Stewardship in a stakeholder world

Peter Montagnon

CORPORATE GOVERNANCE AND STEWARDSHIP IN A STAKEHOLDER WORLD

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Only a few weeks before he passed away, Peter Montagnon visited the Corporate Governance Forum in Stockholm where he gave a much appreciated address. He also sent us an edited version of his speaking notes, which he encouraged us to share with a wider public. We are pleased to feature these notes below together with a tribute provided by Peter's friend and former colleague John Plender, Senior Editorial Columnist at the Financial Times.

Mats Isaksson Rolf Skog

TRIBUTE

The death of Peter Montagnon at the age of 69 has robbed the corporate governance fraternity of one of its most admired figures. After a notably successful career in journalism at Reuters and the Financial Times, where his roles included those of World Trade Editor, Asia Editor and International Capital Markets Editor, he moved to the Association of British Insurers to become Director of Investment Affairs. He quickly established himself as a powerful shareholder advocate and expert on corporate governance. He subsequently became chairman of the International Corporate Governance Network, which represents investors with $34tn of assets, while at the time of his death from a heart attack in June he was an Associate of the Institute of Business Ethics.

Peter was formidable in argument and could be forceful when necessary in engaging with companies on behalf of institutional investors. He provided influential input into the framing of regulation and the construction of governance codes inside and outside the UK. Of the many initiatives with which he was involved it was perhaps his role in drafting the ICGN's stewardship principles in 2003 for which he will be best remembered. Yet there were few policy debates on governance where he did not have something important to contribute. His expertise led him into a number of advisory roles including serving as a founder member of the corporate governance advisory board of Norway's $1.1tn sovereign wealth fund.

One of the great pleasures of attending corporate governance functions around the world – including those sponsored by the OECD – was to bump into Peter. He was excellent company, combining a sense of fun with a fund of wisdom on a range of subjects far beyond his day to day work concerns. As Huw Evans, Director General of the Association of British Insurers put it, he was a force to be reckoned with and an individual with a rich hinterland of family and outside interests who took a lasting interest in the careers and welfare of those who had worked with him. He will be sorely missed by friends and colleagues, for many of whom he was a revered mentor.

John Plender

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Speaking notes for presentation to the Swedish Corporate Governance Forum on June 3 2019

Peter Montagnon, Associate, Institute of Business Ethics

I want to talk today about the way corporate governance is evolving in the UK. We are seeing a striking change in attitude, driven heavily by political pressures and public opinion. It has both good and bad elements, but there are some real risks that where we end up will be in a situation where our approach to governance is much more politicized, and where the power of comply-or-explain has been eroded in favour of greater prescription.

On the assumption that the core purpose of governance is to build strong and resilient companies that are in turn the foundations of a strong economy able to meet the needs and expectations of its citizens, we must ask ourselves whether this is really what we want. If not, what should we do about it?

Governance in the UK is not evolving in isolation. In Europe, more generally, we see a tendency for governments to become more involved, reflecting public clamour for more prescriptive rules in the wake of various corporate scandals, worries about short-termism, inequality and the power of big business, and the residual impact of the global financial crisis.

Thus, for example, France has passed legislation requiring companies to reserve two board seats for members of the workforce and the European authorities have produced some prescriptive Level Two recommendations on the Shareholder Rights Directive.

These go beyond the provisions of the Stewardship Code and, as far as the UK is concerned, seem likely to facilitate a shift of responsibility for stewardship towards the Financial Conduct Authority – a traditional regulator – and away from the Financial Reporting Council, which has been the champion of comply or explain and a softer approach. The FRC is in any case itself due to be replaced by a new, tougher regulator and standard setter.

What happens in the UK matters to the rest of the world because, hitherto, the UK has been seen as a global leader in corporate governance. We shall see, as the situation evolves, whether this continues to be the case, but for the time being the challenges to the traditional model being thrown up by the UK political process are important to the international debate more generally.

I want to address this theme in relation to four particular initiatives: the requirement for companies to report on their response to Section 172 of the Companies Act 2006, the revised Corporate Governance and Stewardship Codes and the Kingman proposals for reforming the Financial Reporting Council.

The common threads in these are: a new focus on the importance of purpose and culture, a much bigger role for stakeholders as opposed to shareholders, and a higher level of prescription. In the background there are two contrasting thoughts.

First, the current developments are positive because they have taken governance away from being an inward-looking, process driven activity. Instead of worrying about board structures, even though these remain important, boards are now being encouraged to be more outward looking with a focus both on the culture within their organisations and on the social impact of their company. Put simply, they have to be much more aware of what is going on and accountable for what happens.

Second, however, the new approach embodies risk because the way in which the debate has empowered stakeholders raises the influence of unelected campaigners with their own agenda, especially at a time when government itself is extraordinarily weak. Shareholders are thus coming under pressure to use their voting rights to implement a version of public policy regardless of whether this is actually in the interest of their beneficiaries. Perhaps more important still, there is beginning to be a serious debate about the appropriateness of shareholder primac y.

We should not stick our heads in the sand and refuse to recognize any need for change. The public is increasingly unforgiving about the way in which large corporations have been in the habit of externalizing costs and keeping the benefit for themselves both in the form of excessive remuneration for their executives and through reluctance to allow society to recover the externalised costs in the form of taxation.

Corporations cannot flourish in a world of blatant inequality. The problem is that they will also never flourish in a world where entrepreneurialism is stifled in the name of social purpose. We need an approach to governance

that acknowledges these two truths and strikes the right balance between them.

Section 172

With that in mind, let's start by considering Section 172. Just to remind ourselves Section 172 requires each director to:

> act in the way he (sic) considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
>
> (a)the likely consequences of any decision in the long term,
>
> (b)the interests of the company's employees,
>
> (c)the need to foster the company's business relationships with suppliers, customers and others,
>
> (d)the impact of the company's operations on the community and the environment,
>
> (e)the desirability of the company maintaining a reputation for high standards of business conduct, and
>
> (f)the need to act fairly as between members of the company.

This is politely described as delivering what is called "enlightened shareholder value" but in reality is a classic British fudge because, by introducing reference to stakeholders, it both dilutes the concept of shareholder primacy but does not reject it, leaving a muddle in its wake.

Critics say that Section 172 is more or less entirely unenforceable because directors can always say that they did have regard to the various factors and then chose to override them in their decision-making. For that reason Section 172 has not been taken seriously and many boards were not really even aware of its existence.

In the wake of corporate scandals around BHS and Sports Direct, however, the government decided to beef up the impact of Section 172. Companies are now required to report in their Strategic Report on how they had regard to Section 172 in their board decision-making. This is very much part of the context of policymakers' wish to emphasise the importance of stakeholders and their diminishing interest in the rights of shareholders.

It is important to note that whereas there is a requirement to report under all clauses a-f covered by the section, Part 4 of the regulation requires much more specific detail on relations with employees, customers and suppliers. Thus on employees the regulation states that directors must describe the action that has been taken during the financial year to introduce, maintain or develop arrangements aimed at:

> (i) providing employees systematically with information on matters of concern to them as employees,
>
> (ii) consulting employees or their representatives on a regular basis so that the views of employees can be taken into account in making decisions which are likely to affect their interests,
>
> (iii) encouraging the involvement of employees in the company's performance through an employees' share scheme or by some other means, and
>
> (iv) achieving a common awareness on the part of all employees of the financial and economic factors affecting the performance of the company,

and summarising:

> (i) how the directors have engaged with employees,
>
> (ii) how the directors have had regard to employee interests, and the effect of that regard, including on the principal decisions taken by the company during the financial year.

The government justified this more detailed requirement on the grounds that these particular stakeholder relations were very important and it feared that, if special arrangements were not made, reporting on these topics would be skimpy. Companies would choose to say little on the grounds that the issues were not material.

Curiously ministers do not therefore appear to attach much importance to high standards of business conduct or the rights of minority shareholders which are covered in clauses e and f, something which indicates a very superficial political approach together with a serious lack of real interest in business and governance and how it works.

UK Corporate Governance Code

The same stakeholder emphasis is also evident in the new UK Corporate Governance Code. In general the code places a new and heavy emphasis on purpose, values and culture, and in this context it elevates the importance of stakeholders with again, for strong political reasons, overt reference to the workforce.

In an unguarded moment early in her premiership Theresa May suggested that companies should have a representative of the workforce on their board. This was strongly supported by the Trades Union movement, but met strong pushback from business. As a result the new Code introduced a compromise. It now simply requires boards to choose from a range of options: a director appointed from the workforce, a formal advisory panel or the designation of an independent director to follow the concerns of the workforce.

Stakeholder issues also enjoy new prominence in the accompanying board guidance which states:

> An effective board understands that a company has to engage with its workforce and build and maintain relationships with suppliers, customers and others in order to be successful over the long-term. It will be able to explain how those relationships contribute to that success and help deliver the company's purpose. The company's approach to stakeholder engagement will be an important topic in the induction programme for new directors.
>
> Dialogue with stakeholders can help boards to understand significant changes in the landscape, predict future developments and trends, and re-align strategy. Boards will find it useful to start by identifying and prioritising those key stakeholders who are important in the context of their business. This is likely to include the workforce, customers and suppliers. It may also include other stakeholders who are specific to the company's circumstances, such as regulators, government, bondholders, banks and other creditors, trade unions and community groups.

The guidance thus appears to be suggesting that boards should be responsible for dialogue with stakeholders. Of course, boards need to have

direct relations with shareholders because, for the time being these are the people who elect directors. Relations with the broader community of stakeholders ought to be a principally a matter for the executive. The board's role is an oversight one. It needs to ensure that the right relationships are in place. For that it will need some direct exposure to stakeholders but only enough to meet this objective.

Stewardship Code

At the time of writing, the final version of the new Stewardship Code, is still under wraps. However, the Financial Reporting Council slipped some radical language into the draft text. Thus, it says the object of stewardship is to create sustainable benefit for "beneficiaries, the economy *and society*."

The Code makes specific reference to ESG factors at the compulsory Principle level. Principle E says they must demonstrate how they take account of material ESG factors, including climate change. One provision tells investors to explain what actions they take to interact with other stakeholders and exercise their role as stewards of the market.

Yet it downplays the Code's original purpose, which was to ensure, after the financial crisis, that institutional investors were ready and willing to challenge flawed business models in investee companies. The critical provision is deleted. It stated:

> Institutional investors should endeavour to identify at an early stage issues that may result in a significant loss in investment value. If they have concerns, they should seek to ensure that the appropriate members of the investee company's board or management are made aware.

There is thus the potential, as I have pointed out, for investors to be busily charting the use of palm oil in Patisserie Valerie's cakes but not bothering to notice that it was quietly going bust. Arguably this would still be fully compliant with the new version of the Code.

Another issue worth noting is that the new Stewardship Code drops references to collective engagement, which means shareholders working

together, in favour of the term collaborative engagement (Provision 20), which can also mean shareholders working together with other stakeholders. This gives much greater leverage to unelected, unaccountable NGOs who can use the Code to force their way into the debate.

Kingman Review

The Kingman Review rounds off the debate. Most of this was about the need to reform the FRC in the light of its failure to tackle audit failures that are seen to have contributed to corporate collapse. However, there was also some important and very radical governance related material.

One of these was a recommendation that, in certain circumstances, the regulator should have the power to order a skilled person's investigation of matters of concern Such circumstances would include situations where there were worries about accounting judgments, weak corporate governance explanations, unsustainable dividend policy, inadequate internal controls, or where the audit committee was not doing its job properly.

This is accompanied by a proposed requirement on auditors to be subject to a duty to alert the regulator to concerns about viability or other serious matters. The whole package thus introduces the concept of prudential regulation into the general corporate sector.

Although the review envisages that the powers would be used sparingly, it creates an opportunity for the regulator to override the role of shareholders if these are effectively seen to be failing to take appropriate action with troubled companies, for example by accepting weak explanations for deviations from governance best practice. Indeed, it could be seen as meaning the regulator will take over where shareholders have failed, leaving the Stewardship Code with a more or less exclusive stakeholder focus.

The FRC's successor would have powers to order an independent board evaluation, to require immediate auditor retendering, or to require boards to develop a formal recovery plan. In the most serious cases the regulator would be empowered to issue a report to shareholders suggesting that the dividend policy be reviewed or that they consider the case for a change of Chair, CEO, CFO or Audit Committee Chair.

To be sure, this theoretically still leaves power in the hands of shareholders though the regulator would have much stronger oversight and powers to intervene in the governance process. The initiative would lie with the FRC's regulator, and it would be difficult, for example, for shareholders to ignore a recommendation that senior officials at a company be removed. We are thus moving away from a situation where power is exercised by shareholders through the combination of comply or explain and their right to fire directors.

In part this must reflect Sir John Kingman's view that shareholders have been ineffective in their governance oversight. This is borne out by a critical approach to the operation hitherto of the Stewardship Code. Kingman says the regulator's monitoring should focus more on effectiveness and outcomes than on boilerplate reporting and that if there is no improvement the Stewardship Code should be abolished. Were it to be abolished, it is clear that the market would be left to rely on investigations undertaken by the regulator and these would become more common.

Conclusions

Three headline conclusions follow from this analysis:

1) Institutional investors are being increasingly pushed by the authorities to undertake a public policy role.
2) Shareholders are deemed to have failed at what might be called prudential oversight, and the Kingman report suggests the regulators may have to take over.
3) We are moving away from comply-or-explain, and levels of prescription are increasing.

This adds up to radical change, and we have been drifting into it without really considering where we are going.

At this point, however, it is necessary to introduce two caveats. First, it is not yet entirely clear how the debate on Stewardship and Kingman will come out at the end of the day. Second, even though some of the debate is pretty radical, it is not necessarily all bad.

For example, the focus on corporate culture is sensible, as is the expectation that, in these days of heightened reputation and conduct risk, boards should be carefully tracking their company's relationship with society from which it derives its franchise.

Many directors still have a lot of difficult defining corporate culture. Perhaps it helps to describe it as the sum total of the forces which drive behaviour in a company. Where those forces are malign or uncontrolled, risks are higher. It is thus a legitimate to expect boards to take steps to understand and shape the forces that are driving behaviour. All of this does mean, as suggested earlier, that governance needs to become less of an inward-looking process-driven exercise.

The risks lie in two places. One is that regulation and the regulators take ultimate control. This would mean we lose the great benefit of flexibility and incremental improvement, which comply-or-explain has delivered over the years and which has generally-speaking enabled governance to support entrepreneurialism. The whole environment would instead become much more prescriptive and risk averse.

The other is that governance does indeed become an instrument of public policy with a strong focus on stakeholder issues. The difficulty here is how to set boundaries. It is of course reasonable, right and proper for shareholders to seek to ensure that companies in which they invest take a long-term view of their prospects, that they do not create spurious value through externalization of costs, and that they do not run material reputational and conduct risks. That means that a focus on non-financial issues is perfectly legitimate.

But where does this stop? Are shareholders supposed to be investing in a way that creates a benign world in which their beneficiaries can eventually retire? How do they define such a benign world? And if they can't define it, who does? NGOs who are not elected but who have a powerful political agenda?

Or put the question another way. There is some debate these days in the International Corporate Governance Network and elsewhere about systemic risk and how shareholders should manage this. The suggestion is that they should act when they see an investee company behaving in such a way that creates systemic risk, which would damage other investments in their portfolio. Failure to address the governance weakness of banks, for example, arguably led to widespread loss of investment value outside the financial sector.

Yet, again the question is who should define systemic risk? It is very easy for this to become a political issue, so that political and moral pressure would be put on institutions to deliver. I have heard it suggested last year, for example, by a board member of an Italian company that institutional investors should use their powers over companies through their voting rights to take some responsibility for helping resolve the refugee crisis in Europe.

At a recent London workshop, a participant suggested that the role of boards should be redefined. Instead of overseeing strategy and risk and ensuring accountability, directors should see themselves as "trustees of corporate purpose", that purpose of course having a social rather than a purely economic objective.

It is doubtful whether the world is yet ready for such a change, but the mere fact that it is being suggested indicates the way in which opinions are shifting.

We do need some defence against this if we are to preserve the entrepreneurial spirit, which is vital if business is to thrive and contribute to economic development. That means setting clear priorities for governance and boundaries around the extent to which those involved can be charged with delivering public policy through the back door.

My own view is that boundaries will be easier to set if we have a much clearer view of fiduciary duties both of investors and corporate directors.

Thus investors have a fiduciary duty towards their beneficiaries and their approach to governance must reflect their commitment to that act in the interest of their beneficiaries. This will extend into the non-financial area, especially where the beneficiaries have long-term time horizons, but not to the point where a public policy duty trumps delivery of value to beneficiaries.

Directors equally have a duty to the company. They cannot ignore its social impact because that is germane to the long-term health of the business. But they should not use their position as directors to deliver a political agenda on behalf of outsiders regardless of whether it is right for the company.

These boundaries are difficult to define. In its 2015 report on the Fiduciary Duties of Investment Intermediaries the UK Law Commission acknowledged this but set out some useful pointers. It said that investors should take account of ESG factors where they were financially material but this statement was seriously qualified. The key section reads:

> We do not think it is helpful to say that ESG or ethical factors must always be taken into account. These labels are ill-defined and liable to cause uncertainty The fact that a particular factor is conventionally classified as an "ESG" or "ethical" factor will not be conclusive as to whether it is financially material or not. Nor will a factor that is financially material in respect of one investment always be financially material in respect of others. In every case, the test must be: what are the risks associated with this investment?

It would help us navigate through this process if investors, as part of their Stewardship responsibility were invited to make a clear statement of how they interpret fiduciary duty. This would both legitimize focus on ESG matters and protect them against outside pressures to respond to situations where the issue was not financial material, as the Law Commission suggests.

If the UK is to retain its lead in corporate governance, it must take care not to rush to short term reforms that will not deliver strong companies in the long term. The risk is particularly great at a time when the City needs to assert its global competitiveness. We need to evaluate more carefully both the opportunities and the risks inherent in the new approach.