Institutions and good governance

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Thank you for the opportunity to participate in the ASIC Summer School.

My colleagues and I at Ownership Matters believe that the interests of all owners are served by fair, open and transparent markets – where all types of risks are well understood and can be priced accordingly.

ASIC's role in keeping the rules fair for all investors is crucial and the opportunity to contribute to a debate about the policy settings to promote good governance of our listed companies at this Summer School is very much appreciated.

I'd like to cover 3 areas of governance interest, director election, capital raisings and takeovers, where the role of institutions is paramount, but not always straight forward and pose policy dilemmas for regulators.

Whether we like it or not, institutions <u>are</u> responsible for monitoring the performance and effectiveness of the boards entrusted to govern Australia's listed entities.

This is simply a product of the weight of capital institutions control, due in no small part to their central role in Australia's $1.3 trillion compulsory superannuation system.

According to the latest figures from Orient Capital, the beneficial ownership analysts, institutions control on average, 54% of ASX 200 companies, compared to 30% held by retail shareholders.

Domestic institutions are the most important group with an average 33% holding, followed by foreign institutions with 18% and hedge funds with 3%. Some estimates have the voting controlled by large super funds between 12 – 15%, though this might understate the actual occurrence is some entities where super funds have been known to hold well in excess of 20% of the register.

Institutions are the swinging voters of ownership matters, their actions and perceptions determine the primary governance of a company. And, in aggregate they are voting, of that there is little doubt.

Voter turnout in AGMs at ASX 200 companies has risen from 30% in 1999, to 61.7% in 2011. Institutions, driven by the mandates won from many wholesale superannuation funds which now insist on all proxies being cast.

But are institutions well placed to perform the role of holding boards and management to account?

Some would have us believe that institutional ownership is part of the problem of poor governance of listed companies, the so-called "ownerless corporation" thesis. Whereas once underperforming management would have been turned over by owners, the relentless, short-term focus of the funds management industry means that underperforming management is able to turn over its owners instead of vice-versa.

Governance issues can appear intractable at some companies, compounded by a lack of co-operation between investors.

A combination of mandate limitations, manager style (such as passive funds) and aptitude for the dirty, thankless task of getting involved to turnaround an underperforming company means that frequently, *no one* has been taking responsibility for stopping shareholders' money being fleeced by rent-seeking agents.

I have come to take a more sanguine view.

Firstly our policy interest should not be drawn by a desire to save institutions and their end savers from their own apathy. Shareholders are blessed with power in Australia, if they choose not to use those powers, there are no grounds for complaint.

Secondly, as long-term investors emerge, mandates will evolve to accommodate performance metrics that incentivise managers to get deeply involved in turnaround stories. There is nothing stopping funds managers agreeing with super funds to "bench" a stock from temporal performance metrics on the understanding that the manager will actively seek to improve that company's governance.

Thirdly, disclosure on governance issues in Australia is generally good. Whilst institutions may not generally have the resources or expertise on governance issues, the barriers to entry for funds managers and firms like ours that serve them with specialist governance analysis are low.

The marketplace should be well positioned to put a value of governance and identify those managers who can exploit it.

In theory institutions should be well placed, over time, to address governance matters; however in practice there are conflicts between this pursuit and the day to day pressure of performance demanded by their clients.

I'd like to illustrate this conflict by reference to three crucial areas of governance concern: director elections, capital raisings and takeovers.

Director Elections

As I mentioned earlier, Australian shareholders are blessed with powers. Unlike the US, Australian shareholders can call a meeting at any time to remove a director with 5% of the vote. Any shareholder can stand for election. And the Parliament's recent intervention to curtail the "No Vacancy" limitation, has meant that there is now procedural fairness in how any ballot is conducted.

It is clear that Australian shareholders, in large part, value those powers. In 2011, seven ASX 200 companies that attempted to get around the NO VACANCY rules by changing their constitutions, were rebuffed by shareholders.

However whilst shareholders might cherish their power, it is equally clear that most institutions don't use them.

The frontline defence against the destruction of shareholder value remains a competent board. Yet investors are seemingly incapable of distinguishing between good and bad directors at the ballot box. Over the past 5 years, an incumbent ASX 200 director has been returned to office with an average vote of 96%.

In part it is an information problem; shareholders can't know which directors are better than others. However logic suggests that non-executive performance should be normally distributed, and the prolonged underperformance of some companies should reflect more dissent than can be observed. The reasons for this are complex, but we would be naive to think that conflicts of interest did not play a part.

There is some recent evidence in companies such as Tassal, Paperlinx and Spotless that the overt threat to remove directors is being utilised by activist investors. To date that seems to be directed toward transactions. However mainstream institutions prefer "off balance sheet" activity to convince directors to move on, rather than public embarrassment.

Our knowledge of how this feedback mechanism works in practice is why Ownership Matters believes the two-strikes legislation on executive pay is such a limited option. There is no evidence that institutions will suddenly feel emboldened to turf out boards on pay issues alone, if they don't use their powers on general underperformance. Shame is an ineffective regulator of corporate behaviour, because the rewards for enduring it are so high.

Our fears that the feedback loop on executive pay would be diminished by investors "pulling their punches" on remuneration reports for fear of triggering an EGM may yet be realised. Last year remuneration report defeats were down on previous years, and whilst first strikes were triggered at 23 ASX 300 companies; the real test will come next year when the second strike is considered.

As a policy preference on remuneration issues, Ownership Matters strongly favours a preventative approach over cure that may take two years to arrive.

Capital raisings

The prominence of institutional ownership also raises a tension where the governance of capital raisings is concerned. Relying on institutions to police the fairness of capital raisings through traditional governance routes may be in conflict where institutions themselves stand to gain at the expense of minorities who cannot participate in mechanism chosen.

This tension was on display during 2008 – 2009 where ASX 200 companies, beset by the global financial crisis raised $99 billion in capital. $45 billion was raised by placement at an average discount to the prevailing market price of 12.5%.

When a discounted capital raising is done in which an investor cannot participate, it's akin to their interest in the company being transferred to someone else. During this period, institutions clearly benefited at the expense of retail shareholders; and domestic institutions profited at the expense of their foreign counterparts.

Australia runs a very liberal dilution limit, permitting directors to issue shares up to 15% of the company to a single shareholder in any rolling 12 month period.

Underneath the substantial shareholding cap of 5%, there is no transparency over access to placements and shortfall allocations.

Institutions who have benefited from placements are in the happy position of having increased their voting stake, and thus, presumably favourably disposed to directors in the future.

If there is a policy interest in promoting fairness within the existing flexibility, then it should be directed at disclosing which institutions have increased their pro-rata ownership interest by greater than 10 - 20 basis points in non pro-rata raisings. This information is already available via inspection of the beneficial ownership register, however it is not contemporaneous and unlikely to make the market for raisings work more equitably. When the Council of Financial Regulators grants ASIC, as I hope it does, the power to make listing rules and impose them on the ASX, then I hope that this is one of the first issues considered.

Admittedly the market has developed far more sophisticated structures for raising capital (such as the PATREO structure that enables acceleration with equity between classes), however institutions can't afford to be wilfully blind about the effects of dilution by placement, as they may be next to be disadvantaged by it.

Indeed in situations like Fortescue Metal or the raft of smaller resources companies have placed substantial amounts of their capital with foreign shareholders (often together with an off take agreement), they already have been.

Takeovers vs Schemes

The final situation where the role of institutions is multi-dimensional from a governance perspective is takeovers.

In recent years we have witnessed the acceleration of a two-tiered takeover regime. Within the ASX 200 (where institutional ownership dominates) it is now extremely rare for takeovers to be effected by on-market bids that require 90% acceptance before compulsory acquisition.

Rather the preferred option for bidders and the directors involved in agreed bids is the takeover by Scheme of Arrangement, which can be approved, subject to the Court's imprimatur, by 75% of securityholders who turn out to vote.

At stake here are the rights of dissenting investors – their property can be acquired from them for consideration they do not believe to be fair value.

Institutions are more likely to vote on all issues, including schemes; and thus have a disproportionate influence in Schemes. This is a fact, though it should be said that all shareholders are able to vote – apathy is no excuse.

There is certainly a belief amongst many institutions that the existence of schemes increases the market for corporate control, enabling transactions and more effective governance of underperformers.

This is a superficially appealing proposition for investors whose time horizon is short, especially in an environment where alpha is difficult to demonstrate. However the differential thresholds between schemes and on market bids is an incongruous proposition for many long-term investors who would prefer a consistent approach so they can better value the risk of being "transacted out" of ownership by director discretion.

Section 411 (17) of the Corporations Act which was intended to stop Schemes being used to avoid on market takeover bids, now appears to be a dead letter. The impassioned attempt by Kerr Nielsen at Platinum Asset Management to frustrate the Xstrata / MIM scheme and force it on market was roundly dismissed, though it should be noted that his view on the value of MIM stock was endorsed by time.

Though I accept that ASIC does an extraordinary job in making the full information available to investors whatever takeover path is followed, the differential acceptance thresholds are a major issue when it comes the protection of an owner's fundamental right not to sell.

ASIC now rarely objects to the choice of takeover by Scheme in ASX 200 companies, and almost never on the basis that they are easier to effect.

The preponderance of Schemes in ASX 200 companies where 90% of stock market value sits suggests that our policy choices are obscuring the value of investors long term property rights, and tilting them in favour of institutions short term focus.

If this is really the choice that the Australian capital market wishes to make, then maybe we should have a debate about determining and aligning the appropriate thresholds for agreed bids, regardless of the mechanism chosen.

Thank you for your attention.