

Engagement between boards of FTSE-small caps and FTSE-250 companies and institutional shareholders

by
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Engagement between the boards of companies and their institutional shareholders requires more than just contact between the parties. It must include dialogue.

In practice there are different degrees of engagement ranging from dialogue to explain a departure from the Combined Code to more active engagement with the objective of increasing shareholder value. This article seeks to identify some of the key issues to be taken into account and makes some practical recommendations for enhancing engagement in practice.

Key Issues

1. Where does the responsibility for initiating engagement lie – with company boards or institutional shareholders?

- Arguably with company boards in the first instance because they are naturally most familiar with the company's circumstances. Institutional shareholders should nevertheless be prepared to initiate the engagement. Active shareholders will, as likely as not, take the initiative with companies that are considered to be underperforming, i.e. where there is an opportunity to increase shareholder value or a need to arrest decline in shareholder value.
- However, for company boards to identify those key shareholders for engagement can prove a challenge because of the diversity of types of shareholding arising from today's composition of capital markets and array of investment instruments.
- Engagement should not, on the other hand, be in any sense mandatory. Well run companies, complying with the Code and providing reports of high quality, should not be requested to spend time, and their institutional shareholders time, on engagement where no value would be added. Consideration should be given to reducing the reporting and regulatory burdens for such companies, releasing more time to be spent on managing and growing the business.

2. Should the engagement be with the fund manager or governance specialist? There are some important issues underlying this question, amongst which the most fundamental are:

- There is a need to draw a distinction between fund managers acting as traders, i.e. making the buy/sell decision on the stock, and those more akin to the underlying investor, taking an active interest in the performance of the company rather than simply the day to day movement of the share price.

- The skills required to engage with boards on governance issues are not normally required of fund managers to be effective in their investment role. There are two remedies, either to ensure that fund managers have the necessary skills, or for fund managers to have recourse to governance specialists with the required skills.
 - In either case, in addition to a proper understanding of the company's circumstances, effective and constructive engagement with company board members requires interpersonal, questioning and other behavioural attributes.
 - Where there are governance specialists with the required skills, how are they best integrated into the fund management process? Effective integration is necessary to avoid the mixed signals on governance that some companies experience.
3. Where does the responsibility for identifying the governance issues that require engagement lie – with company boards or institutional shareholders?
- Again, for reasons of familiarity with the company's circumstances responsibility must lie mainly with the board. But institutional shareholders should also be prepared to raise governance issues of which the company may be unaware.
 - Once governance issues have been identified by the company, the fund manager must be responsive to requests for meetings by the company. This is not always the case. Responsibility is therefore two-way.
 - The quality of reporting also has a part to play. The better the quality, the easier the identification of governance issues which require engagement for their resolution. Companies need to be more forthcoming in their governance reports, and institutional shareholders need to be more understanding of explanations.
 - To establish a definitive list of key governance issues for companies and institutional shareholders, so as to provide a basis for initiating engagement, is probably unrealistic in view of the variety of circumstances that apply to such a significantly large number of companies in an investment portfolio. However, generically these issues will usually fall into one or more of the following categories: board composition, effectiveness and succession; strategy; risk management; capital structure; and remuneration versus performance.
4. Accepting that in practice there are different degrees of engagement ranging from: engagement to explain Code exceptions to active engagement to increase shareholder value - under what circumstances does active engagement apply? This begs the question of costs versus benefits and may bring into play a threshold for percentage shareholding and/or the value of the shareholding below which active engagement becomes uneconomic.
- Active engagement applies where there is clear opportunity to increase shareholder value. This might arise for a number of reasons of which the need to rectify underperformance is but one.

- That there is an economic case for active engagement is demonstrated by the presence of shareholder activists in the market, and arguably they are behaving as responsible owners insofar as they are working to increase shareholder value.
- On the face of it, therefore, there is a case for active engagement by traditional long-only investors, most probably when their shareholdings are sufficiently material. There is an economic value to such engagement if it is properly targeted. It would appear highly likely that there are particularly appropriate companies for active engagement amongst the small and mid cap quoted sector. Newly listed companies could present especially worthwhile subjects for active engagement, for example.

5. The evidence indicates that active engagement with FTSE-small cap and 250 companies by fund managers is by no means universal. To the extent that there is an economic value to this engagement, this is to the disadvantage of beneficial owners. This raises the fundamental question – are the incentives for fund managers to actively engage sufficient?

- The responsibility for ensuring that the investment mandate agreed with the fund managers provides sufficient incentives to engage rests with the fund’s trustees as part of their fiduciary duties.
- In considering incentives and fund manager mandates it is important to take into account that there has been a significant shift from relative to absolute return strategies by the fund management industry in recent years.
- Beneficial owners of shares might reasonably assume that fund managers are engaged, in appropriate cases, to preserve and increase the value of their investments, and that this is included in the management fee.

6. Do company advisers and brokers have a role in engagement?

- Company advisers and brokers should be in a strong position to play a key role in facilitating the engagement between boards and shareholders on governance issues, but the indications are that not enough is being made of this opportunity.

Practical recommendations

Below are some practical recommendations on engagement which deserve serious consideration.

- i) Company boards should be proactive in identifying those governance issues which are key to the company’s sustainability and to increasing shareholder value in the longer term. They should be prepared to include them on the agenda for engagement, and institutional shareholders should be ready to respond. Companies and their institutional shareholders should maintain focus on these key governance issues.

- ii) Company boards should initiate the engagement in most instances, but institutional shareholders should be prepared to initiate active engagement with those companies where there is an opportunity to increase shareholder value in the longer term.
- iii) Companies should aim to identify and maintain a dialogue with their key institutional shareholders.
- iv) Institutional shareholders should ensure that fund managers and/or their governance specialists have the required skills, including interpersonal skills, and level of experience to engage with company board members on governance issues.
- v) Institutional shareholders should ensure that, where engagement on governance issues is the responsibility of governance specialists, they are integrated into the fund management process.
- vi) Institutional shareholders should be prepared to raise governance issues of which the company is unaware.
- vii) Incentives for institutional shareholders to actively engage with companies to preserve and enhance shareholder value should be incorporated into investment mandates.
- viii) The use of company advisers and brokers to facilitate engagement should be enhanced.

Conclusion

As evidence accumulates to show that active engagement carefully targeted can lead to an increase in shareholder value, the message needs to be reinforced to encourage the fund management industry to take engagement with the boards of FTSE-small caps and 250s more seriously. Engagement to underpin the ‘comply or explain’ principle in those cases where an explanation for a departure from the Code is required is also important. This too needs dialogue between company boards and institutional shareholders.

It is in the interests of the beneficial owners of shares in companies that opportunities for increasing shareholder value through active engagement are taken by institutional shareholders. Appropriate incentives will need to be included in fund management mandates for this to happen.

Dr John Mellor is Founder and Executive Director of the Foundation for Governance Research and Education, a charitable foundation. This article is taken from the Foundation’s Engagement Publication No.1. The complete Publication may be obtained by contacting Dr John Mellor at drjohnmellor@foundationgre.com.