

Taking stock

Since the financial crisis, governance has come under the spotlight for issuers and investors alike. Demi Derem of Broadridge explains how it can best be navigated.

Governance has emerged as the signature risk of the post-financial crisis era in Europe. The 2008 recession brought in its wake costly bank failures, bailouts, and write-offs of bad debts, followed by tense debt renegotiations in several nations. These events severely eroded investor confidence.

More recently, hotly contested “say on pay” votes, legal and regulatory controversies, and outright scandals have also taken their toll.

To navigate this uncertain, fast-changing environment, issuers and investors need accurate, comprehensive governance data, both quantitative and qualitative, to develop clear, timely, and actionable insights into the governance of European corporations.

There is a growing need for this information because the 2008 crisis spurred significant changes in the asset management industry. Historically, family offices, institutions, and sovereign wealth funds—referred to collectively as “institutions” in this article—tended to manage risk by diversifying both their portfolios and their asset managers, while delegating their governance oversight to proxy advisory firms.

Since the crisis, however, many institutions have concluded that diversification alone cannot insulate institutions from financial and non-financial governance risk.

To adapt, many institutions have stepped up their efforts to monitor the governance of the



companies whose shares fill their portfolios. It's not an easy job. Large portfolios typically hold the securities of hundreds of different issuers, and keeping track of them all—the composition of the issuers' boards, their executive remuneration practices, the timing and agendas of their annual meetings—has become increasingly complex.

Investors have an acute need for comprehensive, objective,

1 Oversight

Can a director provide the necessary stewardship and oversight?

Directors can't be expected to do their jobs properly if they are not fully informed about the companies they are paid to oversee. So investors need to know how far a director's span of control and oversight extends.

Membership on too many boards is a red flag—a signal that a director's energy and attention are spread too thin to enable

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and predictive information about how their portfolio companies are run and about the people running them. They also need to ask the right questions to elicit the information they need to monitor their portfolios and manage governance risk.

There are four key questions that both investors and issuers need to address.

effective oversight. Issuers and investors also need to be able to spot “interlocks”: the potential conflicts that arise when directors or executives of two companies sit on one another’s boards.

There is nothing inherently wrong or unethical about interlocks, but they do make it possible to transmit material, non-public information among companies, raising the risks of insider trading or cartel-like behaviour.

The risk of legal or regulatory action also increases, exposing issuers and investors to financial and reputational losses.

When you can identify interlocks, you can guard against any potential conflicts of interest. It’s an important risk-management tool.

2 Impact

Are a company’s executive and board pay practices sustainable, socially responsible, and in line with industry benchmarks?

Executive remuneration has emerged as a high-profile topic in recent years. Today’s investors want to know not only if remuneration is in line with industry benchmarks, but also if pay practices raise questions about an issuer’s commitment to social responsibility or sustainable value creation.

For example, does an issuer’s record reveal pronounced gender-based pay disparities? Are incentives structured to reward short-term results rather than long-term success?

Middling financial performance, combined with outsized, badly aligned pay packages, may be an indicator of heightened risk—investors are adjusting their portfolios accordingly.

And they’re not only adjusting their portfolios. Thanks to recent regulatory changes, investors in European companies can now express their approval or disapproval of pay practices through votes at annual meetings.

Although such “say on pay” votes have produced few victories for opponents of management, strong showings by opponents at several well-known European companies signal a widespread lack of confidence in some boards.

The votes have also taken a toll on share prices. These high-stakes contests illustrate why issuers and investors need access to comprehensive, transparent information about pay practices at individual companies and the tools to benchmark those practices against industry norms.

3 Risk visibility

Do institutions have adequate visibility into the governance risks facing issuers—including non-financial risks?

Recent scandals at several well-known European companies have made governance front-page news and focused attention on board and director performance.

Directors and executives need to ask not only if the company is doing well, but why it’s doing well. Sometimes they’re unwilling to look into the reasons for a sudden surge in performance by a company, division or product.

That success might be built on a short-term, unsustainable foundation. That is why investors need directors and management who are willing and able to look closely into the root causes of

corporate successes—as well as failures. Either of these can be a sign that something is not quite right at the company.

It all comes down to the people at the top of the corporation, the senior executives and directors. Are the people on the board and executive committee competent? Are they ethical? Do they have the right level of focus to steer the ship and identify bad practices? Are they conflicted?

To answer those questions, investors require deep insight into the individuals who make up the top executive ranks and the board.

ABOUT DIRECTORINSIGHT

Good information is the foundation of good governance, and enables companies and institutional investors to make informed decisions. Broadridge DirectorInsight is a one-stop, interactive corporate governance data and analytics solution. It provides smart, predictive insight and an independent platform for analysing governance risks, executive pay and benchmarking through a pay-for-performance screening tool, board intelligence, company financials, filings and interlocks.

4 Insight

Do institutions have sufficient company-specific insight into board elections, shareholder resolutions, and other proxy matters to enable well-informed voting?

Proxy statements give shareholders a valuable opportunity to learn whether a company has robust corporate governance and strong management.

Investors can gauge the quality of the management team both by financial results and by how well the team communicates the corporate strategy.

And shareholders can determine whether directors have

the best interests of shareholders at heart by scrutinising how they reward management, how they engage shareholders, and how they respond to shareholder proposals.

The annual meeting is where all these questions come together. Institutions, therefore, need information about annual meetings, the questions on the proxy ballot, and pay practices, in order to vote wisely and protect

their investments.

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Partnership

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