Shareholder democracy: an analysis of current trends

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With continuing revelations that challenge confidence in governance practices at publicly held companies, there is a renewed focus around the world on the rights and responsibilities of shareholders. With this focus has come a growing awareness among managers, investors and regulators that governance models cannot function effectively without a more active role for shareholders in the supervision of companies. This role is seen as a critical complement to recent policy initiatives that have focused on boards of directors, independent auditors and other participants in governance processes.

Corporate governance standards and practices vary from country to country, reflecting different business cultures, legal systems and traditional financing mechanisms. Consequently, jurisdictions are at different stages in their development of corporate governance.

In some of the jurisdictions with less developed standards and practices (including some countries in continental Europe and in many parts of Asia), regulators and investors are still working to improve basic voting mechanisms and rights (such as streamlining proxy voting and establishing the “one-share-one-vote-one-dividend” principle).

However, in the most developed jurisdictions, such as the US and the UK, where governance is already well advanced, reforms are now focusing on issues such as shareholders’ ability to influence the composition of boards of directors. Shareholder democracy at this stage of development represents the leading edge of a movement that is likely to continue to develop, particularly given:

- The increasing internationalisation of capital markets.
- The steady growth of professionally managed collective investments around the world.
- Companies’ increasing reliance on public equity financing.
- Increasing regulatory pressure for transparency and accountability.

This chapter analyses current trends in shareholder democracy, particularly in relation to efforts aimed at enhancing public company corporate governance and in particular examines:

- Recent developments in the role played by institutional investors in shareholder activism and public company supervision.
- Shareholder activism on executive compensation, board independence and structure, and accounting issues.
- The recent US proposal regarding shareholder access to annual meeting proxy statements.

THE CONTINUED RISE OF INSTITUTIONAL INVESTORS

Institutional investors (that is, mutual funds, managed investment trusts, pension funds and other collective investment vehicles) continue to expand their influence over public companies in the world’s most developed capital markets.

The following are just a few examples of the increased role taken by institutional investors around the world.

- In the US, institutional investors have started a new wave of shareholder activism by making more proxy statement proposals to companies and by pressing for regulatory reforms. The Investor Responsibility Research Center reported that shareholders in 2003 submitted 774 proposals regarding corporate governance for inclusion in annual meeting proxy statements, compared with 528 in 2002 and 502 in 2001. Many of these proposals have required company management to get more shareholder input on important corporate governance matters, including, notably, the process by which candidates are nominated for election to boards.

- In the UK, institutional investors have shown a greater willingness to go directly to a company’s board on governance issues. For example, institutional investors led by mutual fund company Fidelity intervened to block a senior executive’s appointment as chairman of ITV. This follows the creation by institutions in recent years of codes of conduct and good practice recommendations (for example the Institutional Shareholders’ Committee’s Statement of Principles and the Hermes Principles), which, among other things, involve institutions taking an active role in the companies in which they invest. Elsewhere in Europe, institutional investors and associations, such as DWS Investments, Proxinvest and AFG-ASFI, have been active in the development and enactment of various governance reforms.

In Asia, Japanese pension funds have taken more active roles in recent years, including voting against management on a variety of issues, such as executive compensation. In addition, the California Public Employees’ Retirement System has established a US$200 million (about EUR234 million) fund to make investments in Japanese companies and...
work with managements to increase company values. In Australia, institutional shareholders have participated in a group that assisted the Australian Stock Exchange in preparing its good governance recommendations.

- A global corporate governance rating industry has emerged in the last few years. Catering to institutional investors, these firms now provide ratings and analyses of governance practices at public companies in the US, Europe and Asia. The ratings not only help institutions assess investment risks related to corporate governance but also put pressure on companies to change their practices in order to improve their ratings.

A number of long-term trends have encouraged this larger role for institutions as a collective voice for shareholders:

- Concentration of public company ownership and voting power in institutional investment funds.
- Evolving legal duties owed by institutions to their beneficiaries and stakeholders.
- Improvements in technology, access to information and voting processes.

Increased voting power

Institutions continue to increase their ownership of public company shares in the developed capital markets of North America, Europe and Asia.

Institutional investors' ownership of US public companies has increased more than four times on a percentage basis during the last several decades. For example, institutions held over 55% of all US corporate equity at the end of 2001, up from 37% in 1980, according to The Conference Board. More striking, institutions have increased their control over the equity of the 1,000 largest US corporations from about 46% in 1987 to 61% in 2000, according to The Conference Board. Institutional ownership of UK, Canadian and Australian public companies are now at similar levels.

In European countries other than the UK, institutions generally own between 15% and 30% of the total market capitalisation of public equity. This represents almost a doubling in assets under institutional management in most European countries, on a relative basis, during the last ten years.

A number of factors are contributing to the growth of institutional investors in the world's more developed countries, in particular:

- The aging of the populations in developed countries has produced an increased demand for retirement investments. In countries with sizable numbers of government employees, aging populations are also making it harder for governments to finance pay-as-you-go pension systems. This is further encouraging the growth of advance-funded pension plans. Simultaneously, many countries have introduced special tax rules to encourage retirement investments.
- The advances in communications technology, information processing and financial asset pricing techniques have allowed the creation of sophisticated new financial products that offer the possibility of higher returns with less risk. This requires a level of specialised investment advisory support that is only cost-effective when provided to an aggregated pool of investments.
- The de-regulation of the banking and securities industries which, since it started in the US in the 1970s, has fostered greater competition between banks and other financial institutions and encouraged a shift in savings from bank deposits to equity mutual funds, money market funds and more performance-oriented instruments.

Heightened legal responsibilities

Historically, institutional investors have been largely passive investors, unwilling to challenge corporate management on many issues. The “Wall Street Rule” in the US, otherwise known as “voting with your feet”, exemplified this passive approach: investors should either vote with management or sell their shares. In other countries, cross-ownership of company shares has discouraged institutional shareholders from disagreeing with management. While in certain others, institutional investors have not had voting rights equal to those of other dominant shareholders, such as governments.

However, during the past 25 years, as voting power has become more concentrated in the hands of collective ownership entities, such as pension and mutual funds, it has become untenable for institutional shareholders not to vote shares that they hold. Institutional investors generally owe fiduciary duties to the beneficial owners of the investments. It has become increasingly recognised that these duties include the obligation to vote shares. Institutions recognise that the right to vote is part of the asset they manage for beneficial owners and increasingly are willing to exercise that right in order to protect their investment in a company's shares and satisfy their duties to beneficial holders. This is particularly the case when institutions find it difficult to sell large blocks of shares when they disagree with management’s stewardship.

In the US, regulators have made it clear that asset managers and trustees have fiduciary obligations to vote shares that are held in mutual funds and pension plans. Under Italian law, investment managers also have an express duty to exercise voting rights in the interests of beneficial shareholders.

Although there are no statutory requirements for UK pension trustees or investment managers to vote, the same principles are evident in the UK. Both pension trustees and investment managers are subject to general fiduciary duties. In addition, the UK’s Combined Code of Corporate Governance (Combined Code) provides that institutional shareholders “have a responsibility to make considered use of their votes” and should “take steps to ensure that their voting intentions are being translated into practice.” The Institutional Shareholders’ Committee, which represents Britain’s largest institutional investors, has adopted a voluntary best practice code, which requires the:

- Monitoring of company performance.
- Disclosure of an institution’s voting policies.
Cross-border

■ Intervention in company affairs in order to enhance the value of an investment.

The code also requires that institutional shareholders and their investment managers “vote all shares held directly or on behalf of clients wherever practicable to do so.”

Elsewhere, while there are no express statutory obligations on institutional investors to vote, new laws and regulations (such as Germany’s Cromme Code on Corporate Governance and The Netherlands’ Tabaksblat Committee Code) encourage institutions to be more active in voting proxies. International organisations, such as the Organisation for Economic Co-operation and Development (OECD), as well as various groups representing shareholders have been active in developing codes of conduct and best practice guidelines designed to encourage institutions to cast votes at annual meetings.

The US Securities and Exchange Commission (SEC) has put further pressure on an important class of institutional investors to exercise their voting rights. Following two rule amendments in April 2003, US-registered mutual fund companies are now required to adopt and disclose written policies and procedures for voting proxies and to make available proxy voting records.

Similarly, the European Commission (Commission) has stated in its Company Law and Corporate Governance Action Plan (Action Plan) launched in May 2003, that it will require institutional investors to disclose investment and voting policies and how voting rights have been exercised (see The EU enters the corporate governance arena in this handbook).

Improved technology and voting processes

Improvements in communications and information technology have made the process of evaluating company performance and exercising voting rights much simpler.

It is now possible for company information (such as financial statements, annual reports and press announcements) to be readily obtained from either free websites operated by either the company or a national securities regulator (for example the SEC’s EDGAR website (see www.sec.gov/edgar.shtml), or proprietary electronic data services.

In many cases, comparative financial data for many industries and the historical performance of benchmark share indices are also now available online.

Better technology allows institutions to exercise voting rights with relative ease. Electronic communication facilitates the canvassing of beneficial owners. It also allows institutions to deliver votes electronically to public companies, which reduces costs and also gives institutions more time to canvass beneficial owners.

The use of these technologies is most evident in the US, where, for example, thousands of publicly traded companies now allow proxy voting on the internet. Other countries, including the UK, Germany and Japan, have taken steps to encourage the electronic distribution of meeting notices and proxy materials. A smaller number of countries permit the use of electronic signatures on proxies.

However, there remains a delay in the introduction of new technology in many markets, which restrains shareholder activism. For example, in some cases, there may be no electronic interface between companies and their shareholders, or if it does exist, it may not be seamless.

In addition, in many cases, the laws regarding the voting of shares at annual meetings are still undeveloped, compared with those in the US. For example, voting by proxy is still not permitted in some countries, therefore imposing the additional burden on shareholders to attend meetings in person or hire representatives to do so. Share blocking and share depositing are still required in certain European countries. Restrictions persist on the persons to whom proxies may be granted and on the number of shareholders that may be represented by the same person. In some countries, a physical signature on a proxy must be delivered. There are also issues about timely notice of annual meetings (which in some countries can be no more than 14 days), as well as receipt of proxy materials if companies are not required to distribute proxy materials to beneficial owners.

The Commission has noted the need for reform in this area. In its proposed Transparency Directive, it has called for allowing companies to use electronic means to both:

■ Provide shareholders with information about meetings and their rights to participate.
■ Make proxy forms, meeting notices and periodic financial information available online.

In addition, the Commission has said in its Action Plan that cross-border voting procedures should be simplified, including the right to vote in absentia and to participate in meetings by electronic means. These reforms are scheduled to be proposed in the next two years.

SHAREHOLDER ACTIVISM ON EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE

While social responsibility and public policy issues continue to attract shareholder concerns, corporate governance reforms have become increasingly prominent on the shareholder democracy agenda. Several of the most prominent governance-related issues championed by shareholders in recent years are:

■ Executive pay.
■ Board independence and structure.
■ Accounting issues.

Executive pay

The most pressing corporate governance issue for shareholders continues to be executive compensation, particularly in the US and the UK. While share prices have fallen in recent years, executive pay has continued to rise and at a faster rate than that of non-executive employees. According to The Economist, the average pay for the chief executives of the largest US companies has gone from being 40 times greater than the average produc-
tion worker in 1980 to now being about 400 times greater. Similarly, during the past ten years, the average earnings of chief executives of the FTSE 100 companies have risen more than six times as fast as that of British employees as a whole, according to UK research firm Incomes Data Services.

In the US, it has been reported by the Investor Responsibility Research Center that more than 40% of all governance proposals that were submitted for inclusion at annual shareholder meetings held in 2003 asked companies to change the way that they compensate their executives. Linking some portion of pay to performance has been a common theme.

For the last several years, UK pension funds and other institutional investors have strongly criticised executive pay at some of the UK’s biggest companies, particularly as share prices continued to decline. This criticism prompted the Labour government in 2001 to approve legislation requiring shareholders to vote on company compensation at annual general meetings of shareholders. While the vote is non-binding, the process of publishing annual remuneration reports and giving investors an opportunity to express their approval (or disapproval) over executive pay was intended to put pressure on UK companies to be more responsive to shareholder concerns about compensation and benefits.

Based on 2003’s annual meetings in Britain, the plan seems to be working. Investors in a number of well-known public companies registered their opposition to executive pay arrangements by voting against remuneration reports. Most notable was GlaxoSmithKline shareholders’ rejection of the company’s report in an advisory vote in May 2003. Almost 51% of shares voted were cast against a resolution to approve GlaxoSmithKline’s remuneration report, which was the first majority vote against a British company’s compensation policies. Shareholders, including some prominent UK institutional investors, were particularly concerned about a severance package for GlaxoSmithKline’s chief executive that was not subject to adjustment for company performance. It also followed GlaxoSmithKline’s withdrawal in November 2002 of a new compensation proposal for the same chief executive after the proposal was criticised by some shareholders.

Several other well-known UK-based companies have received significant opposition to their remuneration reports, with shareholders delivering surprisingly high levels of disapproval, including a 49% vote against the remuneration report at BAE Systems.

In recent years, regulators in several other European countries have introduced requirements that companies disclose the compensation paid to directors. The effect of the disclosures has been similar to that in the UK. In France, for example, the release of details about severance packages paid to former chief executives has sparked shareholder protests at companies such as Vivendi Universal and Alstrom. The Commission has now recommended in its Action Plan that all member states should require previous approval by shareholders of “share and share option schemes in which directors participate.”

**Board independence and structure**

Activist shareholders have also been concerned about the independence of boards of directors. In the US, about 35% of all governance proposals that were submitted for inclusion at annual shareholder meetings held in 2003 were focused on improvements to boards of directors. These concerns have fuelled reforms in this area. In the US, the Sarbanes-Oxley Act of 2002 contains standards for independence, and new stock exchange listing standards include heightened standards of independence for directors and board committees. In addition, continuing concern about board independence has been a key catalyst of the proxy access debate in the US (see US proxy access rights for director nominations below).

European institutional investors largely agree that a majority of board members should be independent and that the role of chairman and chief executive officer (CEO) should be split. Some of these principles have been adopted in the UK’s Combined Code, as recommended by the Higgs Report. Under the Combined Code, the same individual should not be both chairman and chief executive officer (CEO). It also provides that at least half of the board, excluding the chairman, should comprise of independent, non-executive directors. The UK Listing Authority also has introduced additional requirements, which come into effect in April 2005, regarding the independence of boards of UK listed investment companies. Other countries have adopted the same approach, including Australia, where the stock exchange has published good governance principles that include board independence.

What remains to be seen is how management will respond to these principles. The Combined Code simply requires companies to “comply or explain” with respect to its principles. If companies fail to split the chairman and CEO roles or do not create the balance between executive directors and non-executive directors, it will fall on institutional investors to take action against company management or press for further legal reforms.

**Accounting issues**

Institutional investors have also been active in relation to the accounting treatment of stock options. During the 2003 annual meeting season in the US, union pension funds were largely responsible for submitting 113 shareholder proposals that asked companies to expense the value of stock options (that is, recognise them as an expense on the income statement) at the time of option grant (Investor Responsibility Research Centre). At the annual meetings in which the option-expensing proposals were put to a vote, the proposal received on average 48% of the votes cast in support and in several instances received over 70%
support. It now appears that both the Financial Accounting Standards Board and the International Accounting Standards Board will require companies to expense stock options at the time they are granted.

**US PROXY ACCESS RIGHTS FOR DIRECTOR NOMINATIONS**

In October 2003, the SEC took a major new step towards giving shareholders additional governance rights in public companies. It proposed new rules granting certain shareholders access to the annual proxy statements of US-registered public companies in order to nominate up to three independent directors.

These rights constitute an important new tool for shareholder democracy advocates and a possible model for legal reform of the director nomination process outside the US.

**Shareholder concerns about director nominations**

The call for greater proxy access rights has grown out of the belief among some shareholders that boards of directors may not represent their interests effectively because they are not sufficiently independent of management and are not adequately responsive to shareholder concerns.

Historically, US shareholders have had limited input over the composition of boards of directors. While corporate laws in the US give shareholders the right to elect directors, typically a committee of a company’s board decides who is nominated, and it is these nominees that are included in the proxy materials that the company sends to all shareholders. A shareholder seeking to nominate its own candidates must go through the expense and effort of circulating its own annual meeting proxy statement. Given the costs, it is unusual for shareholders to undertake this effort unless the shareholders are trying to take over a company.

A union pension fund initiated the current debate about the director nomination process by asking a number of large US companies to include a proxy access proposal on the agenda of their 2003 annual meetings. Although the proposal ultimately was not voted on, it got the attention of the SEC, which commissioned a study that recommended greater proxy access rights for shareholder nominations.

**Proxy access rights explained**

Proxy access rights are designed to allow a shareholder an opportunity to include its nominees for the board of directors on the proxy statement that the company circulates before the annual meeting. A shareholder can exercise these rights when shareholders have demonstrated significant dissatisfaction with the director nomination process through a “triggering event”. For example, the rights may be triggered when a large number of shareholders (such as those representing at least 35% of the votes cast) choose to withhold their votes in an election for a company-nominated director, or when a shareholder proposal for proxy access wins more than 50% of the votes cast at an annual meeting.

If a triggering event occurs, certain shareholders may nominate up to three directors to the company’s board at the next annual meeting under the SEC’s framework. The company would be required to include in its proxy statement the names of the shareholder nominees together with some disclosure about them.

To discourage abuse by shareholders that do not represent broad shareholder concerns, only a shareholder or group of shareholders that represents a substantial ownership stake in a company may use the access rights to nominate director candidates. For similar reasons, the SEC also proposed a certain level of independence between the director candidate and the shareholder that nominates the candidate. Proxy access rights may also be limited, as the SEC has done, so that they may not be used as part of a takeover bid.

**Practical implications**

Proxy access rights are likely to be more than just a potential new method for institutional investors to communicate with the rest of a company’s shareholders regarding board elections. In practice, they may also give institutional investors and other groups of large shareholders more influence with management and company boards regarding not only the director nomination process but also executive compensation and other company policies.

The SEC has structured a two-stage process under its rules by requiring shareholder access to the proxy statement in the year after a triggering event occurs. Because of the longer process, it may be more likely that, rather than actually using the access rights, shareholders will rely on the threat of a triggering event to force company management to consider its views on director candidates or on policies and practices that shareholders otherwise could only get approved at an annual meeting as a non-binding recommendation to management. Even if a triggering event has occurred, it may be more productive for management to agree with shareholders on board nominees rather than go through the effort, expense and bad publicity of a formal proxy access process.

Outside the US, the proxy access concept may be a model for governance reform aimed at fostering more shareholder participation. This may alert non-US companies to listen more carefully to what their major shareholders are saying.

**CONCLUSION**

Public company shareholders, led by institutional investors, will continue to play an important role in supervising companies not only at annual shareholder meetings but also in direct discussions with company management outside of annual meetings. Regulators are adding weight to this role by putting pressure both on institutions to exercise greater oversight duties and on public companies to develop governance models that are more independent of management and open to shareholder input. In particular, investors and regulators are pushing for changes in such important governance areas as executive compensation and board composition. While shareholder democracy and the expanding influence of shareholders are on different paths around the world, broad trends are manifest. The involvement of shareholders in the affairs of public companies, particularly in relation to corporate governance matters, has significant momentum. This will result in continued changes in the ways in which the world’s publicly held companies are governed.