Role of Institutional Investors
Chapter 2
ROLE OF INSTITUTIONAL INVESTORS

Leadership in governance and responsible ownership

2.1 OVERVIEW

Institutional investors are in a unique position to exercise influence over companies and to hold them accountable for good governance. Given the typically significant stake they hold, they have the ability to demand meetings with the senior management of companies, challenge them on issues of concern, discuss strategies for achieving the companies’ goals and objectives and be the leading voice of shareholders in demanding corrective action when wrongdoing occurs.

Thus institutional investors have a critical and proactive role to play in the governance of companies. They have better access to information and possess the resources to build the necessary monitoring capabilities. Given their unique position of influence, there is a need to prioritise their leadership role in governance.

Globally, the concept of “responsible ownership” is gaining momentum, premised on the belief that it is not enough for institutional investors to simply hold shares. They must also play an active role to promote good governance practices in companies by adopting a more long-term strategy to share ownership. Active engagement by institutional investors is an essential component of market discipline. By bringing their voice and lending their reputation to gain the attention of management, they can usher in an ownership culture that ensures management prioritises the best interest of the company at all times.

Institutional investors are professional investors who act on behalf of beneficiaries, such as individual savers or pension fund members. The categories of institutional investors are wide and can include collective investment vehicles, which pool the savings of many, and licensed fund managers to whom these funds are allocated.

Active participation of institutional investors in the exercise of shareholder rights will raise the level of governance as a result of increased shareholder engagement. Institutional investors should therefore continually assess their approach and invest in the necessary expertise and resources that will enable them to play a more effective role in monitoring and engaging the companies they invested in, leading by example and influencing good governance practices.

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1 As set out in the ICGN Statement of Principles on Institutional Shareholder Responsibilities.
2.2 STATE OF PLAY

In Malaysia, the large institutional investors, like the Employees Provident Fund of Malaysia (EPF), Lembaga Tabung Angkatan Tentera (Armed Forces Fund Board), Permodalan Nasional Berhad (National Equity Corporation), Pertubuhan Keselamatan Sosial (Social Security Organisation), Lembaga Tabung Haji (Pilgrimage Board) and Khazanah Nasional, have over the years taken various measures to instil better governance practices in their investee companies. As proactive shareholders, they conduct regular engagements with management of companies and vote on key issues at general meetings.

In 2007, the Guide of Best Practices for Institutional Investors (Guide) was issued jointly by the Institutional Investor Committee and Minority Shareholder Watchdog Group (MSWG) in line with the recommendations in the first Capital Market Masterplan to complement the CG Code and the Green Book – Enhancing Board Effectiveness. The Guide sets out the framework for how institutional investors should discharge their responsibilities on behalf of their beneficiaries and other stakeholders to influence, guide and monitor investee companies in a responsible way.

In 2010, EPF took a major step to instil a higher level of governance best practices and overall adoption of good corporate governance through the release of its Corporate Governance Principles and Voting Guidelines. The areas of focus in the guidelines include size and composition of the board, board committees, separation of power between chairman and CEO, re-election of directors, related-party transactions and dividend policy.

Internationally, various statements of principles, guides and codes have been issued to guide institutional investors in the exercise of their role. The International Corporate Governance Network (ICGN) Statement of Principles on Institutional Shareholder Responsibilities and the UK Stewardship Code are key examples.

A facilitative enabling environment has been cited as an important prerequisite to the practice of responsible ownership. This includes, among others, internal capacity building of institutional investors, addressing the high cost of engagements and allocating the time and resources to monitor companies.

As large institutional investors may hold diversified portfolios of stocks, resource limitations can hinder their ability to effectively monitor investee companies. In this regard, proxy voting and corporate governance advisory agencies can supplement institutional investors’ capacity to discharge their role as responsible share owners. The use of proxy voting and corporate governance advisory agencies can therefore provide greater opportunities to facilitate more substantive and constructive engagements with boards of companies. While the use of such services may be costly, such cost can be reduced if there is sufficient demand within the industry to create a critical mass.

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2 Issued by the Putrajaya Committee on GLC High Performance.
The ICGN Statement of Principles on Institutional Shareholder Responsibilities

The International Corporate Governance Network (ICGN) brings together some of the largest institutional shareholders with estimated assets under management exceeding US$10 trillion. The ICGN approved the Statement of Principles (Statement) in 2007. The Statement sets out the ICGN’s view of the responsibilities of institutional investors both in relation to their external role as owners of company equity, and also in relation to their internal governance. Both are of concern to beneficiaries and other stakeholders.

The key areas covered under the broad ambit of internal governance of institutional investors relate to oversight, transparency and accountability, conflict of interest and expertise; whereas the key areas under external governance with the investee company relate to engagement with the companies, voting and addressing corporate governance concerns of the investee company which relate to transparency and performance, board structures and procedures and shareholder rights.

The statement also observes that institutional investors which comply with these principles will have a stronger claim to the trust of their end beneficiaries and the exercising of the rights of equity ownership on their behalf.

The UK Stewardship Code

The UK Stewardship Code (Stewardship Code) was published in July 2010. It aims to enhance the quality of engagement between institutional investors and investee companies to help improve long-term returns to shareholders and the exercise of governance responsibilities by setting out good practices on engagement with investee companies to which the Financial Reporting Council believes institutional investors should aspire.

The Stewardship Code operates on a ‘comply or explain’ basis and the Financial Reporting Council encourages all institutional investors to report publicly the extent to which they observe the Stewardship Code.

Disclosures made pursuant to the Stewardship Code will assist investee companies to understand the approach and expectations of their major shareholders. The disclosures will assist institutional investors issuing mandates to asset managers to make informed choices, assist asset managers to understand the expectations of clients, and may help investors interested in collective engagement to identify like-minded institutions.
2.3 CASE FOR CHANGE

2.3.1 Effective exercise of ownership rights

Exercise of ownership rights ranges from contributing to improvements to the functioning of boards, to promoting information disclosure and transparency as well as supporting market discipline by rewarding better governed companies.

According to the Government-linked Companies (GLC) Transformation Programme Progress Review\(^3\), the total shareholder returns of the 20 largest GLCs controlled by Government-linked Investment Companies generated a five-year compound return of 14.2% to February 2010, outperforming the FTSE Bursa Malaysia KLCI by 2.9% per annum. This positive performance is reinforced by ensuring heightened governance in investee companies.

To a large extent the performance of the role of institutional investors is influenced by their mandates. The differences in investment objectives and strategies can lead to different approaches and levels of shareholder activism. Performance evaluation systems and incentive structure of fees and commissions which encourage short-term strategies will discourage any meaningful levels of shareholder engagement. Thus, where permitted by their mandate, a revamp of the performance metrics can encourage long-term thinking and active ownership.

Responsible ownership requires high standards of transparency, probity and care on the part of the institutions which may be met by adhering to a set of over-arching principles in the form of a code for institutional investors. There is a need for institutional investors to review their existing practices in the light of growing recognition of the significance of their role and heightened expectations to monitor management and moderate managerial discretion.

The formulation of a new industry-driven code can strengthen the accountability of institutional investors to their own members and investors. The new code will require institutional investors to explain how corporate governance has been adopted as an investment criteria and the measures they have taken to influence, guide and monitor investee companies. It is also important for institutional investors to include governance analysis in their investment appraisal to help identify better governed companies.

The following areas exemplify best practices to be considered in the new code for institutional investors.

\(^3\) Released in March 2010.
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Expectations of best practices under new code for institutional investors

Commitment to engagement

The code for institutional investors must address the issue of transparency with regard to institutional investors and their agents’ commitment to meaningful engagements and whether such engagement policies are effectively implemented.

Incorporate corporate governance into the investment decision-making analysis, and ensure effective communication between asset owners and fund managers

Specific good practices that should be encouraged include integrating corporate governance considerations into the investment decision-making analysis. In addition, institutional investors should also assess whether the company takes a view on the sustainability of its business.

Exercise of voting rights

The diligent exercise of voting rights is a key indicator that an institutional investor is effectively implementing its engagement policy. Publishing a voting policy will give both beneficiaries and investee companies a better understanding of the criteria used to reach those decisions. Publishing information on voting records after shareholder meetings also gives the beneficiaries greater clarity on how the votes are cast. Disclosure of the institutional investors’ voting record is also a way of demonstrating that conflicts of interest are being properly managed.

Establishing a ‘focus list’

Corporate governance may be used as a tool for extracting value for shareholders from underperforming and undervalued companies. A number of global institutional investors have established ‘focus lists’ where they target underperforming companies and include them on a list of companies which have underperformed a main index. Underperforming the index would be the first point of identification, while other factors would include not responding appropriately to the institutional investor’s enquiries regarding underperformance, and not taking into account the institutional investor’s views. By targeting companies which are underperforming and analysing their corporate governance practices, improvements can be made which could unlock the hidden value. These can include replacing poorly performing directors and ensuring companies comply with best practices in corporate governance.
Expectations of best practices under new code for institutional investors (con’t)

Monitoring performance

Institutional investors should monitor performance of investee companies regularly, communicate the outcomes clearly and periodically review the monitoring process for effectiveness. Monitoring performance would include reviewing annual reports and accounts, circulars, and resolutions as well as attending company meetings. In particular, institutional investors should satisfy themselves that the investee company committees are structured effectively. They should ensure that independent directors provide adequate oversight and maintain a clear audit trail of their meetings and of votes cast on company resolutions, in particular for contentious issues.

Intervention

Institutional investors should intervene when there are concerns about issues such as the investee company’s strategy, its operational performance and acquisition or disposal strategies, failure in internal controls, inadequate succession planning, inappropriate remuneration packages and failure of independent directors to hold executive management properly to account.

Commitment to the code

Institutional investors must be encouraged to adopt the code and consider publishing their commitment to the code or to explain why their business model precludes adherence to the code. In addition, institutional investors are encouraged to attend customised training programmes to help them engage effectively with boards.
2.3.2 Network of institutional investors

It is important for institutional investors to harness their resources to co-ordinate and network as a group in order to actively promote governance practices. A dedicated umbrella body could represent the common interest of all institutional investors and be a platform to shape and influence a wider sphere of corporate governance culture.

In jurisdictions such as the UK and Australia, dedicated institutional investor representative groups play a leading role, not only in formulating the code of best practices for institutional investors, but in monitoring its effectiveness and providing advice to its members. Institutional investors in these jurisdictions will generally, in addition to their own research and analysis, consult their representative group on whether a particular company is complying with good corporate governance practices.

An example of such a representative group is the Institutional Investor Committee in the UK.

The Institutional Investor Committee (IIC) in the UK is a group of trade associations which represent institutional investors and comprises the Association of British Insurers, the Investment Management Association and the National Association of Pension Funds.

The terms of reference of the IIC are to provide a forum through which its member organisations may:

- Consider relevant matters where it is felt a co-ordinated approach or representation may have a greater impact with the UK Government and regulators; European institutions; and, any other relevant international legislative, regulatory or standard setting bodies.

- Make joint representations/recommendations on occasion and by mutual agreement.

- Present a single voice for the institutional investment industry on matters affecting its role as investors in companies.

- Encourage compliance with appropriate codes from regulatory or other relevant bodies.

- Consider any matter affecting or likely to affect the interests of investors in companies to ensure that there is a better outcome for savers and investors.

Given the strategic role of institutional investors in promoting governance, a dedicated umbrella body of institutional investors will bring together the collective voice of institutional investors more effectively and will provide a platform to address governance issues, address impediments and seek solutions.
RECOMMENDATIONS

I. Formulate a new code for institutional investors
   ■ Institutional investors to drive the formulation of a new code and publish their commitment to the new code for institutional investors.

II. Create an industry driven umbrella body for institutional investors
   ■ Institutional investors to work together towards the establishment of an umbrella body.