Corporate Governance and Investment Management – The Promises and Limitations of the New Financial Economy

In January 2018, Jeff Fairburn, CEO of FTSE 100 housebuilder Persimmon, was awarded a total annual remuneration package of £100 million. This was an eye-watering pay award, and was based on approval of a long-term incentive scheme in 2011 by both the board of Persimmon and most of its major shareholders. However, the real context was that much of Mr Fairburn's recent success in boosting corporate earnings had apparently arisen as a consequence the serendipitous launch of a government-subsidised scheme (Help-to Buy) aimed at boosting UK housebuilding, which gifted a big boost to the sector's profit margins.

As a result, an award of absurd proportions was made through an entirely legal process and, despite public criticism, Mr Fairburn felt under no moral compunction to refuse the payment. In his defence, he pointed to the fact that, although his personal reward was substantial, shareholders had also enjoyed significant gains in the wake of the fulfilment of the company performance conditions for the award.

The Persimmon case can be viewed as a bellwether for the wider corporate governance debate as an increasing number of governments around the world (including those in the UK, US and the EU) have expressed faith in the capacity of institutional shareholders to act as 'stewards' of listed and, to a lesser extent, private companies. Many have enacted regulation or legislation (like the UK Stewardship Code, the EU Shareholder Rights Directive and the Dodd-Frank Act) which empowers shareholders and encourages them to become more engaged in a high profile corporate governance role (including the oversight of CEO remuneration).

Policy makers appear to be convinced that if institutions can be persuaded to adopt a meaningful corporate governance oversight role, the resulting impact on corporate performance, behaviour and accountability will be beneficial for the companies themselves and the economy as a whole.

In our new book, "Corporate Governance and Investment Management: The Promises and Limitations of the New Financial Economy" (Edward Elgar, 2017), we examine the major institutional shareholders in UK corporate equity, including pension funds, retail collective investment funds, alternative investment funds and sovereign wealth funds. The rise of institutions as owners of corporate equity is in no small part due to the general trend of "financialisation" in developed economies, and collective investment vehicles have grown to become dominant owners and representatives of corporate equity.

The ownership of corporate equity brings with it historically-defined legal and economic rights to participate in corporate decision-making. It also arguably brings with it moral rights and obligations relating to the practice of good corporate ownership which policy-makers nowadays call 'stewardship'.

As owners of corporate equity, institutions should, in theory, be aligned with the social interest in the long-term performance, well-being and sustainability of their investee companies. They should be eager to contribute their influence to the shaping of a healthy and sound corporate sector which delivers long-term savers' needs through long-term value creation. However, for a variety of reasons

(described in the book and demonstrated by cases like at Persimmon), this optimal corporate governance role is often not realised in practice.

For example, most pension schemes and retail collective investment schemes are subject to short-termist pressures that can make the expenditure of significant time or resources on the corporate governance oversight of any particular investee company incompatible with their commercial imperatives and regulatory obligations. Indeed, regulatory obligations are often a key source of the short termist pressures that funds face even though these obligations are well-intentioned for beneficiary protection and prudential objectives.

Private equity funds that play an engaged corporate governance role in unlisted enterprises can exert significant economic and governance impact on their investee companies. Activist hedge funds can also influence corporate performance by using their shareholder powers to make certain specific demands of boards and management. Their activism is however instrumentally orchestrated to achieve certain objectives primarily to benefit themselves, and it is uncertain if their shareholder roles are necessarily for the good of the company in the long-term. We find that such investment fund models are, on the whole, also unlikely to promote a long-term ownership approach based on stewardship (although there may be individual cases of beneficial impact).

Sovereign wealth funds are important new players in the corporate ownership universe and are inherently less subject to short-termist investment pressures. In principle, they could be well-suited to advancing the sustainable well-being of their investee companies. However, many of them may be subject to the political influence of regimes whose public governance is viewed with suspicion in many western countries, although some institutions - such as Norway's public pension fund - should be applauded for using their ownership rights in corporate equity to encourage improved corporate responsibility and behaviour.

Overall, therefore, we are sceptical of claims that institutional investors possess in aggregate the capacity or the willingness to genuinely embrace a 'stewardship' role – based on principles of good company ownership – notwithstanding the contrary claims which are often made by their PR and corporate governance teams. This is not to deny that the investment management sector performs an increasingly important function of intermediating myriad and voluminous savings needs on a global scale. However, investment management is just one economic sector amongst many, with its own commercial and regulatory concerns.

In order to address the public interest in a well-governed and performing corporate sector over the long run, perhaps part of the solution will be to re-examine the legitimacy of the traditional ethos of shareholder primacy. The policy expectation that institutions will embrace 'stewardship' is itself a facet of shareholder primacy - it is taken for granted that shareholders have both the legal right and the inherited social mandate to guide corporate decision-making and behaviour.

However, shareholder primacy in listed companies has generated problems of corporate and market short-termism, an unhealthy focus on dividends and share buybacks, and often justifies the sacrifice of stakeholder interests for boosting financial performance. Shareholder primacy is a narrow and limited premise for company law, as it does not take into account the reality that the economic organisation of the company is made up of many more sources of value than its top management and its shareholders. The best companies already recognise this reality themselves. However, it is

now imperative to consider introducing a more stakeholder-oriented model in company law and the wider corporate governance framework. This would in turn broaden the focus of corporate governance beyond the investment management industry in favour of wider sources of accountability and oversight.

It may be argued that enrolling a wider group of stakeholders in company law would necessarily be disruptive for existing legal structures, creating confusion for directors' duties and corporate decision-making. However, the stakeholder voice could be incorporated in many practical ways, including board or board committee representation for employees and major creditors, making independent directors genuinely independent instead of vulnerable to dismissal by major shareholders, and establishing dedicated forums for engaging stakeholder voice in the company.

Our conclusion is that the investment management industry will continue to flourish as a major industry in many economies, but should no longer distort the wider corporate system in a way that is inconsistent with the social and economic requirement for long-term value creation. This is a change of role that fund managers themselves may ultimately come to welcome.

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