

## Best Practices for Dealing with Non-Controlling Shareholders – An Institutional Investor's Perspective

by

**Christian Strenger**

Chairman, International Corporate Governance Network (ICGN)  
Member of the Supervisory Board, DWS Investment GmbH, Frankfurt  
Member of the 'German Government Commission on Corporate Governance'

---

### **I. The value proposition and main ingredients of good corporate governance**

There is ample evidence today that demanding best practice standards of good corporate governance and convincing enforcement processes lead to higher market valuations of enterprises in free capital markets.<sup>1</sup> A few recent examples: according to a Harvard Law School study the disregard of shareholder rights causes lower firm valuations (7.4 % p.a. difference) and large negative abnormal returns during the 1990-2003 period.<sup>2</sup> Current Deutsche Bank research shows that European companies with improving governance standards outperformed a portfolio of deteriorating companies by

---

<sup>1</sup> See for example Becht / Franks / Mayer / Rossi (2006): Returns to Shareholder Activism, ECGI Working Paper in cooperation with Hermes, forthcoming; Gompers / Ishii / Metrick (2003): Corporate Governance and Equity Prices, in: The Quarterly Journal of Economics, Issue 118, No. 1; Drobetz/ Schillhofer / Zimmermann (2004): Corporate Governance and Expected Stock Returns: Evidence from Germany, in: European Financial Management, Vol. 10, No. 2, 267-293; Klapper / Love (2004): Corporate Governance, Investor Protection, and Performance in Emerging Markets, in: Journal of Corporate Finance, 10, 703-728; Chakrabarti (2005): Corporate Governance in India – Evolution and Challenges, Georgia Institute of Technology – Finance Area.

<sup>2</sup> Lower shareholder rights have led to lower share returns during the 1990s (7.4% p.a abnormal return for a respective long/short-portfolio). Bebchuk / Cohen / Ferrell (2004): What matters in corporate governance?, Harvard Law School, Discussion Paper No. 491

4.4 % per annum.<sup>3</sup> A joint study of the European Corporate Governance Institute (ECGI) and London Business School (LBS) shows that the governance-focused Hermes UK Focus Fund outperformed its benchmark by an average 4.8 % each year from 1999 through 2004. For Asia, CLSA/ACGA Governance Scoring for 27 countries (including India) confirms that firms with better governance outperform significantly even in bull markets when governance usually has a lower priority with investors.<sup>4</sup> All this confirms the positive effects not only for shareholders but also for the companies: their cost of equity capital declines and acquisitions can be made on more favourable terms.

Many fast growing countries like India have made significant governance progress since 2002, when the well known McKinsey-Survey found that investors were then willing to pay a premium of 23 % for well-governed companies in India.<sup>5</sup> Today, this premium seems more likely to be in the area of 5 – 10 %, with wider differences in governance quality for individual companies, depending on their size and international scope.

Institutional investors are a major arbiter in what constitutes good governance in practice. They now speak for the majority of the share capital of the large publicly listed companies in the top 10 countries of the world. In Germany for example, their share in the top 30 DAX companies often exceeds 60 %, sometimes even 80 %. Institutional investors know very well that they must pursue good governance as it increases the longer-term value of the investments. As they manage portfolios for hundreds of millions of beneficiaries (that rely on their performance for their retirement and education), these institutions have themselves considerable pressure to perform well enough - otherwise their clients go elsewhere.

With the OECD Corporate Governance Principles (revised in 2004)<sup>6</sup> serving as the global benchmark, satisfactory governance standards are therefore expected worldwide. Countries like India with fast growth and large international shareholdings (the companies in the DWS funds presently account for some 1.5 billion euros) have to face international expectations for best practice.

---

<sup>3</sup> Grant (2005): Beyond the numbers – Corporate Governance in Europe; Deutsche Bank AG (Ed.), Global Equity Research – Strategy Focus;

<sup>4</sup> CLSA/ACGA: CG Watch 2005 – Corporate Governance in Asia, 'The holy grail', October 2005.

<sup>5</sup> McKinsey & Co.: Global Investor Opinion Survey 2002. Internet at [www.mckinsey.com/governance](http://www.mckinsey.com/governance)

<sup>6</sup> Available in the Internet at [www.oecd.org](http://www.oecd.org); see also the ICGN global corporate governance principles available at [www.icgn.org](http://www.icgn.org)

As India has an ever growing shareholdership by global investors and there is a strong desire by its own major companies to become even bigger international forces through sizable acquisitions, it is a given that its road to good governance is a one-way street only. India and its companies should therefore see good governance not as a burden but as an opportunity.

What constitutes good governance from the international investor's point of view? Full transparency and convincing independence are key ingredients for the long-term success of listed companies. This should be coupled with a proper balance between able executives and sufficiently independent non-executive directors, strong prevention against undue conflicts of interest and an equitable treatment of non-controlling shareholders.

## **II. Key prerequisites for success with non-controlling shareholders**

### **1) Transparency standards in line with international requirements**

This starts with comprehensive disclosure of all relevant financial and non-financial information. In India this appears to be comparatively good – also indicated by the number of companies listed in the US with its rigid disclosure rules. The move to IFRS reporting is another important step towards sufficient transparency standards. Companies that have moved from national reporting standards have gained substantially from this effort.

Regular financial information for a true picture of the company's affairs and to prevent abuses should include: Mandatory quarterly financial reporting, timely reporting and disclosure of share-dealings by insiders and controlling shareholders as well as low (5%) disclosure-thresholds for share-positions. While this is all covered by the rules and regulations in India, the disclosure of shareholder agreements and cross-holdings does not appear to be mandatory. This deficit could well be used to exercise de facto control by a group of 'friends' at the expense of the real minority shareholders.

Governance reporting: A good way to provide governance transparency is to draw up company specific corporate governance guidelines. Coupled with regular and meaningful governance and compliance reports (signed by executives and checked by the Stock Exchange) a reasonable idea of the governance quality of a company can be gained by outside shareholders. Therefore, the Supervisory Authorities and the Stock Exchanges need to

cooperate closely to effectively monitor and enforce compliance with the disclosure rules in practice.

Then there is the issue of clarity and comprehensiveness of the information: as shareholders have to be efficient in their analysis of thousands of companies, real transparency requires comprehensive and 'readable' reporting. Taking the disclosure for management compensation as an example: transparency through comprehensive presentation of all compensation items (including the valuation of stock options) in a single block in the annual report would considerably enhance the information value in this important governance issue.

Equal and timely distribution of information to all shareholders: This is a key element of market integrity. No single shareholder should be given preferential access to insider information. Especially one-on-one interviews create critical occasions where board members must take considerable care not to provide price sensitive information. A fair disclosure policy also means that domestic and foreign shareholders receive all relevant information at the same time independent of their origin.

## **2) Convincing independence and quality of boards and auditors**

A crucial element of good governance is the quality of the non-executive (supervisory) board members, i.e. the ability to effectively monitor and control the management without stifling its entrepreneurial drive. The international corporate scandals of a few years ago have sharply increased board accountability. They highlighted its responsibility to ensure that efficient and sophisticated internal controls and risk management systems are installed by management.

Central for the effectiveness and the quality of the board is obviously the standing and independence of the non-executives. It is paramount that independence is not only confirmed by the formal absence of material conflicts of interest. What matters even more is that non-executive directors openly discuss and stand firm to well reasoned positions. Institutional investors therefore want to see a sufficient number of truly independent directors. The general requirement of the Indian Stock Exchanges that one-third (or even one half) of the board should be independent directors is an important element that, if properly implemented gives the opportunity for a satisfactory board

control. This must be provided by directors who can afford the necessary time to perform their board and committee duties. It seems inconceivable that any non executive director can provide quality service if he or she sits on more than 5 boards of listed companies (which is the maximum according to the German Governance Code<sup>7</sup>).

The establishment of board committees – especially audit, nomination, and remuneration committees – with at least a majority of independent members is today international best practice. Such committees enable intensive discussions, ensure quality decision making and reasonable control of the financial reporting.

Given the increasing complexity of most business models the need for enhanced qualification of board members is evident. Director training programmes are an important element of continuous upgrading. Equally, the independence and effectiveness of the board and its committees should be confirmed by regular performance evaluations (board reviews) with independent outside experts as drivers of the process.

The welcome progress of many OECD countries in their privatisation policy of state-owned enterprises (SOEs) to improve their competitiveness should be accompanied by adequate corporate governance practices and an appropriate institutional framework. To address the specific governance issues of SOEs, the OECD has developed a Guideline on the Corporate Governance of SOE<sup>8</sup> that is complementary to the OECD Corporate Governance Principles. This includes the establishment of well structured and transparent board nomination processes with the acceptance of truly independent directors. Particularly listed companies with substantial state influence need protection from undue public sector influence.

The German experience with Deutsche Telekom, Deutsche Post, and (particularly interesting for Delhi) Fraport AG proves that opening SOE's to the rules of the capital markets without special provisions is well possible and worthwhile for the greater welfare of the country's economy.

High auditor independence and quality imperative: To ensure the trust in the audit of financial statements, true independence of the auditor and the prohibition of most non-auditing services are important. Even with disclosure,

---

<sup>7</sup> The German Corporate Governance Code is available at [www.corporate-governance-code.de](http://www.corporate-governance-code.de)

<sup>8</sup> Available in the Internet at [www.oecd.org](http://www.oecd.org)

the permission to provide consulting services in the same size as the audit fees appears problematic. Auditors can be the best allies of shareholders as they are involved with the companies on a nearly daily basis, i.e. much more than non-executive directors. International best practice also favours independent auditor oversight by a body that operates in the public interest and that is not under the control of the auditing profession, e.g. 'PCAOB' in the US and 'DPR' in Germany.<sup>9</sup>

The quality of the audit work is equally important as the users of the financial accounts rely on audit quality to significantly reduce the probability of abuse and misleading statements. This requires audit people with sufficient experience and international background know-how.

### **3) Equitable treatment of shareholders**

Particularly if corporate ownership is highly concentrated (as it is still the case in India) it is of utmost importance that non-controlling shareholders are fairly treated.

Equal voting rights for all shareholders are the core of the one share – one vote principle. Any inequality in the control rights for ordinary shares can provide incentives for undue actions of the controlling shareholders at the detriment of the other shareholders. Therefore, the elimination of non-voting and super-voting shares should be vigorously pursued. In Germany, all ordinary voting right restrictions were legally banned in 1998. The remaining outstanding preferred shares have been mostly phased out since then. It is astonishing that there are still many violations of this core principle in the US and in Europe. Particularly striking imbalances exist in Sweden and the in the Netherlands (this allows for example Mittal to continue with its super voting power for the family held B shares, a feature that would be impossible to have with a listing in India).

The Annual General Meeting (AGM) is the premier governance instrument for investors to directly articulate their concerns (and also approval) through the exercise of their rights. Thus, a level playing field for all shareholders at the AGM is imperative. This requires compliance with the following best practice principles:

---

<sup>9</sup> German Financial Reporting Enforcement (see [www.frep.info](http://www.frep.info)) and Public Company Accounting Oversight Board (available at [www.pcaobus.org](http://www.pcaobus.org)); see also the recent statement of concern on the structure of the Audit market by the Accounting and Auditing Practices Committee of ICGN (see [www.icgn.org](http://www.icgn.org))

- Elimination of cross-border voting impediments and other voting barriers (e.g. through installing appropriate electronic and legal means)<sup>10</sup>: Many companies still do not give their shareholders the possibility to properly exercise their shareholder rights at the AGM. This is particularly relevant in a large country like India, where shareholders must often travel to rather remote areas of the country.
- Not only for the AGM it is necessary to provide timely and comprehensive shareholder access to all relevant financial and non-financial information (including the AGM agenda and counter motions). This information should be available to all shareholders also via the Internet well before an AGM (rather 30 than 21 days). Equally important is a functioning proxy voting process that allows unrestricted voting by mail or via Internet.
- Also, holders of depository receipts (mostly foreigners) should have the same rights and opportunities to vote as the direct shareholders. It is remarkable that no satisfactory solution has yet been found to implement full cross-border voting powers for ADR's of many companies (not only in India).

Fair treatment in merger transactions: This requires a takeover code that enables non-controlling shareholders to participate equitably in offers with minimum thresholds for a full offer of not less than 30% (the Indian rule that starts already at 15% seems quite low), the 'highest price paid – rule' to be established, impediments against 'creeping' acquisitions and the ban of poison pills.

#### **4) Satisfactory control and enforcement of good governance through independent regulators**

Strict enforcement mechanisms, for example disclosure rules and right of access to company data by the regulators, are essential for good governance quality. This is elementary to build and keep investor confidence in the regulatory framework. In addition, the authorities must be well-equipped and willing to impose appropriate sanctions. For example: While generally the listing is a very good lever for sanctions, the de-listing in case of non-compliance is hardly a big threat for companies with very little freefloat (in India more than 85% of the listed companies). Significant fines imposed on companies and personal liability by board members that fail to meet the requirements could be more promising here.

---

<sup>10</sup> See also the Cross Border Proxy Voting report commissioned by ICGN (see [www.icgn.org](http://www.icgn.org))

Efficient protection against insider-trading and uncontrolled self-dealing is a must to sustain the integrity of the market. This requires a concerted effort of the stock exchanges, financial intermediaries and appropriate internal company controls to avoid late or unsatisfactory transparency.

To guarantee sufficient enforcement it is vital to build and develop the appropriate bodies and sanction mechanisms. This should include:

- Centralise competencies in one market supervisory authority and concentrate courts in one authoritative place that can process all normal court issues within say one year. This requires regular and extensive training for enforcement authorities.
- The introduction of an independent arbitration panel consisting of accepted market experts to resolve conflicts between non-controlling and controlling shareholders could be an important solution to achieve market oriented, self-regulatory solutions. This panel should be able to decide within three months thus relieving the courts from unnecessary work that can be settled directly between the parties. According to the OECD Principles' commentary this has proven beneficial in many countries.<sup>11</sup>

### **III. Institutional investors have a fiduciary duty to act convincingly in the interest of their clients**

While it is vital that companies respect the rights of their shareholders, the shareholders themselves must exercise them responsibly. This applies both to the external governance, i.e. the relationship with portfolio companies but also to the internal governance, which is to uphold best practice governance in the own organisation.

Institutional investors must be exemplary in the comprehensive and educated exercise of the voting rights at their portfolio companies. They should therefore develop and disclose comprehensive corporate governance and voting policies encouraged by the regulators. While qualified voting of any sizeable holding should be a must, a mandatory obligation to vote even small share positions irrespective of size and location could mean to incur overly large costs not outweighed by the benefits. However, the individual voting record and any exceptions made should be annually disclosed.

How to achieve meaningful results from the communication with portfolio companies? A critical, yet constructive dialogue with companies is necessary.

---

<sup>11</sup> OECD Principles of Corporate Governance (2004), available at [www.oecd.org](http://www.oecd.org)



Institutional investors should also be able to share their views on the governance of individual companies. Such communication should not be considered as 'acting in concert' by the authorities as this would forego any positive influence that institutions can exert on companies.

In their own operations, institutional investors must comply with high standards of transparency, sufficient independence of the supervisory body, and a clear separation of functions. The process to manage potential conflicts of interest that are relevant to portfolio managers belonging to diversified financial groups should be explained. Particularly in group structures, independent directors are a must to protect the interests of fund shareholders or other beneficiaries. Regular disclosure how material conflicts have been managed is an important requirement. Finally, disclosure of the internal governance policy and compliance with an industry-representative code of conduct are key elements of best practice.

The ICGN has acknowledged the duty of institutions to comply with best practice in their own governance and drafted a 'Statement on Institutional Shareholders' Responsibilities'.<sup>12</sup> It will soon present an update to reflect further developments for credible internal and external governance standards.

#### **IV. A good governance framework is essential but only sufficient quality convinces institutions to be long-term shareholders**

Apart from the necessity to have a solid legal base in the individual country, self-regulatory initiatives and guidelines are a vital complement of better governance quality that cannot be achieved by prescription of good laws and proper enforcement only. The international guidelines and regulations by the OECD, World Bank, and the ICGN are a good basis for better governance practices world wide. For their application and measurement, it is vital to use practical tools (rating and scoring systems<sup>13</sup>) to achieve better implementation of good governance with investors, analysts and companies. This should also facilitate the understanding of its complex nature by the general public.

However, it is not only conformity with the letter of the rules, regulations and guidelines that matters but, most important, it is the quality of the individual good governance as perceived by third parties. To achieve the best possible

---

<sup>12</sup> Available in the Internet at [www.icgn.org](http://www.icgn.org)

<sup>13</sup> See, for example, the IFC Corporate Governance Questionnaire ([www.ifc.org](http://www.ifc.org)) and the DVFA Scorecard for German Corporate Governance developed by the Society of Investment Professionals in Germany ([www.dvfa.com](http://www.dvfa.com))

results, both the companies and their shareholders have to play their active part:

Company executives and their supervisory (non-executive) directors must accept that an active pursuit of good governance is paramount for longer-term success. At the same time, investors must play their part by an active engagement with the companies they invest in. Only then will they be able to generate extra value for their clients. The idea of 'free riding' on the coattails of active managers without incurring the respective costs will fail: passive behaviour does not allow insight into the positive differences of better companies.

The motivation to pursue good, even better corporate governance is simply the self-interest of all concerned: outperformance for the investors, better financing for the companies and more efficient systems for the countries and their governments.