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CORPORATE GOVERNANCE – AN ENHANCED ROLE FOR INSTITUTIONAL INVESTORS?

By Stuart Pickford

Amid the much publicised comments on remuneration policies, last week's Walker Review also examined the dynamic of the relationship between listed companies and the shareholders who own them. As with so much else in the review, the focus is on the banking sector, but what Sir David Walker says has the potential for much broader application.

When the review was commissioned in February, it was clear that the Government saw institutional shareholders as very much part of the overall corporate governance landscape, alongside non-executive directors and the regulatory role performed by the FSA. As Lord Myners put it: "Boards are effective only when held to account by vigorous and alert owners who devote the time and effort needed for engagement. This review is the first step in generating renewed commitment from institutional shareholders".

Walker agrees that institutional shareholders have a significant role in that landscape, but will fund managers feel a tension between their primary duty – the optimum management of their clients' funds – and this suggested role?

The review rightly recognises that their primary duty is the effective management of their clients' funds, and that in some cases this might be better achieved by disposing of a shareholding rather than engaging with the board. Walker nonetheless starts by making the case for long-term engagement rather than the "blunt instrument" of a selling strategy.

There is a strong focus on how an ongoing dialogue between shareholders and boards can be facilitated. This will be welcomed by those fund managers who already have a long-term strategy and are prepared to devote the necessary time and resources to see the potential benefits of active engagement. It will be less well received by those managers with short- term objectives – although the "duty of stewardship" enshrined in the recommendations will not be binding, the proposed "comply or explain" model is yet another signal that managers with short-term objectives will come under pressure not to operate in the financial institutions space.

Walker is realistic about the level of engagement that can be expected – it clearly cannot be expected that an institutional shareholder will get involved in management. This must remain the role of the executive. Where institutional shareholders can (and often do) usefully engage is by ensuring that the company's leadership is of the right calibre and performing effectively to set the right strategic goals and ensure they are executed – engagement as preventative medicine rather than crisis management.

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Engagement is of course a two way process. Walker stresses the importance of the chairman and senior independent director in making this happen (with the corporate broker as a valuable conduit). It is not an easy task, particularly when faced with the practical reality that investors do not always speak with one voice. The review rightly acknowledges some of the legal issues around "collective engagement" and suggests how they might be tackled, but collaboration between shareholders ultimately depends on fund managers having the time and resources to identify common concerns (and common goals) around which a consensus can be built.

The review's recommendations will help to facilitate the engagement of those fund managers with a long-term strategy who can see the benefits to be had by engaging with the board to effect change. It is less likely to lead to more active engagement by those managers who invest for the short-term – indeed, it could well be said that Walker's presumption in favour of engagement implies an unfair criticism of those fund managers with perfectly legitimate short-term investment objectives.

When it comes to the practicalities of shareholder engagement, it remains to be seen whether we will find that this aspect of corporate governance will be stuck between the rock of fund managers not having a united position (both on whether to engage and on what issues) and the hard place of individual managers not having sufficient influence to have their concerns aired at board level.