended to monitor or influence corporate management if the fiduciary expects that such activities are likely to enhance the value of the plan's investment.

Although, within the corporate structure, the primary responsibility to oversee corporate management falls on the corporation's board of directors, the Department believes that active monitoring and communication with corporate management is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such activities in the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved.'[14]

The SEC has also strengthened rules on disclosure of shareholder voting practices. In January 2003, it mandated that all mutual funds must disclose their votes and proxy voting policies, annual votes cast and their approach to material conflicts of interest in order for beneficial shareholders to know how their shares are being voted.[15]

In the US, it is common for institutional shareholders such as TIAA-CREF[16] and CalPERS[17] to have their own corporate governance guidelines and actively challenge US company boards though proxy voting and research into corporate governance. It is also common for shareholder membership bodies in the UK such as the National Association of Pension Funds and the Association of British Insurers to recommend guidelines to encourage responsible share ownership.

In the UK in 2001, the relationship between institutional investors and companies was addressed by the government-commissioned review by Paul Myners, *Institutional Investment in the UK: A Review.*[18] The objective of the review was to consider whether there were factors distorting the investment decision-making of institutions. The extent to

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[13] ICGN Statement on Institutional Shareholder Responsibilities, International Corporate Governance Network, 2003.

[14] Pension and Welfare Benefits Administration, Department of Labor, Chapter XXV, Part 2509 – Interpretive Bulletins Relating to ERISA 1974.

[15] 'Securities and Exchange Commission Requires Proxy Voting Policies', SEC Press Release, 23 January, 2003.

[16] Teachers Insurance and Annuity Association – College Retirement Equities Fund.

[17] California Public Employees' Retirement System.

[18] Her Majesty's Stationary Office, March 2001.

which recommendations in the review were being implemented was examined in 2004 and further recommendations were published in the *Myners Principles for Institutional Investment Decision-making: Review of progress.*[19] This included suggestions for the improvement of communication between shareholders and companies and encouraged institutional shareholders to consider their responsibilities as owners and how they should exercise their rights on behalf of beneficiaries.

The 2001 review by Paul Myners included a recommendation that the UK should adopt an ERISA-style approach to formalising shareholder responsibilities. The response from institutional shareholders was to develop a set of voluntary good practice guidelines in 2002 which were published by the Institutional Shareholders' Committee (ISC). These guidelines were updated in 2005 and are summarised as follows:

'Institutional shareholders should:

1. *Set out policy on how they will discharge their responsibilities – clarifying priorities attached to particular issues and when they will take action.*

2. *Monitor the performance of, and establish, where necessary, a regular dialogue with investee companies.*

3. *Intervene where necessary.*

4. *Evaluate the impact of their engagement.*

5. *Report back to clients/beneficial owners.'*[20]

In 2004, the National Association of Pension Funds in the UK conducted a survey of its members into compliance with the ISC principles. The report found that:

- 97% of respondents were aware of the ISC principles;

- 60% of funds had incorporated the ISC principles into their investment manager's contracts;

- just under 80% of pension funds had corporate governance policies in place; and

- 88% of pension funds received regular reports from their managers on voting and their engagement with companies.[21]

The UK's Combined Code on Corporate Governance 2003 ('Combined Code') recommends that shareholders should follow the ISC principles and also recommends that:

'E.1. Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.

E.2. When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.

E.3. Institutional shareholders have a responsibility to make considered use of their votes.'[22]

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[19] Her Majesty's Stationary Office, December 2004.

[20] 'The Responsibilities of Institutional Shareholders and Agents – Statement of Principles', Institutional Shareholders' Committee, 2005.

[21] 'Pension Funds' Engagement with Companies', Research Report No.2, National Association of Pension Funds, 2004.

[22] 'Combined Code on Corporate Governance', Section 2: Principles E.1. – E.3, Financial Reporting Council, 2003.

Since the publication of the ISC principles many shareholders in the UK have publicly disclosed voting policies on a voluntary basis. Policies should clearly outline what is expected of companies by institutional shareholders. In addition, some shareholders provide information about the way in which shares are voted including explanations as to why decisions were made to vote for or against or to abstain on a particular resolution.

1.3 Shareholders and the comply-or-explain approach to corporate governance

The UK approach to enforcing good governance is often referred to as a comply-or-explain or shareholder-led approach. It is effective because shareholders in the UK often play an active role in corporate governance and are accorded genuine power and influence through company law to hold boards to account. While the Financial Reporting Council (FRC)[23] is responsible for generally monitoring the use of the Combined Code and updating it where necessary, shareholders ultimately act as quasi-regulators.

In the UK, the preference for a shareholder-led approach to corporate governance depends on constructive dialogue between boards and investors. The Combined Code is the primary mode of reporting corporate governance disclosure and is appended to the Listing Rules of the United Kingdom Listing Authority. All domestic companies listed on the London Stock Exchange's Main Market are required to observe the Combined Code, apply its principles and comply with its provisions or explain to shareholders why they have deviated from the Code. This information is disclosed in the annual report and accounts. This comply-or-explain approach has been recommended in the European Commission Company Law Action Plan[24] and has been replicated internationally.

The comply-or-explain approach allows for a degree of flexibility that traditional law, which imposes the same rules on all companies, does not. The expectation is that the large majority of companies will comply with the provisions of the Combined Code but it is recognised that there will be occasions where complete adherence may not be the most appropriate course of action.

Critics of the system point to the danger of some shareholders taking a 'box-ticking' approach to evaluating company disclosures. However, shareholders themselves are expected to observe the Combined Code's principles which include the following recommendation:

'Main Principle

When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.

Supporting Principle

Institutional shareholders should consider carefully explanations given for departure from this Code and make reasoned judgements in each case. They should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position. They should avoid a box-ticking approach to assessing a company's corporate governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces.'[25]

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[23] The Financial Reporting Council is the UK's independent regulator for corporate reporting and governance. The FRC have some statutory powers which are derived from Parliament and have the support of Government. See www.frc.org.uk.

[24] 'Modernising Company Law and Enhancing Corporate Governance in the European Union – A plan to move forward' (company law action plan), European Commission, 21 May 2003.

[25] Combined Code on Corporate Governance, Section 2: Institutional shareholders, Principle E.2: 'Evaluation of Governance Disclosures', Financial Reporting Council, 2003.

In most cases, shareholders in the UK are pragmatic about how to apply the Combined Code's recommendations in a way that is in the best interests of the company. Shareholders can be persuaded that compliance with a Code recommendation may be adapted as long as there is sufficient reason to do so and an adequate explanation has been given for any deviation.

An example of where a company has explained, rather than complied, with a Combined Code provision is provided below in the chairman's statement of the 2003 Annual Report of Barclays Plc. The Combined Code recommends that a chief executive should not go on to become chairman of the same company. This was the case with Barclays Plc when the CEO, Matthew Barrett, was appointed to succeed Sir Peter Middleton as chairman. Sir Peter explained the decision to appoint Mr Barrett as his successor in the following extract from the Annual Report:

'I wrote to all shareholders on 6th November 2003 explaining why the board came to its decision to appoint Mr Barrett as chairman. The board's decision to appoint Mr Barrett followed an extensive and rigorous process involving all the non-executive directors. The process involved establishing the desirable characteristics for a new chairman and reviewing external candidates, identified with the help of specialist recruitment consultants, and their availability. Mr Barrett was the board's unanimous choice. The board does not regard his appointment as setting a precedent in Barclays for appointing the Group Chief Executive to the position of chairman.

Mr Barrett's appointment helps ensure stability within the senior leadership team at a time of considerable change when a number of senior managers have been given revised and broader responsibilities. The board also felt that Mr Barrett was the right person for the job given the need to continue to implement our strategy, which has shown to be successful and value creating for shareholders; Barclays financial results in 2003 were very strong. The board was also conscious that Mr Barrett has only been with Barclays for four years and was keen to ensure we obtain maximum value from his contribution, given the success Barclays has enjoyed under his leadership.

The board thus considered that this particular combination of considerations at this particular time meant that Mr Barrett's appointment was in the best interest of shareholders.'[26]

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[26] 2003 Corporate Governance Report, Chairman's Statement, Barclays Plc Annual Report, 2003.

2. Ownership rights and control

The ability of shareholders to engage with directors of companies on issues concerning the stewardship of their investment is largely dependent on the rights accorded to them through company law and regulation. This may include provisions around access to information, participation at annual general meetings and voting rights.

Incorporation rights can give shareholders the power to intervene when there are perceived governance failures and thus enable them to exercise a degree of control in relation to their investment in a company. The proportion of shares held determines the degree to which shareholders may influence decisions through their voting power. In this respect, pre-emption rights provide an effective measure for ensuring that shareholders do not suffer from an erosion of control or influence when a company is raising new capital. While commonly accepted in the UK and most of Europe, pre-emption right provisions are not common in company law in the US, highlighting differences in approach to the role and power of shareholders between the two jurisdictions.

The *Pressure Points* consultation paper raises the following question:

Q9. Do pre-emption rights adversely affect competitiveness and are shareholders deterred from investing if a company does not provide such rights?

In considering this question, the following areas are relevant:

- Basic shareholder rights.
- Reasons for the importance of pre-emption rights.
- US and UK approaches to pre-emption rights.

2.1 Internationally accepted principles for shareholder rights

In legal terms, a shareholder is the entity or person whose name appears on the register of members. The commonly accepted basic rights of shareholders are described by the Organisation for Economic Co-operation and Development (OECD) in the *OECD Principles of Corporate Governance*:[27]

'Basic shareholder rights should include the rights to:

1) *secure methods of ownership registration;*

2) *convey or transfer shares;*

3) *obtain relevant and material information on the corporation on a timely and regular basis;*

4) *participate and vote in general shareholder meetings;*

5) *elect and remove members of the board; and*

6) *share in the profits of the corporation.'*

Both US and UK corporate governance systems allow for the purchase, transfer or sale of shares as fundamental basic rights. By contributing capital to a company, shareholders of ordinary shares may benefit from a distribution of the company's profits through dividends or through surplus assets when a company is wound up.

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[27] *OECD Principles of Corporate Governance*, OECD Publications, 2004.

The OECD principles also make reference to rights attached to decisions affecting fundamental corporate changes which include decisions about amendments to companies' articles of incorporation, the authorisation of additional shares and extraordinary transactions.

The European Commission's proposed directive on shareholder rights (published on 5 January 2006) is an example where minimum legal requirements for shareholder rights are being developed across borders. It includes proposals covering access to information relevant to general meetings, the exercise of voting rights by correspondence and by proxy and provisions for the abolition of share blocking (the obligation to deposit or block shares for a specified period before the annual general meeting (AGM) to be able to vote) and related practices.

2.2 The significance of pre-emption rights

The way in which shareholder rights differ between the US and the UK is a common theme throughout this paper. One example where there is a clear difference is in shareholder pre-emption rights. It is common for shareholders in the UK to have such rights but this is not the case in the US.

The fundamental objective of pre-emption rights is to provide a company's existing shareholders with protection from wealth transfer and erosion of control.[28] When new share issues are offered at a subscription price below the market price the overall effect is a dilution of the shareholders' existing holding. It can also lead to a dilution of control or influence through reduced voting rights. In recognition of this, section 89 of the UK Companies Act 1985 requires that when a company issues new shares it must offer them, as far as practicable, to existing shareholders in proportion to their shareholdings before offering them to other investors. This system is known as a rights issue because existing shareholders are given the right of first refusal.

It is common for companies in the UK to seek approval from shareholders to disapply pre-emption rights as provided for under section 95 of the Companies Act 1985. A 'section 89 disapplication' is routinely passed in the UK by special resolution at the AGM. This requires a 75% majority shareholder vote in favour of the resolution and generally includes permission to:

- Issue shares for cash up to 5% of the issued share capital in any one year or 7.5% in aggregate over three years.

- Make any rights issue under the requirements of the Listing Rules, rather than in compliance with the stricter requirements of section 89 of the Companies Act 1985.

In considering whether or not to approve a disapplication of pre-emption rights, UK shareholders are guided by a voluntary *Statement of Principles* issued by the Pre-emption Group whose members represent listed companies, investors and intermediaries.[29] The principles were published in May 2006 and supersede the *Pre-emption Guidelines* originally published in 1987. The new principles were introduced following a report[30] published in February 2005 by Paul Myners, former chairman of Gartmore Investment Management Ltd, which recommended that the original guidelines be reviewed. Mr Myners was commissioned by the DTI in 2004 to examine whether pre-emption rights have an adverse effect on a company's ability to raise capital which may impact on innovation and growth.

[28] 'The impact of shareholders' pre-emption rights on a public company's ability to raise new capital: An invitation to comment', Paul Myners, Department of Trade & Industry, November 2004.

[29] *Disapplying pre-emption rights: A statement of principles*, The Pre-emption Group, www.pre-emptiongroup.org.uk.

[30] 'Pre-emption rights: Final Report: A study by Paul Myners into the impact of shareholders' pre-emption rights on a public company's ability to raise new capital' Department of Trade & Industry, February 2005.

In the US, provisions for pre-emption rights were historically a common feature of company law in many states. Today, state law often does not oblige companies to establish pre-emption rights and companies are able to restrict such rights or simply ignore them. It is common practice for companies to include opt-out clauses in their constitutions (charters) reflecting the default position of the Model Business Corporation Act (MBCA), a model set of articles adopted in many US states. In this respect the MBCA states that:

'The shareholders of a corporation do not have a pre-emptive right to acquire the corporation's unissued shares except to the extent the articles of association so provide.'[31]

However, while company law in many US states provides relative flexibility for companies in relation to the use of pre-emption rights, the listing rules of the NYSE and NASDAQ limit share issues over a certain size without shareholder approval.

A commonly held view in the US is that the longer time period required to issue new shares with pre-emptive rights can hamper a company's ability to raise cash quickly, thus impeding growth and innovation. Other reasons why US companies may not provide for pre-emption rights are described in the February 2005 Myners report as follows:

- historically the complexity of structures and different types of shares and other securities meant that it was never easy to define which types of holding had pre-emptive rights attached and which did not. Attempts to define this with greater precision often resulted in what appeared to be arbitrary distinctions;

- disclosure requirements and lengthy offer periods associated with pre-emptive issues increased costs and uncertainty; and

- the fear from small shareholders that they might suffer abuse of power at the hands of the majority shareholder receded as the US common law on fiduciary duty developed. Thus the protection against abusive conduct provided by pre-emption rights was not needed since it could be provided by other means.

The US approach to pre-emption rights was described by Paul Myners as follows:

'It has been suggested to me that, putting it crudely, in the US the corporates and the financiers have the upper hand, and investors have the limited role of buying and selling without any particular commitment to the governance or long-term strategy of the companies in which they invest.

The law provides an effective remedy for shareholders who believe that they have been abused by the directors of a company they have invested in but, in cases of poor decision-taking rather than wrong-doing, the more obvious (and common) response is simply to dispose of the shares. The market is highly liquid making this a realistic prospect in most cases. It is this, rather than pre-emption rights, which 'keeps the directors honest'. This is explicitly recognised by the shareholders who could choose to opt in to pre-emption rights but almost invariably do not do so, apparently comfortable with the protection offered by market forces, the NYSE and NASDAQ upper limits and the legal obligations on directors. There is anecdotal evidence that some US investment groups would prefer to see pre-emption rights re-introduced, but they are not in a sufficiently powerful position to be able to achieve this.'[32]

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[31] 'Section 6.30, Model Business Corporation Act, 3rd Edition, 2003, American Bar Foundation.

[32] 'Pre-emption rights: Final Report: A study by Paul Myners into the impact of shareholders' pre-emption rights on a public company's ability to raise new capital', Department of Trade & Industry, February 2005, p. 16.

3. Board composition and shareholder influence

Shareholders in the UK have the right to appoint or remove a director on the basis of a simple majority of votes cast under section 303 of the Companies Act 1985. In the US, while there is a trend for companies to adopt their own version of majority voting the plurality voting system is most commonly used. Under plurality systems, it is not possible to vote against a director and an uncontested director can be elected on the basis of a single affirmative vote, regardless of the number of votes withheld.

The *Pressure Points* consultation paper raises the following question:

Q8. To what extent should shareholders be afforded powers to influence or determine the composition of boards?

In considering this question, the following areas are relevant:

- The powers of the board to appoint or remove directors.
- The rights of shareholders to appoint or remove directors.
- The director nomination process.

3.1 Director appointment and removal

In both the US and the UK the recommendation to reappoint a director, or fill a casual vacancy with a new appointment, is normally determined by the board. The power of the board to do so is provided for in company charters and generally enshrined in company law. In the UK, the company's notice of the AGM will include resolutions regarding the appointments and in the US this is provided for in a company's proxy statement. In terms of removing a director from office, again, this is generally conducted by the board and resolved by a majority of votes cast by board members.

While the powers of the board are similar in both the US and the UK in respect of the appointment or removal of directors, the same cannot be said for the rights of shareholders to influence the process. In the UK, shareholders have the right to appoint or remove (and replace) a board director by a simple majority of votes cast on an ordinary resolution (i.e. a majority of votes cast in favour at a meeting of the company). Each director is subject to a separate vote on an individual basis (i.e. not as a slate) and shareholders can vote either for or against each director, or abstain.

UK shareholders vote annually at the AGM on the election of one-third of the board under a staggered board member rotation system. The exception to this is at the first general meeting of the company when all directors must retire and submit themselves for re-election. In addition, any director appointed by the board to fill a casual vacancy must retire and submit themselves for re-election at the first annual meeting after their appointment.

In the UK, shareholders may requisition an extraordinary general meeting (EGM), provided they have at least 10% of the issued share capital according to section 368 of the Companies Act 1985. Shareholders may also requisition a resolution, provided they represent at least 5% of the voting rights, to be put forward at the general meeting, or they number at least 100 and hold shares on which there is an average amount paid up of at least £100 per member. Ultimately, UK shareholders can remove a director (or indeed an entire board) at any time.

In practice, requisitioning EGMs or putting forward shareholder resolutions to remove a director are rare in the UK, but nevertheless the threat of the use of these rights serves as an efficient check on board accountability to shareholders. The system is considered a democratic and meaningful process for director accountability to shareholders. As a result, other measures to influence board decision-making, such as the use of shareholder resolutions and litigation, are not common.

The law relating to the election of directors in the US is a matter governed by state corporation law. Historically, the law provided for majority voting but changed in the 1980s. Most states now follow guidance from the Model Business Corporation Act which provides that:

'Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election of a meeting at which a quorum is present.'[33]

While there is little in the legislative history that explains intent behind a movement away from a majority vote standard, the state of Delaware introduced the default plurality provision after a spate of takeovers and apparent concern around directors potentially losing their positions. Other reasons for the introduction of the plurality vote rule relate to the possibility of failed elections as described by Keith Johnson, chair of Reinhart Institutional Investor Services below:

'Concern about "failed elections" where there were more candidates than slots was a reason for the introduction of plurality voting. Without the provision it would be possible for some or all of the candidates to not receive a majority of votes. It also accompanied the authorization of cumulative voting for directors, which could result in some candidates not receiving a majority of votes. However, cynics also point out that the switch occurred during a time when institutional investors were first beginning to become active on corporate governance issues.'[34]

Under the plurality voting system an uncontested director is elected on the basis of a single affirmative vote regardless of the number of votes withheld. The US system of plurality voting does not enable shareholders to vote against the election of a director and they must instead rely on the number of votes withheld to express their dissatisfaction. Although not common, the exception to this is where shareholders force actions by written consent and call special meetings if the state company law or the company's Articles of Association allow.

Furthermore, US state law often provides for holdover directors where a director may remain on the board until a successor is named. This contrasts with the UK approach where, if a director is not re-elected, he or she may not be immediately re-appointed to the board.

In response to shareholder concerns, in June 2005 the American Bar Association's Committee on Corporate Law published a discussion paper, *'Voting by Shareholders for the Election of Directors.'*[35] The objective was to solicit opinion on the system of plurality voting and to consider possible changes to the Model Business Corporation Act. In a paper for the ICAEW transatlantic roundtable in 2005 in Washington DC, Ira M. Millstein, Senior Partner, Weil Gotshal & Manges LLP, provided his views on the discussion. Along with the responsibility of the board to remove directors, he advocates more shareholder power to select and remove directors in the US:

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[33] Section 7.28, Model Business Corporation Act, 3rd Edition, 2003, American Bar Foundation.

[34] Email correspondence from Keith Johnson to the author, 12 May 2006.

[35] 'Committee of Corporate Laws Discussion paper on the Voting by Shareholders for the Election of Directors', Section of Business Law, American Bar Association (ABA), June 22, 2005. The discussion paper does not represent the policy of the ABA and has been released solely for discussion purposes.

'US corporate governance, if it is to result in a meaningful shift in power, will need to evolve to give shareholders greater rights to selection and removal. The conditions for this evolution are now ripe – ownership is increasingly concentrated in the hands of institutional investors and away from dispersed shareholders. It is possible that power with respect to board composition could shift to institutional investors and away from management and the board (although power to run the company day-to-day will, and must, remain with management).

The business community may point to the UK experience (where the right to remove is rarely exercised in practice) to further an argument as to why those rights should not be granted in the US. This would be a simplistic argument, as the existence of these rights gives shareholders the ability to conduct a constructive dialogue with the board, enabling them to achieve their objectives without requiring actual exercise of the rights. It may be that possessing the right negates the need to actually exercise it very often. However, real rights of selection and removal should not be granted unless institutional investors demonstrate that they can, and will, exercise such rights in a responsible fashion.'[36]

Since increased discussion of the US plurality system of director elections began there has been a general mood for voluntary change among US companies. Many companies have responded to resolutions in favour of majority voting and amended company charters to adopt a version of the majority system. These companies include Pfizer, Hasbro, Tyson Foods, Emerson Electric, Lockheed Martin, and The Walt Disney Company. In most cases company charters have been amended so that a director must submit a resignation if a majority of votes are withheld against him or her. The board would then consider how to respond.

In the US, there is also an increasing trend for companies to move away from a staggered system of board elections (where directors are voted on in different cycles) and instead have annual elections of all directors at the same time. Annual elections make it easier for shareholders to voice opinion and provide a regular opportunity for the board to evaluate its composition and consider if there is a need for it to be refreshed. In 2004, 56% of S&P 500 companies had staggered boards compared to 63% in 2002.[37]

3.2 Director nomination

In the UK, shareholders have a basic right to nominate a director and can include a resolution at an AGM under section 376 of the Companies Act 1985. In practice this is a rare occurrence. Nevertheless the legal right to influence the process can send strong signals of dissatisfaction to a board. A simple majority is all that is required to pass a resolution to nominate a director which is binding upon the company.

In the US, the shareholder solicitation rules allow a company to exclude shareholder proposals related to the election of new directors from the management proxy statement. The practical effect of this is that shareholders wishing to propose nominees to the board must pay the costs connected with soliciting other shareholder support. This is compounded by the ability of companies to counter-solicit by sending out additional communications to all shareholders disagreeing with the shareholder proposed alternative slate.

In 2003, the SEC proposed Exchange Act Rule 14a-8 regarding the way shareholders communicate with boards. Its proposed purpose is to give shareholders a more effective role in the director election process and improve dialogue with boards. The proposed rule would require companies to include in their proxy materials shareholder nominees for the election of directors. The SEC also proposed that companies should state how

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[36] 'Future Steps', Ira M. Millstein, Weil Gotshal & Manges. Paper prepared for the ICAEW *Beyond the myth of Anglo-American corporate governance* roundtable, Washington DC, 6 December 2005.

[37] Investor Responsibility Research Center Report.

shareholders can communicate with the board in relation to nominees and that the board should state how they have chosen specific candidates.

The proposed SEC rule is aimed at promoting better access for shareholders to the proxy statement but the requirements would only be triggered by the occurrence of one of the following two events at annual general meetings:

(1) shareholders withhold 35% or more of the votes cast from at least one of the company's nominees for election to the board for whom the company solicited proxies; or

(2) a proposal submitted by shareholders holding more than 1% of the company's voting securities for at least one year is approved by more than 50% of the votes cast.[38]

The company would be required to include a shareholder nominated director in the management proxy statement if the shareholder putting forward the nominee met requirements outlined by the SEC. The nominee would also need to satisfy criteria of board membership under state and federal law and any relevant requirements from the relevant stock exchange.

[38] 'Security holder director nominations', SEC Proposed Rules Archives, Release No IC-26206, October 14, 2003.

4. Shareholder engagement practices

Governments and regulators in both the US and the UK encourage institutional shareholders to take an active role in corporate governance to discharge their fiduciary responsibilities to their beneficiaries. The effectiveness of engagement can often depend on the method of engagement, for example the use of shareholder proposals, and the regulatory environment. However, critics of shareholder engagement point to a lack of clear evidence that it leads to enhanced corporate performance.

The *Pressure Points* consultation paper raises the following questions:

Q5. How does shareholder oversight and engagement actually improve the corporate governance and performance of companies in both markets?

Q7. How effective are shareholder proposals as a means of influencing the governance of companies?

In considering these questions, the following areas are relevant:

- Common areas of shareholder concern.
- Communication between shareholders and boards.
- The use of shareholder proposals.
- Voting procedures and proxies.

4.1 Identifying issues of shareholder concern

In both the US and the UK, most institutional shareholders have clear policies as to how they will proceed with an engagement strategy if there are concerns about the corporate governance of the companies in which they invest. This commonly includes direct communication with the company, using the media if the issue is not resolved, submitting shareholder resolutions or ultimately selling their shares.

The engagement process often begins with research to identify companies which may have governance problems and have the potential for improvement. Often this is around issues relating to financial policies, board structure and business strategy as described in the example below from the UK's University Superannuation Scheme (USS).

'USS will engage with companies in which it invests on occasions when it thinks it is in members' long-term interests and will endeavour to identify problems at an early stage to minimize any loss of shareholder value... Instances when USS may intervene include when we have concerns about:

- *The company's strategy*
- *The company's operational performance*
- *The company's acquisition/disposal strategy*
- *Independent directors failing to hold executive management to account*
- *Internal controls failing*
- *Inadequate succession planning*
- *An unjustifiable failure to comply with the Combined Code*
- *Inappropriate remuneration levels/incentive packages/severance packages*
- *The company's approach to corporate responsibility'* [39]

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[39] 'Voting and Engagement Policy', University Superannuation Scheme Ltd, 2004.

A number of organisations annually identify companies that should improve governance practices and compile public lists. For example, the US Council of Institutional Investors, a membership organisation of large pension funds, highlighted 25 underperforming companies in its 15th annual Focus List.[40] Companies are chosen for the list based on their total share returns relative to the industry average.

In other instances corporate governance rating methodologies have been created to enable benchmarking between companies in the same index or industry group. Institutional Shareholder Services, a proxy voting and advisory service, developed its Corporate Governance Quotient (CGQ),[41] a corporate governance rating system and database:

'To generate a CGQ for each company, ISS use publicly available documents and website disclosure to gather data on 63 different issues on the following four broad rating categories: (1) board of directors, (2) audit, (3) anti-takeover, and (4) compensation and ownership. Based on this information and a scoring system developed by an external advisory panel and ISS, the next step is to calculate a CGQ for each company. While each variable is evaluated on a standalone basis, some variables are also looked at in a combination under the premise that corporate governance is improved by the presence of selected combinations of favourable governance provisions.

Each company's CGQ is compared with other companies in the same index and industry group. All scores are relatives and expressed on a percentile basis, comparing the company to a Relevant Market Index and an industry peer group.'

Credit rating agencies also play a significant role in the rating of a company's governance standards. For example, Standard & Poors measures corporate governance through indicators[42] relating to:

- concentration, influence and transparency of ownership;
- shareholder rights and stakeholder relations;
- information transparency, disclosure and audit; and
- board structure and effectiveness.

4.2 Board and shareholder communication

Market regulations in both countries govern the timeliness of the reporting of information to shareholders to ensure equality of access to information which may affect investment decisions. Corporate governance guidelines on both sides of the Atlantic recommend increased transparency and disclosure around corporate governance practice to encourage communication.

In the UK, the Combined Code recommends that:

'The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders…'[43]

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[40] '2005 Focus List' Council for Institutional Investors.

[41] 'ISS Corporate Governance: Best Practices User Guide & Glossary – Corporate Governance Quotient,' Institutional Shareholder Services, 27 September 2005.

[42] Corporate Governance Evaluation and Scores, Standard and Poor's Rating Services.

[43] Combined Code on Corporate Governance, Provision D.1.1, Financial Reporting Council, 2003.

[44] 'Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors,' Release No. IC-26145, 8 August 2003.

In the US, SEC rules introduced in 2003 require enhanced shareholder communication including disclosure of whether or not a company has a process for communication and disclosure of director attendance at AGMs.[44]

In general, institutional shareholders in the UK engage with companies behind the scenes, perhaps reflecting British reservations about public displays of disagreement. The relatively high concentration of shares held in individual companies by comparatively few shareholders enables them to influence board decision-making. It is also common for major institutions in the UK to co-ordinate their responses to company proposals and intervene jointly on particular issues. This is often assisted through representative bodies such as the Association of British Insurers, the National Association of Pension Funds and the Investment Management Association. The cohesiveness of the UK approach was referred to by Tony Watson, former Chief Executive of Hermes Pensions Management Ltd in the UK, as follows:

'Investors in the UK have the ability to talk to each other and propose joint action without triggering concert party conditions that could require a takeover bid. The UK really is one of the most fertile markets in the world for involved, responsible, shareholder friendly investment.'[45]

In the US, while there is direct communication between shareholders and boards it is less substantive than in the UK. This may be attributed to restrictions arising from Regulation Fair Disclosure, introduced by the SEC in 2000, which limits communication with individual shareholders. Shareholders tend to act more independently and are less averse to having their views known in public, through the media. This approach is highlighted by Professor Bernard S. Black as follows:

'Co-ordinated shareholder activism is rare. Instead each institution acts as a lone wolf, and the institutions stay out of each other's way – two institutions try not to target the same firm in the same year. This practice contrasts sharply with Great Britain where co-ordinated institutional investors often approach a company jointly, to increase their influence (Black and Coffee 1994).'[46]

One of the biggest differences between US and UK shareholder communication is that US shareholders are obliged to follow SEC rules governing communication with each other on voting issues, which is not the case in the UK. The objective is to avoid concert parties in relation to a proposal being put forward by the company. If shareholders acting together collectively hold more than 5% of the issued share capital they must file Form 13-D with the SEC. This requires a summation of any content of the correspondence after communication has occurred. Any omission of information can result in litigation from either the company or other shareholders.

In a practical sense, the sheer size of the US in terms of geography and population can also impact the effectiveness of communication amongst shareholders. US investment activity occurs across many cities in different time zones whereas in the UK, much of the activity takes place in the City of London. This naturally affects the extent to which informal networks between investors can develop and ultimately affects public and private engagement with boards.

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[45] 'Shareholder Activism Worldwide', Speech to a Brandes Investment Conference, California, November 2002.

[46] 'Shareholder activism and corporate governance in the United States', Professor Bernard S. Black, Columbia University, 1997.

4.3 The use of shareholder proposals

While the formal use of shareholder proposals is not common in the US and the UK, the threat of a proposal can be a catalyst for change. The extent to which they are effective relies on the degree of dialogue between shareholders and the company as a result of a proposal being put forward. Often disagreements are resolved and the proposal withdrawn before being put to a vote.

To submit a shareholder proposal in the US, shareholders must own for at least one year, $2,000 in market value of share; or 1% of the company's issued share capital, whichever is less. If these criteria are met, shareholders may approach a company to include a proposal (plus a statement of up to 500 words) with the company's proxy statement under SEC Rule 14a-8.

A company is obliged to include a proposal, and bear the costs of circulation, as long as it falls into one of a number of categories and is not considered 'ordinary business', i.e. decisions entrusted to management. Some common examples of shareholder proposals allowed by the SEC include proposals concerned with the use of poison pills or staggered boards.

If a company wishes to refuse the inclusion of a shareholder proposal it must seek permission from the SEC. If the SEC agrees with the company, it will respond with a 'No-Action' letter to the company, indicating that it does not intend to take any action against the company for excluding the proposal. If the SEC decides that the proposal should be included, a letter to that effect is sent to the company.

Shareholders wishing to put forward proposals which do not meet criteria outlined in SEC Rule 14a-8 must pay the often significant costs connected with soliciting other shareholders' support. This is compounded by the ability of companies to counter-solicit and trigger a 'proxy fight' by sending out additional communications to shareholders disagreeing with the shareholders' alternative proposal.

In the UK, shareholders have the right to present a resolution at the AGM provided they have support of 5% of the votes, or if there are at least 100 shareholders who hold shares in the company on which there has been paid up, on average, not less than £100 per shareholder. While the minimum thresholds enabling shareholders to put forward resolutions in the UK are higher than those required by the SEC in the US, they are rarely used. This may be due to provisions in the Companies Acts which accord rights to shareholders through other means (e.g. the ability to remove a board director) to influence board decision-making.

4.4 Voting procedures and proxies

In the US, all votes (including proxies) are counted as being cast including votes 'for', 'against' and 'withheld'. This contrasts with the UK approach were only votes 'for' and 'against' are counted as being cast. Votes 'withheld' are not counted and proxies are excluded unless a poll is called. It is common practice in the UK for shareholders to 'abstain' from voting if they do not fully support a resolution but equally do not feel strongly enough to cast a vote 'against.' It is becoming increasingly common for companies to include a vote 'withheld' box in their proxy cards with 92% of FTSE 100 companies including the option in 2005.[47]

In the US, organisations such as Institutional Shareholder Services provide proxy voting and research services. The proxy service providers can advise companies on the likely outcome of a vote if a formal proposal is put forward by shareholders. They may also

[47] 'Review of the impediments to voting UK shares – an update on progress', a report by Paul Myners to the Shareholder Voting Working Group, November 2005.

advise shareholders on how to vote. The use of proxy service providers can sometimes help facilitate agreement between companies and shareholders before a formal proposal is put forward. Proxy service providers can influence the outcome of proxy fights in the US and are becoming increasingly prominent. This was highlighted by Professor Bernard S. Black:

'An important factor in whether a proposal wins majority shareholder support is the recommendation of Institutional Shareholder Services, a private consulting firm that provides proxy voting advice and voting services to institutional investors. Between the shares that ISS votes on behalf of clients, and the shares held by institutions that follow ISS's recommendations, an ISS recommendation can make a 15-20% difference in the support that a shareholder proposal receives. As a result, shareholder proponents often tailor their proposals to meet ISS's guidelines on which proposals it will support, and devote significant effort in convincing ISS to support their proposals.'[48]

In the UK, the most common method of voting is by a show of hands at the AGM. In principle 'one share, one vote' is the system by which resolutions are voted upon but this is restricted to the shareholders in actual attendance at the AGM. Unless a poll is called and proxies are counted, voting by a show of hands can skew power to the small number of shareholders present regardless of their shareholding. Proxy votes can effectively be legally ignored unless the chairman (or not less than five members) calls a poll under section 373 of the Companies Act 1985 and subject to provisions in the company's Articles of Association.

UK shareholders have been criticised for being apathetic in their approach to attending AGMs and not always actively voting their shares on routine issues. However, there is evidence that voting levels have increased. Manifest reported that the average voting level for FTSE 100 companies in the year to August 2005 was 59%, up from 54% in 2003.[49] In the US, the onus is on the company (under state law and stock exchange listing rules) to ensure that at least a majority of shares are voted.

In 2004, Paul Myners produced a report[50] into the impediments to shareholder voting and recommended that shareholders be encouraged to register their votes even if wishing to 'withhold'. The FRC is currently considering whether to amend Section D.2 of the Combined Code to *'provide shareholders voting by proxy with the option of withholding their vote, and to require the publication of details of proxies lodged at the AGM where votes are taken on a show of hands.'*[51]

4.5 The value of shareholder engagement

In pursuing an engagement strategy, institutional shareholders do not intend to usurp the responsibilities of the board. Instead, shareholders will generally engage with companies when there are deemed to be governance problems which may impact on the value of their beneficiary's investments. In this way, institutional shareholders can play a part in aligning the interests of the beneficial owners of shares with those of the directors.

Critics point to a number of problems of engagement, in particular the costs of implementing engagement strategies versus the rewards. In this respect the 'free rider' problem is often referred to where all shareholders benefit from the engagement efforts

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[48] 'Shareholder activism and corporate governance in the United States', Bernard S. Black, Professor of Law, Colombia University, November 1997.

[49] Figures quoted in 'Review of the impediments to voting UK shares – an update on progress', a report by Paul Myners to the Shareholder Voting Working Group, November 2005.

[50] 'Review of the impediments to voting UK shares', a report by Paul Myners to the Shareholder Voting Working Group, January 2004.

[51] Consultation on possible amendments to the Combined Code, Financial Reporting Council, 2003.

of a few who bear all the costs. Fund managers must also justify devoting time to specific companies when they may hold a wide range of shares in their investment portfolio.

Other difficulties include a general lack of business experience of shareholders to engage with directors on business matters, although there are exceptions. For example, Hermes[52] in the UK has dedicated significant human resources to its Focus Funds with around 50 individuals experienced in business and investment. Also there are now a number of outsourcing services for corporate governance engagement in the UK. For example, the Wellcome Trust, the largest UK charity (with a £3bn investment portfolio) has outsourced corporate governance activities to Insight Investment and the British Coal Staff Superannuation Scheme (with a £6bn investment portfolio) has outsourced corporate governance oversight to Hermes' Equity Ownership Service.

A number of studies have been conducted to determine how shareholder engagement impacts on company performance and there is much debate around how it ultimately affects share prices. For example many studies have focused on variables such as:

1. whether or not the level of institutional share ownership affects company performance by comparing companies with high levels of institutional shareholding to companies with lower levels;

2. whether or not specific tools of engagement (such as the use of shareholder proposals) positively impact on company performance;

3. whether or not engagement affects share price fluctuations by comparing the share price before and after engagement.

Some views on shareholder engagement in the US are described below by Robert C. Pozen, Chairman of MFS Investment Management:

'A few critics would severely restrict stockholder activism because of their belief that the financial impact of activism on target companies is doubtful. These critics emphasize the dominant role in stockholder activism of public pension plans as opposed to mutual funds and other private investors. In the view of these critics this dominance suggests that much stockholder activism is motivated more by the political or personal goals of public pension plan officials than by the financial interests of their pension beneficiaries. However, the supporters of stockholder activism by public pension plans emphasize that the corporate targets of their activism are selected on the basis of low scores on objective financial measures and not on the basis of any political criteria. They also note that the costs of stockholder activism are miniscule relative to the size of such pension plans; for example, the annual cost of CalPERS' stockholder activism program is roughly $500,000 per year, or 0.002% of the plan's assets. Moreover, supporters point to a few studies showing positive financial results from activism by CalPERS and TIAA-CREF, critics, of course, challenge the methodological validity of these studies.'[53]

Ultimately, the highest potential benefit of engagement to the clients of institutional shareholders is a rise in the price of shares resulting in increased financial returns. To an extent, this can be best exemplified in the case of institutional shareholders who can demonstrate higher returns in the funds in which they actively engage. In this respect, funds such as the Hermes' Focus Funds invest in poorly performing companies with the specific intention of using their ownership and their shareholder rights to encourage improvements that they consider will improve the value of their investments.

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[52] Hermes Pensions Management Ltd is wholly owned by the BT Pension Scheme and has assets under management of approximately £44 billion.

[53] *The Mutual Fund Business*, Robert C. Pozen, 2nd Edition, Houghton Mifflin, 2001, p. 500, © Houghton Mifflin Company.

An example of this approach is the engagement of Hermes with Premier Oil. The background to the company and main engagement issues were as follows:

- The capital structure was dominated by two shareholders, each with a 25% holding. The company was also overburdened with debt. The engagement strategy was to create more independence from the dominant shareholders and cut debt.

- The board was not sufficiently independent with six of the eight non-executives not meeting independence criteria. The engagement strategy was to remove some non-executive directors and introduce new ones.

- The company was the largest UK investor in Myanmar (formerly Burma) causing concerns about risk management. Hermes requested that the board either exit the country or justify the risk taken by having a presence there.

- Strategically the company was locked into mature assets. Hermes recommended that the company exited mature assets, slim down and refocus on lighter exploration and production activities.

The evidence of the effect of this engagement is presented below in the price comparison of Premier Oil shares in relation to both the FTSE All Share Price Index and the FTSE Oil and Gas Sector.

Figure 1: Hermes engagement with Premier Oil[54]

[54] Information on Hermes engagement strategy with Premier Oil and the graph were provided by Hermes Pensions Management Ltd.

Useful contacts

United Kingdom

Accounting Standards Board – www.frc.org.uk/asb

Association of British Insurers – www.abi.org.uk

Auditing Practices Board – www.frc.org.uk/apb

Bank of England – www.bankofengland.com

Companies House – www.companieshouse.gov.uk

Confederation of British Industry – www.cbi.org.uk

Department of Trade & Industry – www.dti.gov.uk

Financial Reporting Council – www.frc.org.uk

Financial Reporting Review Panel – www.frc.org.uk/frrp

Financial Services Authority – www.fsa.gov.uk

Her Majesty's Treasury – www.hm-treasury.gov.uk

Hermes Pensions Management Ltd – www.hermes.co.uk

Institute of Chartered Accountants in England & Wales – www.icaew.co.uk

Institute of Chartered Secretaries and Administrators – www.icsa.org.uk

Institute of Directors – www.iod.com

Investment Management Association – www.investmentuk.org

London Stock Exchange – www.londonstockexchange.com

National Association of Pension Funds – www.napf.co.uk

Pensions & Investment Research Consultants Limited – www.pirc.co.uk

United States

American Bar Association – www.abanet.org

American Institute of Certified of Public Accountants – www.aicpa.org

American Stock Exchange – www.amex.com

Business Roundtable – www.brtable.org

CalPERS – www.calpers.ca.gov

Caux Round Table – www.cauxroundtable.org

Conference Board – www.conference-board.org

Corporate Library – www.thecorporatelibrary.com

Council of Institutional Investors – www.cii.org

Financial Accounting Standards Board – www.fasb.org

Global Proxy Watch – www.davisglobal.com

Governance Metrics International – www.governancemetrics.com

Institutional Shareholder Services – www.issproxy.com

Investor Responsibility Research Consultancy – www.irrc.org

NASDAQ – www.nasdaq.com

National Association of Corporate Directors – www.nacdonline.org

National Association of Securities Dealers – www.nasd.com

National Association of State Boards of Accountancy – www.nasba.org

New York Stock Exchange – www.nyse.com

Public Company Accounting Oversight Board – www.pcaob.org

Securities and Exchange Commission – www.sec.gov

Securities Lawyer's Deskbook – www.law.uc.edu/CCL

TIAA-CREF – www.tiaa-crefinstitute.org

International

Commonwealth Secretariat – www.thecommonwealth.org

European Commission – http://ec.europa.eu/index_en.htm

European Corporate Governance Institute – www.ecgi.org

Global Corporate Governance Forum – www.gcgf.org

Global Reporting Initiative – www.globalreporting.org

International Accounting Standards Board – www.iasb.org

International Corporate Governance Network – www.icgn.org

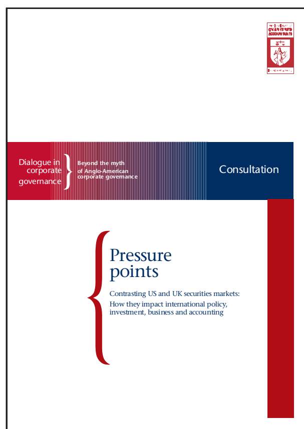
International Finance Corporation – www.ifc.org

International Monetary Fund – www.imf.org

Organisation for Economic Co-operation and Development – www.oecd.org

World Bank Group – www.worldbank.org

Pressure Points consultation and other discussion papers

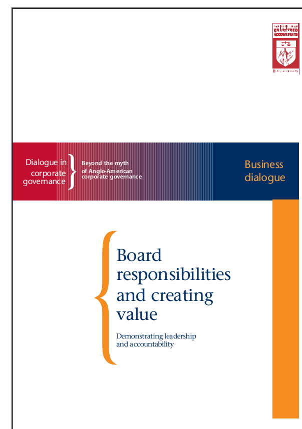


Pressure Points: Contrasting US and UK securities markets: How they impact international policy, investment, business and accounting

Discussion around the similarities and differences between US and UK systems of corporate governance challenges the commonly held presumption of an Anglo-American model. This consultation paper summarises key questions around how policy makers encourage business and investor confidence; how companies are directed and controlled and how disclosure and reporting requirements are framed and enforced.

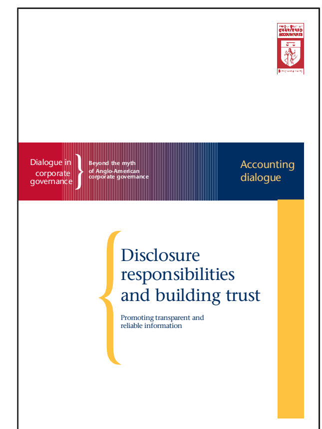
Policy dialogue:
Effective corporate governance frameworks – encouraging enterprise and market confidence

Effective corporate governance frameworks promote prosperity, market confidence and public trust. The US and the UK are amongst the world's most successful economies, each with a strong tradition of corporate governance. This paper explores how policy makers are challenged with striking the right balance between market forces and regulation in supporting internationally recognised corporate governance principles of responsibility, accountability, transparency and fairness.



Business dialogue:
Board responsibilities and creating value – demonstrating leadership and accountability

Boards of directors are responsible for acting in the long-term best interests of the company for the benefit of shareholders. Effective boards require skilled leadership, balanced decision-making, informed risk-taking, good judgement and integrity. This paper explores how US and UK boards operate differently, and the role, responsibilities and powers of directors in each jurisdiction.



Accounting dialogue:
Disclosure responsibilities and building trust – promoting transparent and reliable information

The disclosure of meaningful, reliable and timely information to shareholders is of fundamental importance for informed investment decision-making and market confidence. High levels of financial disclosure are characteristic of both US and UK corporate governance models. This paper explores the role of the accountancy profession in helping to facilitate the flow of capital through transparent, efficient and trusted information.

Dialogue in corporate governance

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