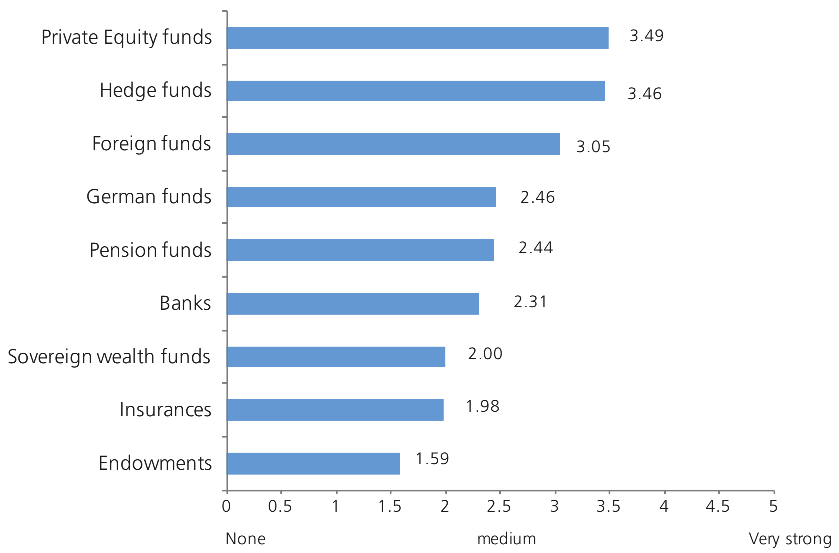
Shareholder Democracy – Reality or Wishful Thinking?

An active shareholder democracy can only work with constructive critical dialogue

Twenty-five years after the introduction of the Cadbury Code, which significantly advanced the development of corporate governance in continental Europe, the discussion of good and responsible corporate governance is entering a new round.
By Petra Nix

Fig. 1: Impact of institutional investors on corporate governance – a ranking



Source: PETRANIX AG

So far the traditional, primarily legal perspective – which aims above all at compliance – has prevailed. In practice, experience shows that listed Swiss companies have done their homework in this regard. Plans for better corporate governance and shareholder democracy predict a more active role for institutional investors in supervising listed companies.

Investors are becoming more active

The term "active investors" often carries a negative connotation. It is swiftly associated with financial investors who play hardball with company management to push through their goal of short-term profit maximization, who hinder bosses from effecting stable, long-term company policies, and who crave for dividend payments or share buybacks. But what role could institutional investors really play?

Initiatives to accelerate investor engagement are starting to bear fruit, in particular concerning the exercise of voting rights. Shareholders of Swiss companies are increasingly exercising their right to vote. Investor participation has especially grown among minority shareholders: it almost doubled from 33.1% in 2010 to 60.7% in 2016. Moreover, these investor groups are often more openly critical than major shareholders.

Dialogue-oriented corporate governance communication

Current efforts around active investor engagement are steering a course of constructive, critical dialogue. Direct communication between institutional investors and boards of directors offers added value for both sides. On the one hand, investors can gain a better impression of whether the board has the right composition and is working effectively. On the other hand, the board has the opportunity – within the permitted regulatory framework – to win investors over to individual corporate

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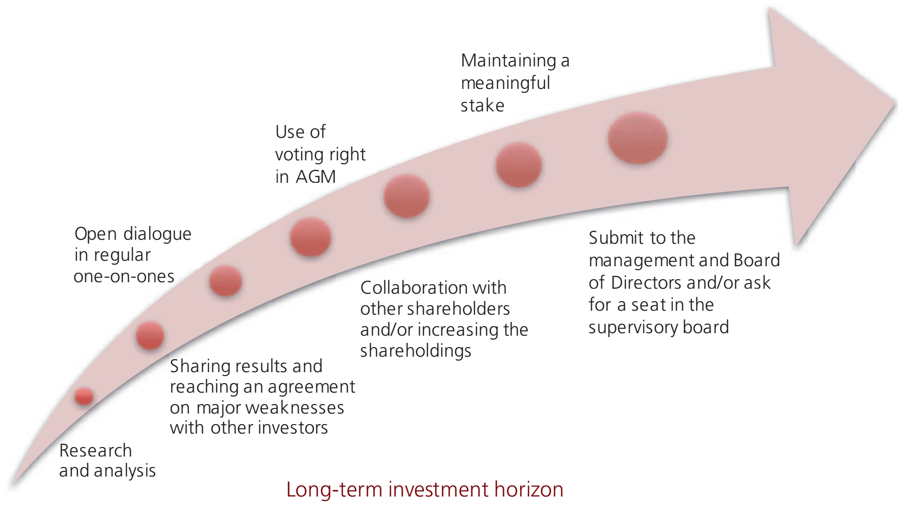
Fig. 2: Escalation strategies for institutional investors



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governance solutions. Such topics of dialogue are, for example:

- the composition, organization and functioning of the management board
- the nomination process, succession planning and required profiles of candidates
- remuneration systems, planned changes, and the interpretation and use of administrative discretion

Especially for companies with a high free float, continuous, timely and dialogue-oriented communication with minority shareholders is becoming increasingly significant. In the process, it is important to know the types of investors and their perceptions of the company, and to have a realistic assessment of the individual business situation. Both are important for influencing shareholders.

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A study has shown that different types of investors exercise varying degrees of influence on corporate governance: private equity investors and hedge funds tend to get the most involved; insurance companies and foundations rather less so (see Fig. 1). However, the latter can also be expected to more strongly embrace investor engagement in the future – not least because they are more deeply influenced by proxy advisor recommendations in forming their opinions, and thus also in their voting behavior.

The individual business situation is likewise important to active investor engagement. Enhanced engagement or pressure for change is to be expected, for example, in the following business situations:

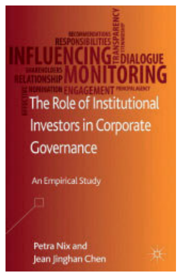
- underperformance of certain company divisions
- difficult corporate situations (such as M&A, crises)
- weak management and wrong appointments to the board of directors
- unsatisfactory business development in comparison to the sector

An effective tool for analyzing this is a regular, comprehensive survey of the current situation in order to objectively evaluate the perceptions of institutional investors. This requires a willingness for open and constructive dialogue – including by the board of directors. Only then can trouble spots be identified and the necessary measures prepared and carried out in a timely manner.

Conditio sine qua non: a long-term investment horizon

The sustainable growth of company value for the benefit of shareholders and all company stakeholders, as well as long-term acceptance of responsibility on the part of owners, must be at the forefront of an active shareholder democracy. Successful shareholder engagement that aims to bring about positive changes in a company requires investors to be willing to pursue a so-called “Escalation Strategy” encompassing several levels (see Fig. 2). For successful implementation, it is crucial that investors collaborate at an international level – so-called “Collaborative Engagement”. Likewise, they must have the financial leeway to increase their shareholding in case of doubt. If dialogue does not achieve its goals, then the only option left is to buy more shares in order to ensure that shareholders have the necessary power in the end to assert themselves in the voting process. A prerequisite for both is a long-term investment horizon that justifies the human and financial effort. In hardship cases, the last resort is to take on responsible supervisory duties by obtaining a seat on the board of directors, rather than divesting the shares as well and quickly as possible. Unfortunately, willingness to do so exists in very few cases. As long as this is not given, shareholder democracy remains only wishful thinking. ■

USEFUL READING



The Role of Institutional Investors in Corporate Governance: An Empirical Study, Petra Nix, Jean Jinghan Chen, Palgrave Macmillan, ISBN 978-1-137-32702-4

Sources:
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The Role of Institutional Investors in Corporate Governance, Petra Nix and Jean Jinghan Chen, 2013.
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