The Five Governance Questions Issuers and Investors Need to Ask

Governance has emerged as the signature risk of the post-financial crisis era in Europe. The great 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 alike need accurate, comprehensive governance data, both quantitative and qualitative, to develop clear, timely, and actionable insights into the governance of European corporations.

GOVERNANCE RISK IS THE SIGNATURE RISK POST-CRISIS ERA IN EU

Creates need for ››

COMPREHENSIVE DATA – QUANTITATIVE AND QUALITATIVE

to deliver ››

ACTIONABLE INSIGHTS INTO GOVERNANCE OF EU 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” for the purposes of 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 nonfinancial 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 scores or even 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, 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.

We spoke with Demi Derem, managing director for investor communications solutions international at Broadridge Financial Solutions, about what institutions need to know to manage governance risk effectively. A veteran of the asset management industry, Derem has firsthand experience of its evolution and has helped many clients develop risk-management strategies. Here are the five key questions that he believes institutions and issuers need to ask.

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WHAT INSTITUTIONS NEED TO KNOW TO MANAGE GOVERNANCE RISK EFFECTIVELY

- Necessary Stewardship and Oversight
- Executive and Board Pay Practices
- Visibility into Governance Risks Facing Issuers
- Company-specific Insight for Wise Voting
- Resources for Good Decisions on Governance

1. 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. Derem suggests that membership on too many boards is a red flag that signals that a director's energy and attention are spread too thin to enable 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, nonpublic information among companies, raising the risks of insider trading or cartel-like behavior. 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 potential conflicts of interest," Derem said. "It's an important risk-management tool."

2. 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. Reflecting heightened concern about reputational and governance risk management, 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, might be an indicator of heightened risk," Derem said. "Investors are adjusting their portfolios accordingly."

And they're not just 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 vividly 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. Do institutions have adequate visibility into the governance risks facing issuers—including nonfinancial 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," Derem said. "Sometimes they're unwilling to look into the reasons for a sudden surge in performance by a company or a division or a 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 can be a sign that something is not quite right at the company.

KEY FACTORS – BOARD OF DIRECTORS / EXECUTIVE COMMITTEE

Senior Executives and Directors

- COMPETENCE
- ETHICS
- LEVEL OF FOCUS
- POTENTIAL CONFLICTS

To Derem, 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?" he asked. "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.

4. 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 scrutinizing 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," Derem said. Institutions therefore need a single source of information about annual meetings, the questions on the proxy ballot, and pay practices to vote wisely and protect their investments.

5. What are the resources needed to ensure that issuers and institutions can make good decisions on governance?

With portfolios growing more complex, issuers and institutions face a stiff challenge making informed decisions and engaging effectively with one another. A one-stop, interactive corporate governance data and analytics solution, accessible via mobile device or desktop, would be a valuable tool for managing that complexity. Such a tool should provide an independent platform for analysing governance risks, executive pay, and benchmarking and be capable of generating predictive insight. It should also be capable of screening for pay-for-performance misalignment over multiple years, board composition, over-boarding, director expertise and interlocks, and broader company-level governance practices.

About DirectorInsight

Good information is the foundation of good governance and what companies and institutional investors need to make informed decisions. DirectorInsight is a one-stop, interactive corporate governance data and analytics solution, providing smart and 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.

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