

The Boardroom Report

European spotlight turns on proxy advisers and asset manager pay

“MANY ASSET MANAGERS ARE SELECTED ON SHORT-TERM, RELATIVE PERFORMANCE”

The role of proxy advisers and how fund managers are rewarded were some of the issues scrutinised by the European Commission (EC) in its recent [green paper](#) on the corporate governance framework in the European Union.

The green paper was based on interviews with a wide range of European listed companies, corporate governance experts and representatives of the investor community and civil society.

Investors and investee companies shared their concerns that proxy advisers were not sufficiently transparent about the methods used to prepare their advice. More specifically, they said the analytical methodology of proxy advisers failed to take into account firm-specific characteristics or characteristics of national legislation and best practice on corporate governance.

Another worry was that proxy advisers were subject to conflicts of interest – for example, when they also acted as corporate governance consultants to investee companies or when they advised on shareholder resolutions proposed by their clients. The lack of competition in the sector also raised concerns, partly about the quality of the advice and whether it met investors’ needs.

The green paper also focused on the short-termism of capital markets. It noted that over the past two decades, investment horizons had shortened considerably and turnover on the major equity exchanges was now running at 150 per cent per year of aggregate market capitalisation, which implied that the average holding period of shares was eight months.

The EC added: “It appears that the way asset managers’ performance is evaluated and the incentive structure of fees and commissions encourage asset managers to seek short-term benefits. There is evidence (confirmed in the EC’s dialogue with institutional investors) that many asset managers are selected, evaluated and compensated based on short-term, relative performance. Performance evaluation on a relative basis, i.e. the extent to which they outperform or underperform a market index, can encourage herd behaviour and a short-term focus, particularly if the short interval is used to measure performance. The EC believes that short-term incentives in asset management contracts may contribute significantly to asset managers’ short-termism, which probably has an impact on shareholder apathy.”

A June 2010 EC green paper on corporate governance in financial institutions supported greater disclosure of the incentive structures for asset managers. “The question is then whether additional measures to better align the interests of long-term institutional investors and asset managers are appropriate (for example, developing a set of investment principles),” the EC notes.

“More transparency about the performance of fiduciary duties by asset managers, including their investment strategies, the cost of portfolio turnover, whether the level of portfolio turnover is consistent with the agreed strategy, the cost and benefits of engagement, etc, could shed more light on whether or not asset managers’ activities are beneficial for long-term institutional investors and long-term value creation on their behalf.

“Furthermore, information about the level of and scope of engagement with investee companies that the asset owner expects the asset manager to exercise, and reporting on engagement activities by the asset manager, could be beneficial.

“More transparency on these issues would help institutional investors to better monitor their agents and thus have a greater influence on the investment process. As a consequence of such improved monitoring, long-term institutional investors might decide to renegotiate asset management contracts to introduce portfolio turnover caps and require their asset managers to be more active stewards of the investee companies.”

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Keeping it in the family

Introducing rules and guidelines in a family constitution could help family businesses deal with issues before they arise, says Sue Prestney, chairman of MGI and a principal of MGI Melbourne.

“It is too late to deal with an issue after it has occurred as the situation may have become emotional and consequently difficult to resolve, resulting in potential damage to the viability of the business and family harmony,” she says.

MGI recently supported a survey that found only 18 per cent of family businesses have formal processes in place to deal with predictable family business issues before they arise, such as succession planning and management of the business in the absence of a key family member.

The *MGI Australian Family and Private Business Survey* of 5,000 Australian companies was conducted by RMIT University and reveals that very few family businesses are actively learning to deal with the challenges that result from combining family with business. Less than 30 per cent hold regular family meetings to share information, build trust and achieve consensus.

Prestney says the family business constitution should deal with all the areas where family and business interact. “It is a cohesive, concise and formal way of getting family and business issues on the table and addressed,” she says.

“As part of that process, you should sit down with members of the family and talk to them about what issues they have before you do anything formal. Get them to fill in some questionnaires that will help drag out the issues and then have family meetings where you put these on the table and work through them together as a family in a facilitated and, hopefully, objective, non-confrontational way, because a lot of these issues can be sensitive.”

The constitution could cover areas such as equity succession, what the family actually wants out of the business, how the business should be managed, who should be on the board, how much input into decision-making the family should have, the management structure and the management succession timeline.

“It gets the dividend policy on the table and family members’ entitlements – all those things that cause tension in a family business.”

Prestney says non-executive directors can be important circuit breakers in this process. They can point out issues, suggest solutions and support the family as it works through these.

“But from my experience, they should raise the issues with the current owner because ultimately any of these processes must be driven by the current owner. If that person doesn’t own the process, they are not going to want to participate in it, and if they are not on board, it will not happen.”

Prestney says some of the mistakes that can be made during this process include:

- Thinking that the current issue is the only issue. Often it may be no more than a manifestation of something that has been bubbling over for years.
- Trying to resolve a particular problem but not getting the right amount of technical input. For example, equity succession could affect aspects like tax, stamp duty and wills.
- Not involving all the people in the family that have an interest in the issue.
- Not getting the balance right between the interests of the family and the interests of the business.

Prestney says family businesses are complicated and tricky. “That’s why it is good to have a process because it gives some order and you get a document where it’s all pulled together and people can read it and understand it. Then there are no misconceptions and wrong expectations about what should happen. Families should also update that document every year and change it where things change so that it’s always current and relevant.”

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Prepare for the UK Bribery Act

Companies doing business in the UK need to ensure they are prepared for the UK *Bribery Act* 2010, which comes into force on 1 July 2011.

According to Caroline Cox, a senior associate with Freehills' litigation practice group, the Act specifically targets overseas companies as well as UK companies.

Australian companies can be caught by the Act in two ways:

- If bribery is committed in the UK – for example, an improper payment is offered or made by a senior officer of an Australian company during a convention or business trip in the UK; or
- If an Australian company carries on business or a part of its business in the UK. Here, the company may be strictly liable for bribery committed anywhere in the world by any person or entity that performs services for or on behalf of the company, unless the company can establish that it had "adequate procedures" in place to prevent the bribery (corporate offence).

Cox says the bribery offences apply to inducements or bribes in a business context, not just bribery of government officials. "This has obvious implications in respect of business hospitality and entertainment. Companies will need to ensure that any such hospitality is not intended to improperly influence another person or entity in relation to a decision or function."

To avoid allegations of such conduct and defend themselves if they arise, she says companies need to have in place:

- Policies on the provision of gifts or entertainment – for example, approval required for gifts or entertainment above a certain value; and
- Accurate record-keeping of any gifts or entertainment provided, including when given, to whom, why and by whom, along with who approved the gift or entertainment and on what basis.

Cox adds that under the Act, a company is liable if an "associated person" or a person who performs services for or on behalf of the organisation bribes another person. This embraces a whole range of people such as employees, joint venture partners, foreign subsidiaries, consultants, agents and professional service firms.

"However, the conduct of an associated person will only give rise to liability if the person is performing services for the organisation and the bribe is paid with the intention of benefiting the organisation," says Cox.

"The commercial organisation will have a full defence if it can show it had adequate procedures in place to prevent the bribery. What constitutes 'adequate procedures' will always be fact-specific, taking into account the size and nature of the business."

She notes that the UK Ministry of Justice has issued guidance on the Act, which sets out six principles that should underlie a company's anti-corruption procedures.

Under the Act, small payments made to expedite or secure the performance of a routine government action, such as granting a licence, will constitute a bribe.

"For companies where facilitation payments have long been accepted as simply a cost of doing business, the zero tolerance for such payments under the Act requires a major cultural change," says Cox.

"According to the guidance, it is unlikely that companies will be prosecuted for one-off small payments, payments made under duress or payments that are revealed to the UK authorities by self-reporting. Prosecutors will, however, be focused on the adequacy of the procedures companies put in place to deal with facilitation payments."

She says the red flags for potential bribery violations that directors should look out for include:

- Entities or individuals who may be "associated persons" (such as employees, joint venture partners, foreign subsidiaries, consultants, agents or professional service firms) that refuse to meet your compliance requirements or that do not accept your due diligence processes.
- A lack of accurate business records from an associated person, such as a joint venture partner or a foreign subsidiary.
- Projects which consistently run over budget or the payment of commissions substantially over the going rate.
- Hospitality, gifts, entertainment or other promotional expenses that are out of line with industry norms.
- A request from a foreign public official for an investment in a local community project or charity.

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Think before you ask

Directors often ask questions in the boardroom to flush out information that could help them in decision-making or advising management. But with a bit of skill and thought, they could also use their questions to empower management.

So says Lindsay Tighe, CEO of Inspirational Coaching and author of *The Answer – Improve your life by asking better questions*.

“While there are many situations when there is a requirement and expectation that we will advise, there is certainly scope to reflect on whether the approach is as balanced in favour of a more empowered approach, particularly given that this role modelling will have a flow on effect on the executive’s style of leadership,” she says.

She notes research shows that 60 per cent of people’s potential does not get used in the workplace and the largest contributory factor creating this is the workplace culture and leadership style adopted.

“When using a questioning approach, it is essential that we think about the purpose of the question. Very often we use questions to gather information to enable us to make decisions. The approach I am talking about is using questions to empower the other person to make their own decisions, which then requires a very different skill set.”

When questioning to empower, she says directors should ask more solution-focused questions, which enable the person to develop their own ideas and solutions. “When we ask these questions, there needs to be a willingness to let go of your way and an openness to listen to and accept the other person’s ideas, even if they are different to your preferred approach,” she says.

“By asking questions we enable the other person to build confidence and capability and start to fulfil their potential. In addition, it has been proven that when someone gets their own idea or insight from a question, it releases chemicals into the brain like adrenalin and endorphins. This means the person will feel more motivated about the idea because they own it and are far more likely to get the job done with an enthusiastic approach.”

Tighe says asking questions to empower executives doesn’t mean letting go completely. “As board members you are still there to guide and provide advice – the real skill is in deciding what approach to use at the right time with the right person. We know generally that human beings have a real tendency to take a more directive and advisory role and it can be a challenge to become more of an ‘asker’.”

By role modelling using questions to empower people, Tighe believes directors will support the executives in building confidence, feeling more engaged and motivated with the decisions made, given that it is they who are making the decision. “This will in turn enable the executives to build a more empowered or questioning culture in their teams, which releases the potential of staff throughout the organisation.”

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Have your say on financial reporting

Directors often find Australia's financial reporting requirements frustrating. Indeed, 39 per cent of those polled in the Australian Institute of Company Directors' recent *Director Sentiment Index* found the International Financial Reporting Standards (IFRS) quite dysfunctional, while only 16 per cent were happy with them.

In late June 2010, both the Commonwealth Government and the Australian Accounting Standards Board (AASB) made changes to financial reporting requirements that were expected to reduce unnecessary compliance costs.

In order to gauge the effect of these changes, Grant Thornton is conducting its *Simplifying financial reporting: Fact or fiction?* [survey](#).

This survey is designed to see whether those changes actually did reduce compliance costs, whether further improvements are needed and what lessons can be learned for the future. Your comments are particularly important as the Government's next area for reform includes its current proposals to simplify not-for-profit reporting and radical changes in accounting standards for leasing. Globally, there is also a push for integrated reporting which combines financial reporting, climate change and sustainability, and non financial reporting measures.

Your participation in this [survey](#) would be greatly appreciated and a copy of its consolidated results will be sent to you. It should take no more than 15 minutes to complete.

Note: The survey closes on Monday 20 June. For more information, contact Keith Reilly, national head of professional standards at Grant Thornton, at: keith.reilly@au.gt.com

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