

Role of institutional investors in relation to management boards and supervisory directors

A triangular survey

By:

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This survey was commissioned by Eumedion. We would like to thank everyone we interviewed for their willingness to speak candidly with us and to provide us with useful insights and tips. In addition, we received valuable comments on our survey as a result of preview presentations at INSEAD and the Studiegezelschap voor Economische Politiek (Dutch Society for the Study of Economic Policy), and the round table at Eumedion. Finally, we would like to thank various individuals who joined with us in reading and thinking. We are, of course, responsible for errors in this survey.

This survey was carried out in the period that both authors were independent.
Angélien Kemna joins APG Asset Management as of 1 November 2009.

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SUMMARY

The qualitative survey of the relationships between institutional investors, members of management boards and supervisory directors is based on interviews with various participants, preview presentations, a round table and literature study. The discussion of the findings and recommendations focuses on the Eumedion members among the heterogeneous group of shareholders.

Less than ten years ago the management system of a company was generally transparent, with a mainly dominant role for members of the management board and relatively passive roles for supervisory directors and institutional investors. This situation has changed into a complex social system within a short time, partly due to new legislation, the introduction of the Tabaksblat Code (the Dutch Corporate Governance Code), and the Anglo-Saxon influence. Existing players received more (institutional investors and supervisory directors) or less power (members of the management board) and new players (external regulatory authorities, politicians and the media, interest groups) came onto the playing field, without all the players having sufficient understanding of their own roles and those of others. This caused a great deal of tension, which practically everyone interprets as insufficient understanding of and confidence in collaboration.

In organizational psychology this is known as the multi-party problem, in which no one party can cope on its own and everyone is dependent on good collaboration as a consequence. The behaviour of a single party can strongly influence the whole. Parties are faced with the task of striking a balance between self-interest, the interests of others and respect for the interdependence. Becoming aware of one's own role and those of other people in the light of the whole is a crucial first step. It will then be necessary to learn how to cooperate on this new playing field. A multi-disciplinary approach must be taken to practicable solutions for reducing complexity and issues must be differentiated where necessary.

The first group of recommendations focuses on behavioural support in the present situation and assumes that even a few small steps will improve the relationships among the triangle of institutional investors, members of the management board and supervisory directors. These can be implemented immediately therefore, to the extent that this has not yet been done. The list is not exhaustive and is intended to be a source of ideas. It is important for the board of management to respect the stronger role of the supervisory board. The supervisory board must organize itself more explicitly, not only where all kinds of committees are concerned, but also with regard to its fiduciary responsibility and supervisory role. The institutional investor would already be taking a serious step if internal governance teams and fund managers were to form a comprehensive opinion on an enterprise.

The second group of recommendations makes a contribution to the discussion of modification of the present situation. We believe that every serious modification should be regarded with reticence, but would, nevertheless, like to contribute to the current discussion on the change of the role of institutional investors that of long-term engaged shareholders. The consequences for the interrelationships of the participants are addressed in the discussion, as are the preconditions for the successful fulfilment of a role of this kind. Such a role makes even heavier demands on the quality and intensity of the dialogue between board of management, supervisory directors and institutional investors, which costs time, money and effort for all parties. The Netherlands Authority for the Financial Markets (AFM) will have to issue clear best practices with regard to price-sensitive information and acting in concert, in order to accommodate more intensive dialogues. In order to persuade pension funds in particular to make the required investments, it is recommended to seek this in preferential prudential treatment and this can be considered in more detail in collaboration with De Nederlandsche Bank (DNB; the Dutch Central Bank).

Eumedion could undertake the coordination of these efforts in order to take the discussion a step further.

1. BACKGROUND AND WORKING METHOD

The recent financial crisis has caused a great deal of damage to institutional investors, who have been confronted with heavy falls in the prices of the shares in the companies in which they invest and with losses on bonds and debentures. Furthermore, a number of listed companies have decided to pay less dividend to shareholders or to cancel the payment of dividend altogether.

In the media, however, the role of shareholders is also referred to as part of the explanation of the causes of the financial crisis. Some shareholders are said to have been interested in achieving short-term results above all and to have had no interest in long-term value creation. Politicians have also reminded shareholders of their responsibilities. On 3 March 2009, during the international Eumedion/ICGN Congress, Wouter Bos, the Dutch Minister of Finance, reproached shareholders in financial institutions for having focused too much on risk-taking and making profit. In his speech, Bos did not only prove to be critical of the role of shareholders, but also of what he regards as the ineffective role played by supervisory directors. He therefore argued in favour of reinforcing their supervisory role.

The foregoing was a reason for the Eumedion Board to have an independent qualitative survey made of the roles defined for the members of management and supervisory boards of listed companies and shareholders on the one hand, and the perceived roles of these participants on the other.¹ Since shareholders form a strongly heterogeneous group, this survey will subsequently be concerned almost exclusively with the group of institutional investors who are members of Eumedion. These are principally institutional investors – such as pension funds, insurers and fund managers - who do not manage money at their own expense and risk, but for third parties (end clients) who have entrusted money to them. Although non-Dutch parties are also members of Eumedion, mainly the role of the Dutch institutional investors will be clarified.

This survey must demonstrate whether the participants experience an expectation gap and how this gap can be bridged, if it exists. This leads to recommendations addressed to institutional investors, members of management boards, supervisory directors, regulatory authorities and interest groups. The recommendations are based on sources that include interviews with the participants referred to above. This is not quantitative research, but a qualitative exploration of the behaviour of the participants who are involved with Dutch listed companies.²

The themes discussed during the interviews included the following:

- What are the roles of members of management boards and institutional investors on the one hand, and of supervisory directors and institutional investors on the other? Have these roles changed in recent years?
- Do the listed companies know the activist investors and other important institutional investors?
- Do institutional investors focus mainly on the short term? Has this increased in recent years and how did this happen, if it did? What was the interaction between the long-term and short-term investors?
- To what extent does an area of tension exist between members of management boards and supervisory directors with regard to giving detail and substance to shareholders' interests and how do they deal with this?
- What do institutional investors expect of companies so that they (can) once more develop long-term ties with these companies?

¹ The research assignment is included in Appendix A.

² For quantitative research among institutional investors, please refer to a recent study carried out on the request of the Monitoring Committee (http://www.commissiecorporategovernance.nl/page/downloads/Report_institutional_investors.pdf).

- How can institutional investors be encouraged, if necessary, to commit to an enterprise for a longer time?

In addition to interviews, a round table was used, a preview presentation, recent studies in the Netherlands and the United Kingdom (UK), recent opinion articles from the Dutch governance literature and insights from organizational psychology. The findings are described in the light of the recent history of the past ten years. The motivation is that the situation in which the triangle of institutional investors, management board and supervisory directors have to function has changed greatly due to a variety of causes.

The sources used make it clear that participants show ignorance and incomprehension of their own roles and those of others, which can be ascribed directly to the multiplicity of changes in recent years. The once-so-simple system has been replaced by a complex social system in which the triangle of institutional investors, supervisory directors and management board must attempt to function. When combined with the present crisis, this leads to misunderstandings, to mutual recriminations, and to strained relationships in general as a consequence.

In order to arrive at recommendations for improving this situation, we use ideas from organizational psychology to create a framework. The basic principle in this context is that minor changes within the present system can, on their own, lead to better understanding between the participants and to improvement of the present system as a result. This is the basis for the recommendations presented within the framework. The list of recommendations is not an exhaustive one, but gives an idea of how the present situation can be improved by relatively easy measures that support positive behaviour. In order to avoid too many overlaps, countless other important recommendations³ made in the material used are only referred to to the extent to which they are suitable illustrations.

Another idea is that improvement can be brought about by modification of elements of the present system. Some reticence is appropriate, however, since some of the problems have developed because too many changes were implemented at the same time. Extensive discussion preceded the introduction of measures that have led to the present system, but because these measures are still insufficiently assimilated, consideration must, in the first place, be given to improvements in this regard. Proposals for modifications to the present system must be well thought-out from all angles first, before they are implemented.

Modifications to the system can be implemented at management board, supervisory board and institutional investor level. Although there is also much criticism of the functioning of supervisory directors, we have focused our discussion on institutional investors. Apart from the short-term shareholders, more long-term engaged shareholders are regarded both nationally and internationally as a possible (partial) solution for the present system. Our discussion considers the advantages and disadvantages of this system change and which preconditions are required to effect this successfully. Here too, we formulate a number of recommendations appropriate in this context.⁴

³ See in this context: Advisory Committee on the Future of Banks in the Netherlands, 2009; Bos et al. 2009; Cools, 2005; Hall & O'Malley, 2009 and Walker, 2009 for example.

⁴ Appendix B contains a list of all recommendations.

Section 2 contains the findings from the interviews, presentations and round table that we held. Section 3 provides an organizational psychology approach to the recommendations we present. In section 4 these are mainly behavioural recommendations for the short term, without substantial modifications having to be made as yet to the system as such. Section 5 considers a system change by means of a discussion and recommendations on long-term engaged shareholdership. Finally, the conclusion and possible follow-ups will be set out in section 6. Section 7 lists the sources used. Appendix A provides the literal text of our research assignment and Appendix B offers a separate list of all recommendations.

2. FINDINGS

2.1 Simple social system

The findings can be best described by placing them in the perspective of the events of the past ten years. The description of what happened in those years contains mainly what is relevant for the roles of and relationships between the participants who are involved in managing Dutch listed companies. A complete historical analysis is not intended, therefore⁵.

Until the internet/accounting fraud crisis around 2000/2001 the management of a listed company had a relatively simple social system with three participants, i.e. the Management Board (MB), the Supervisory Board (SB) and the Institutional Investors (II's). The most important behaviours as they were at that time are set out below.

Management Board

The Management Board was the dominant player among the three participants. Its main characteristic was as a collegial body, with the chairman of the management board as its temporary steward. The members of the management board were jointly responsible for the strategy of the company and also felt that they were really the owners of the company. The management board was in control in terms of strategy at that time and did not feel the slightest need for supervision from either supervisory directors or shareholders. One of the reasons for this was that members of the management board really felt as if they were owners, but also because the anti-takeover measures meant that they did not have to worry too much about hostile action by competitors or shareholders.

Supervisory Board

The Supervisory Board was a somewhat reticent player, consisting of former members of management boards from the “old boys” network. Former members of management boards functioned as a sounding board for the strategy and placed their own networks at the disposal of the management board of the company. Their knowledge of the sector was not great in general, but was covered by the appointment of former members of the management board of the company itself as supervisory directors. It more closely resembled an Advisory Council in terms of role and behaviour. Both the Management Board and the Supervisory Board were satisfied with this situation, because they each knew precisely what they could and could not expect from the other. There was scarcely any kind of a relationship between the Supervisory Board and Institutional Investors in those days.

Institutional investors

The Institutional Investors were somewhat passive players and consisted mostly of Dutch insurers, pension funds and major asset managers. The pension funds and asset managers did not really feel engaged with the company as shareholders; their interests were too small for that. Asset managers had been investing worldwide for years and pension funds were also permitted to invest in shares outside the Netherlands. They often still had a significant part of their assets in Dutch shares, but were increasingly phasing these out. Only the insurers, who had accumulated major interests in Dutch shares due to the tax exemption for 5% participating interests, felt emphatically engaged with the strategy of the company and they maintained an intensive dialogue with the company's Management Board. Power was ultimately in the hands of the Management Board and this was accepted in the Dutch situation at that time.

⁵ See Fentrop (2002) and Winter (2009) for example, for a comprehensive (historical) review.

The characteristics of this relatively simple social system are as follows:

- few players with one dominant player
- few rules (legal/governance) and protection for the company
- simple investment objectives (tax-related/prudential) and mainly focused on the long-term
- familiar behaviour, because change in the roles and relationships was minor

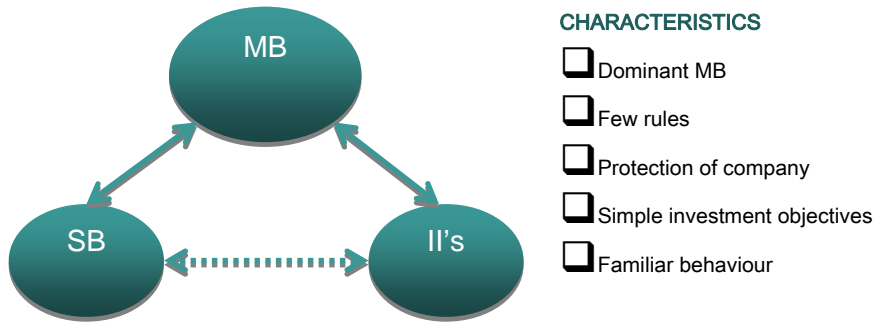


Figure 1 Simple social system

2.2 Changes in roles of existing participants

Relationships changed greatly after the internet/accounting fraud crisis. The reasons for this include the following:

- a. new legislation and regulations (partly as a consequence of the accounting scandals), such as the modification of the two-tier board structure, more transparency rules and the Tabaksblat Code,
- b. more strict external regulatory authorities,
- c. globalization and the accompanying increase in Anglo-Saxon influence.⁶

The following changes are relevant to the current situation, which we will describe below as a complex social system.

Management Board

First of all, the Management Board is no longer the dominant player due to the increased power of supervisory directors, shareholders and external regulatory authorities. Secondly, the collegial management board came under pressure due to the increased influence of the Anglo-Saxon model, which led in practice to a more influential position for the CEO on the Management Board.⁷ The chairman of the Management Board is a clearly visible leader, a CEO, the only corporate officer who can represent the company with authority (Kalff, 2009). The CEO will not only accept little opposition from supervisory directors and shareholders, but equally not from members of his own Management Board. The checks and balances within the Management Board disappear and there is a lurking danger of narcissistic “Sun King” behaviour as a consequence. Finally, the company was affected by the radical changes in its shareholder group; a decrease in the interests of Dutch institutional

⁶ Also see the recent study by Boot (2009), in which he deals extensively with causes and consequences of the uprooted enterprise.

⁷ Kees Cools (2005) has given an outstanding description of the behaviour and many of his observations on the behaviour of management board members in general and the CEO in particular are confirmed in this study. It should be noted, however, that the CEO is encouraged by the public and shareholders to be emphatically present. Van Geest, Commandeur and Meijer (2009) also provide insight into the deeper motives of leaders.

investors, an increase in the interests of Anglo-Saxon institutional investors and a greater spread of shareholders with smaller stakes.⁸

Under the pressure of the crisis and the resultant Tabaksblat Code, the CEO understands that more supervision by the supervisory directors will have to be accepted, but behavioural changes are difficult to effect. Requests from supervisory directors for extra information are mostly met with distrust and meetings without consulting the CEO are also not appreciated and/or permitted. The CEO believes that supervisory directors allow themselves to be guided too much by pressure from the shareholders, who are only interested in governance issues in his opinion, and little in company strategy. The degree of trust between members of the management board and supervisory directors is a decisive factor in whether members of the management board will contact a supervisory director when there are concerns, questions or doubts. What is decisive is whether this will not be used against the member of the management board if it is interpreted as a sign of weakness, which is why the supervisory role of the Supervisory Board forms a contrast in a certain sense to the original role of the Supervisory Board, which was based more on trust.

Most fund managers were not and are not taken seriously, partly because few worthwhile questions are asked about strategy in the perception of the CEO, and the few questions of this kind that *are* actually asked have rather a short-term focus. These same Institutional Investors, but separate governance teams in this instance, do ask a lot of questions about corporate governance, which the CEO perceives as not essential to the performance of the company, but more as “hygienic factors” that are a necessary component of a listing on the stock exchange. Normally speaking, more dialogue could improve this situation, but this very possibility is limited even more by the introduction of legislation dealing with price-sensitive information and the rigid position taken by the AFM (the Netherlands Authority for the Financial Markets) in this respect.

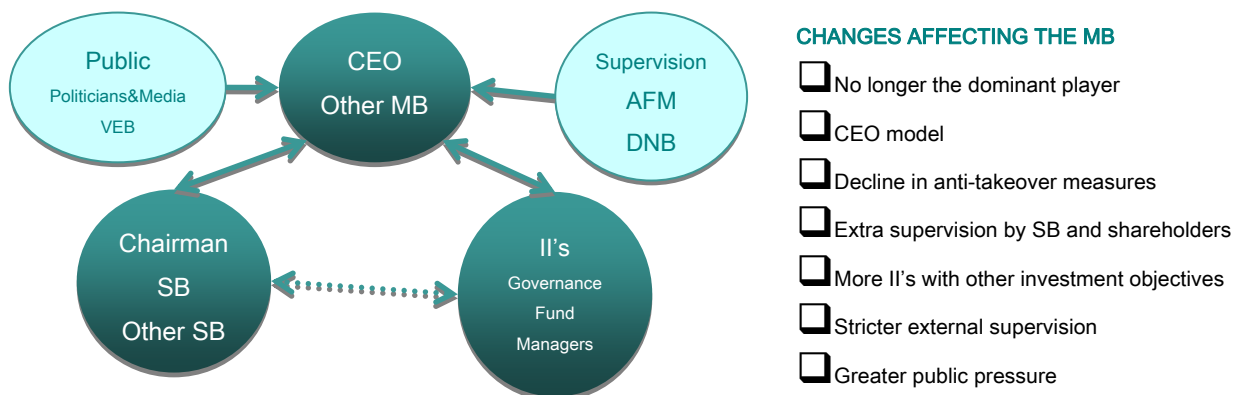


Figure 2 Changes affecting the Management Board

All the negative influences mean that the CEO is in danger of no longer feeling like the owner of the company and is consequently more inclined to pursue his own short-term interests, rather than the interests of the company. The term used internationally in this context is an “ownerless company”, where no-one feels like the owner of the company any more and no longer stands up, therefore, for the interests of the company’s stakeholders.

⁸ See www.fese.eu/_lib/files/Share_Ownership_Survey_2007_Final.pdf for statistics. Reference is already made in Cheffins (2003) to the shareholder dispersion reaching our shores from the USA and UK.

Supervisory Board

In the first place, the Tabaksblat Code gives the Supervisory Board more scope to really supervise the Management Board, allowing the Supervisory Board to become a more equal player. In the second place, the Supervisory Board, and its chairman in particular, is confronted with a Management Board on which the CEO – often appointed by the chairman himself – is dominant, and there are no longer any good checks and balances within the Management Board. Finally, the Supervisory Board also feels increased pressure from shareholders, whose influence has also grown. All of this becomes even more apparent due to a shift in the shareholders' group, because Anglo-Saxon Institutional Investors demand more of supervisory directors than the latter were accustomed to from Dutch Institutional Investors. It could be concluded that too little time had passed in fact between the introduction of the code in response to the internet/accounting fraud crisis and the present credit crisis, to actually allow all the changes to be assimilated.

As a result of the pressure exerted by politicians, the media, interest groups and shareholders, the whole Supervisory Board focuses almost grimly on supervision and is confronted with an influx of information placed at its disposal by the Management Board. The Supervisory Board also wants to do this well, because it is increasingly conscious of the fact that it is not the shareholder, but the Supervisory Board that is ultimately liable. Supervisory directorships have lost some of their lustre as well. The demands made of supervisory directors continue to grow and do so while the remuneration is relatively modest and there is also a risk of liability and a tarnished reputation too. In terms of membership, Supervisory Boards have changed only sporadically. Change has mainly been related to the desire to have more knowledge present with regard to internal supervision and specialists with a knowledge of accountancy have mostly been appointed for this purpose, which means that the old Supervisory Board that interacted with the Management Board in a certain way is now forced to regroup, because it has been given greater supervisory powers. The downside of this is that the sounding board function in relation to the strategy of the enterprise is threatening to be lost. Furthermore, knowledge of the sector is being lost and the resistance offered to the CEO is losing substantive force, because it is no longer desirable for former members of the Management Board of the company itself to have seats on the Supervisory Board.

It is experienced in relation to the CEO, incidentally, that he does not feel comfortable with more supervision by the Supervisory Board. If the Supervisory Board continues to ask questions on certain subjects, this is often regarded as a motion of no confidence, especially if those concerned have known each other for quite a long time, know each other well and the Supervisory Board itself appointed the CEO. The key factor in the functioning of the Supervisory Board in relation to the Board of Management is not so much the structure (one-tier versus two-tier), but is above all the quality of and the trust in the relationships and collaboration. The preconditions required for this are absent in many cases, since the Supervisory Board is too big, it meets too infrequently and for too short a time, and the members never or seldom meet separately from the Management Board. Furthermore, a lack of sector knowledge has been identified and the evaluation of the Board's own effectiveness falls short, at both individual and team level. This is completely in line with the loud appeal for drastic improvements to be made to the effectiveness of non-executive boards, which is also being heard internationally (Conger & Lawler, 2009).

Finally, the relationship of the Supervisory Board with all stakeholders and with the Institutional Investors in particular involves the CEO alone. It is unusual and is mostly regarded as undesirable for a Supervisory Board to conduct a dialogue with individual stakeholders separately from the CEO. This means that the Supervisory Board does not have a sufficiently clear picture of what these relationships actually are and signals are not picked up soon enough, particularly when problems already exist. In the absence of a direct relationship of its own with shareholders, the Supervisory Board then has little choice but to support its own CEO and the risk that conflicts will polarize and become practically insoluble increases as a consequence. This has been most explicitly apparent in

recent years in the contacts with the (Anglo-Saxon) Institutional Investors as stakeholders in an enterprise. Although the more moderate Dutch Institutional Investors also expressed displeasure to the CEO about the strategy pursued, the Supervisory Board did nothing about this. They were not present at these meetings, after all, nor had they had a separate dialogue with these stakeholders.

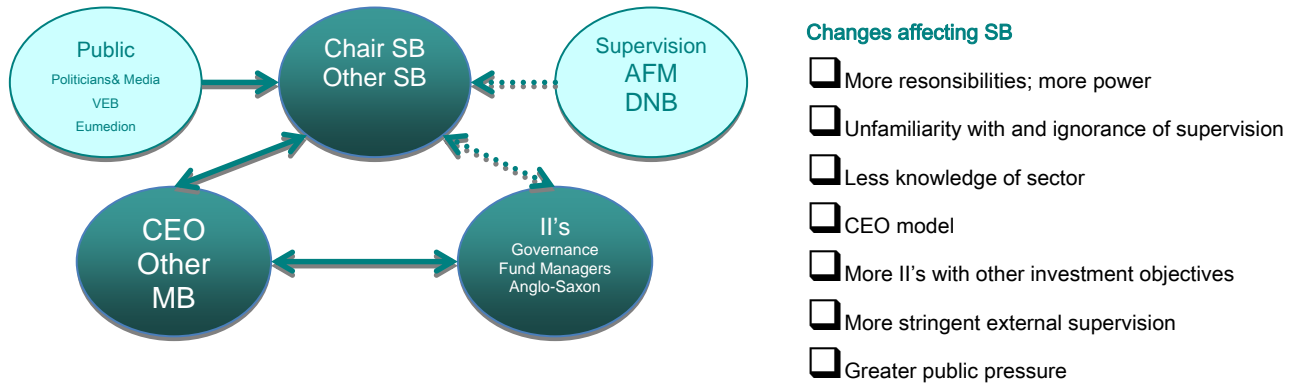


Figure 3 Changes affecting Supervisory Board

Institutional Investors

In the first place, Institutional Investors have acquired more influence due to the introduction of the Tabaksblat Code. In addition, more possibilities have arisen because many companies have abolished their anti-takeover measures. In view of the initial unfamiliarity of Dutch Institutional Investors with this new influence, Eumedion made it one of its objectives to monitor the maintenance of and compliance with the required corporate governance rules, in the interest of its members. Many Institutional Investors have set up their own separate governance teams in which people with a legal education prevail and which focus predominantly on the responsibilities that shareholders have acquired with regard to monitoring governance rules. In practice, these teams mostly operate separately from fund managers, who often do not even know how the governance teams are going to vote at an AGM. This naturally does not only lead to frustration on the part of the members of the management board and supervisory directors of the company, but this duplication of each other's work also leads to internal friction for the Institutional Investors themselves.

In the second place, the arrival of active Anglo-Saxon Institutional Investors who are mostly focused on the short term has influenced the behaviour of Dutch Institutional Investors. Since these Anglo-Saxon Institutional Investors were able to show high short-term profits, the originally long-term Institutional Investors were forced by their clients and the media to achieve comparable returns. As a result, little remains of the long-term Institutional Investor with a good knowledge of long-term value creation at a company. They do not have the mindset of owners and are not incentivized as such by their end clients. They are more 'share owners' than 'share holders'. They have been educated in concepts like the modern portfolio theory and diversification with which they try to beat the benchmark by short-term buying and selling, and the distance between them and the companies in which they invest is quite large as a consequence. The mutual understanding between Institutional Investor and management board members has deteriorated even more as a result and the strict enforcement of the law on price-sensitive information is only driving these parties further apart. The arrival of Anglo-Saxon Institutional Investors has also done no good, incidentally, to the barely existent relationship between Supervisory Board and Institutional Investors. The only serious contact occurs in times of conflict and that does not generally lead to prolonged and sustainable relationships.

Finally, the commercial pressure experienced by Institutional Investors to generate short-term performance for the end clients is further reinforced by other forces. First of all, the Financial Assessment Framework of the DNB, the prudential regulatory authority, gives pension funds an incentive to invest for the short-term. Secondly, members of the management boards of listed companies are also short-term oriented, because their bonuses are based on short-term share-price results. And, last but not least, the attention of the media is mainly focused on short-term returns on investments. Now that all forces are operating in the direction of short-term results, these Institutional Investors will not want to become engaged long-term shareholders again until they have some incentive to do so.

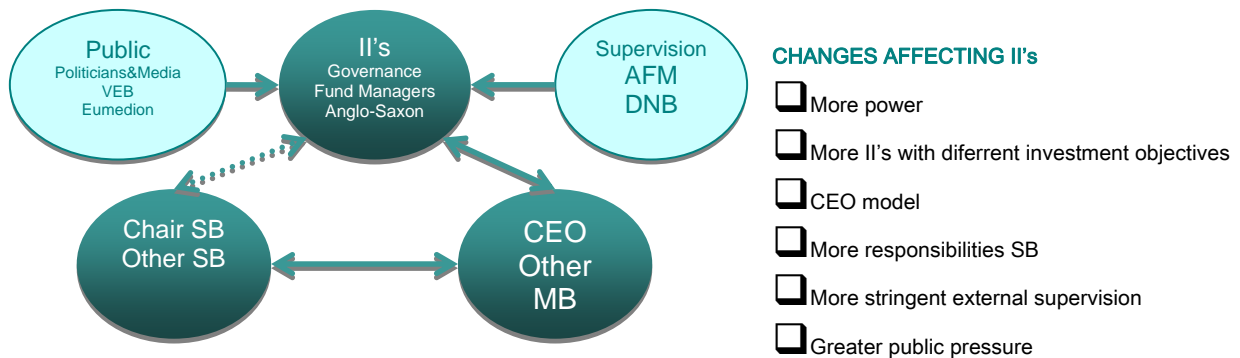


Figure 4 Changes affecting Institutional Investors

2.3 Arrival of new players

The end of the internet bubble and the worldwide accounting scandals meant that the hitherto relatively calm environment surrounding Dutch listed companies became a focus of keen public interest. Measures could not fail to be taken. The participants at the Dutch listed companies have continued to be subject to tighter control by the public, the regulatory authorities and the interest groups since the internet/accounting fraud crisis.

Politicians and media

Politicians and media played a role in this period by giving populist and caricatural descriptions of the participants every now and again. Ruthless shareholders whose sole aim is short-term profit and have no interest in long-term strategy. Sleeping supervisory directors who neither understand what shareholders want, nor are able to keep their Management Board and CEO in check. "Sun King" CEOs with no consideration for the company and its stakeholders, whose sole aim is their personal glory and their own well-filled wallets. And finally, regulatory authorities who allowed all of this to go on for far too long and did not take firm enough action.

A simplified presentation of the situation creates a high risk that solutions will be sought in a fast fix in a subarea with no comprehension of the consequences this will have for all participants. Exaggerated trust is placed in one individual in response to this change, however, and there is an unrealistic expectation that things will soon be better as a result.

Regulatory authorities

Prompted by politicians and the media, the regulatory authorities took a stricter attitude towards shareholders. Particularly important within the context of this survey is the way in which the DNB

deals with pension funds. The short-term pressure exerted by the Financial Assessment Framework is experienced by many Institutional Investors as pressure to be able to invest only in the short term.

The attitude of the AFM, which supervises business conduct, leads to a lack of clarity for shareholders and enterprise alike. The legal measure concerning the provision by the company of the same information to the investors at the same time⁹ is strictly enforced by the AFM, in the view of companies at least, and many companies have become wary as a consequence. Since the company does not want to have trouble with the AFM, the management board decides on a somewhat more distant investor relations contact and less consultation takes place with major shareholders on important issues. The result is that they are also unable to share the really important information and doubts concerning the strategy. This strict conduct is driven, of course, by the fear of insider trading, but also by discussions of the (un)desirability of the possible takeover of Dutch companies. Furthermore, there is pressure from the VEB, the Dutch Investors' Association, because small investors are at a disadvantage if Institutional Investors receive more information than they do.

In addition, there is also unfamiliarity with the acting in concert rules, as a result of which Institutional Investors are reticent about contacting each other. The fact is that collaborating with other Institutional Investors can, in certain circumstances, actually give rise to the obligation for parties who are working together to give notification of a substantial interest in the event of a notification threshold being exceeded,¹⁰ or to issue a public offer for all shares in the company in the event that the collective interest is at least 30 percent.¹¹ The criteria for meeting the definition of acting in concert lead to a lack of clarity. There is a fear of becoming publicly discredited if the opposing party alleges that a statutory rule has not been complied with, with all the consequences this can have for the reputation of the Institutional Investor. Institutional Investors may become more reticent therefore, about consulting with each other in the run-up to AGMs and also about other forms of collaboration in and outside the AGM, behaviour that can hinder the implementation of the corporate governance policy formulated by the Institutional Investor and stand in the way of effective engagement. Institutional Investors who have continued to be long-term engaged shareholders are not being given adequate support in this way. It would be good if the AFM or the legislature were to provide more guidance where the acting in concert rules are concerned.

Interest groups

In the Netherlands most Institutional Investors have joined forces in Eumedion for the purposes of corporate governance issues. Eumedion has been in existence since 2006 and is the extension of the former Foundation for Corporate Governance Research for Pension Funds (SCGOP). Eumedion represents the corporate governance-related interests of the Institutional Investors who are its members. It is Eumedion's objective to maintain and further develop good corporate governance for its members and to advance the acceptance of and compliance with the requisite standards by listed companies, in the Netherlands in particular. Eumedion has a coordinating and alerting role with regard to the AGMs. Furthermore, Eumedion has prepared tools with and for its members for use in the assessment of points on the agenda of AGMs. Eumedion attempts to operate behind the scenes as much as possible, while not shying away from adopting (unanimously supported) positions on policy-related matters (comments on legislative proposals, consultation documents, proposed guidelines and reports from the Monitoring Committee, as well as the drafting of position papers).

There is a mixed picture and mixed experience of the role that Eumedion plays. Some experience Eumedion as a body that asks for even more rules and tightening up of codes. Furthermore, it is still not clear to the Supervisory Board and the Management Board during AGMs on whose behalf the

⁹ section 5:25i, second paragraph, Act on Financial Supervision (Netherlands)

¹⁰ section 5:45, fifth paragraph, Act on Financial Supervision (Netherlands)

¹¹ section 5:70, first paragraph, in conjunction with section 1:1 Act on Financial Supervision (Netherlands)

Eumedion members are actually speaking. Others, however, are pleased with the counterweight that Eumedion can offer in the Netherlands to an organization like RiskMetrics, which has almost more influence than the rating agencies. It is perceived as being useful that Eumedion fulfils its role of monitoring legislation and regulations and of identifying and commenting on issues on behalf of all shareholders.

Although the private investor has not been included in this survey, the VEB (the association that represents the interests of the private investor) really is an influencing factor on the behaviour of and the relationship between the Institutional Investors, Management Board and Supervisory Board. The VEB attempts to support its private investors in maximising the return on their invested capital, by means including seeking publicity, legal proceedings and asking for explicit consideration to be given to corporate governance issues during the AGM. The media attention above all, makes the Management Board and Supervisory Board feel under attack and is partly why they go on the counterattack against all shareholders.

2.4 Conclusion

The interviews made it clear that the views of each other's behaviour have become harsher in recent years. The changes in the playing field of the Dutch listed companies described above are more than enough to explain the increased mutual tension. In a few years' time a simple social system has changed into a complex social system with the following characteristics:

- increased number of players without one or a few being dominant
- many rules with more emphasis on legal and governance issues and less protection of the company
- multiplicity of investment objectives due to new participants and the influence of prudential supervision (Financial Assessment Framework), as a result of which the short-term focus has increased strongly
- unfamiliarity with and incomprehension of one's own roles and those of others, because the changes in roles and relationships have been rapid.

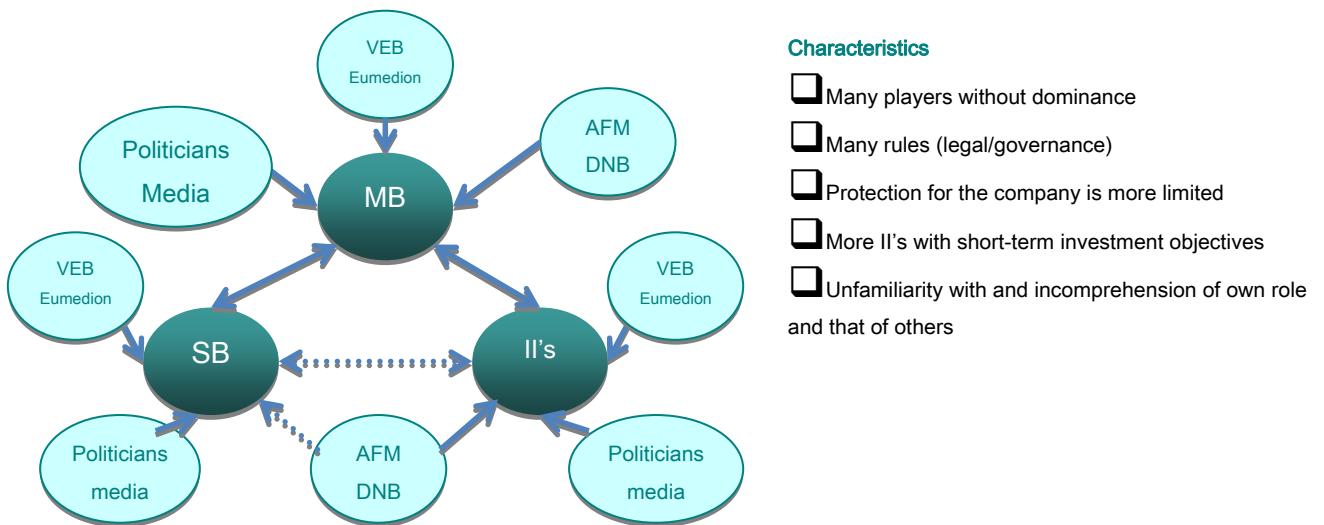


Figure 5 Complex social system

The above findings can also be described using a metaphor from the world of sport. The average Dutch listed company can be compared with a football team that is playing in the Champions League

for the first time. The referees are stricter here and their rules have allowed them to become not only protectors of the game, but playmakers as well. The spectators are critical and noisy and the opponent is a formidable international squad. The company itself is still a local team of limited means with old and new players who all have to play in a new formation without having had the time to get used to playing together as a team. It cannot be expected, in that case, that they will win the game without taking the time to train first. Dutch listed companies can only take on the international competition if they themselves and their participants take the time and are prepared to build up relationships and to stop blaming each other for losing the game.

3. APPROACH BASED ON ORGANIZATIONAL PSYCHOLOGY

The complexity of the present system can also be described as a ‘multiparty’ problem (Prins, 2006). The key factor in a multiparty situation is the combined action of a number of parties, each with a distinctive role and interest. No single party is able to solve the problem alone or to force a sustainable solution. They have to rely on each other and are dependent on each other for finding a good solution. The behaviour and attitude of an individual party can, however, strongly influence the whole.

Although the study of multiparty situations is still in its early stages, a number of relevant complexities and pitfalls have already been identified, nevertheless. For the purposes of our survey, this analysis offers a framework within which the recommendations can be placed. A multiparty situation comprises four distinct forms of complexity:

1. Strategic complexity

The parties are not only occupied with searching for and gauging their own strategies and roles, but they also do not yet know, understand or believe the strategy of the others. They are better able to decide on their own strategies if the aims of the other parties are known. Another complication here is also that the parties have to collaborate with others whose interests do not always run parallel to their own, or with others whom they can sometimes regard or encounter as opponents.

Experience teaches that a multiparty situation benefits hugely if all the parties involved have an idea of and respect for the interests of all the others, while recognizing a common overarching interest at the same time.¹² They all have to endeavour to do as much justice as possible to the separate and the common interests. If this is not what they want, or if they are unsuccessful in the attempt, either a situation will develop that reaches deadlock (the cooperation fails, a crisis occur), or a solution with winners and losers is forced through on the basis of power.

2. Informational complexity

An abundance of information is available on parties, themes and problems. How much of this is relevant? How do you know that you know sufficiently well what you must know? How do you know what you do not yet know? How do you know how you have to weigh up what you know?

3. Procedural complexity

The parties have to deal with each other, but have no unequivocal authority relationship with each other. They do not constitute a formal organization together and no rules have therefore been specified initially with regard to decision-making, conflict management, exchange of information, whether or not to admit or exclude parties, etc. It is considered crucial for a multiparty system to organize itself promptly.

The manner in which agreement is reached on the required method of organizing and operating is certainly as decisive for the effectiveness of the method as the final organizational structure itself. The parties must perceive the decision-making process about rules, roles and interests as fair and just (Van der Heyden and Limberg, 2007). Parties have a tendency to answer fairness with fairness in complex situations, while perceived unfairness generally elicits hostility and obstruction.

¹² Mintzberg, Simons & Bau (2002) provide a critical analysis of economic relationships in which they identify excessive self-interest of parties as a threat to overarching and deeper interests and values.

4. Socio-emotional complexity

Tension and emotions often build up rapidly in an unclear situation of this kind, in which the individual and collective interests and risks are great. Parties can feel unappreciated for example, or accused, subordinated or excluded, in an instant. How effectively do the parties deal with this? The enormous complexity and the frequently deficient organization and addressing of this make multiparty collaborations exceptionally fragile, since a single incident can have a huge deregulating effect within a short time. People should be prepared for this in terms of communication, organization and conflict resolution.

Collaboration involves conscious and unconscious processes, rational and irrational dimensions, which many leaders and decision-makers deal with clumsily and inexpertly (Van de Loo, 2007), with all the attendant consequences. This means that multiparty situations are characterized by pronounced instability and great volatility – one minor change can seriously deregulate the whole under certain circumstances.

When the parties within a social system feel threatened by a complexity that is beyond them, they have a natural tendency to reduce the complexity. Classic examples are the formation of premature sub-coalitions, the exclusion of or levelling of accusations against one or more parties, or the simple denial of the situation. Parties who cannot cope well with the lack of clarity resort to what are known as social defences (Hirschhorn, 1999), which are strategies that are collectively and unconsciously applied as protection against the cumulative anxiety. There is apparently an inability to collectively recognize the difficulty and the risk. In most cases, the focus then comes to lie unilaterally on a subquestion (e.g. executive remuneration, the introduction of a code), or unrealistically high expectations apply to a number of individuals who are considered to have the ability and the obligation to save the integrity of the system as a whole.

In our survey we did not focus so much on substantive technical aspects, but chose behaviour, observation and perception of the various participants as our access to a better understanding of the operation of the system as a whole. Members of management boards, supervisory directors, institutional investors and regulatory authorities all repeatedly stated that they regard behaviour and mutual trust as crucial factors that require a lot of work.

The recommendations are based on the complexity of the social system we are dealing with. How can participants individually and in their collaborative action deal more wisely and more effectively with the increased complexity? To this end, we can point out four important aspects that are essential to the successful implementation of recommendations.

- Awareness: all participants should become and continue to be aware of the complexity. This means the ability to see their own role, task and behaviour in the context of the greater whole in interaction with others. Technical proposals, adjustments to roles, rules and codes should also be considered carefully in terms of their (potential) effect in the system as a whole. Integral, well thought-out and gradual change produces the greatest chance of success in this respect (Ten Have, et al, 2009).
- Multidisciplinary approach: the complexity outlined requires an approach that uses the combination of legal, investment-specific, tax-related, prudential, political, economic, socio-psychological and ethical perspectives. Behaviour, observation and perception are essential components in this process. Representatives of these diverse disciplines must endeavour to achieve practicable solutions more collectively than has been the case until now.
- Differentiation: the complexity should be reduced where possible, by more and better differentiation of roles (Borwick, 2006), tasks and rules, by type of investor (Coyne & Witter,

2002), type of company, and by different roles within one party, like the supervisory board for instance (see Conger & Lawler, 2009 for example).

- Training and study: creating the right time and space to understand one's own role and those of others. This means paying attention to the behavioural translation in order to really be able to deal with the rules, roles and structures devised. The parties must take the time to become accustomed to the rules, to learn to discuss role conflicts and to adjust behaviour and roles accordingly, which will help in addressing issues of behaviour, trust and communication in the correct manner. There is important work to be done here, both within the various participants (management board, supervisory board, institutional investor, regulatory authority), and between participants. This requires, among other things, a rethinking of training processes and other ways of evaluating the quality and effectiveness of players and roles. Cooperation does not materialize out of thin air (Hansen, 2009).

We will make recommendations at two levels in the follow-up to the survey. At the first level, we choose the present system of participants involved with the listed company as the point of departure. Starting from here, it is also necessary and possible to achieve real improvements without a system change having taken place first. These recommendations can be classified as small steps, but this does not make them any less significant. Completeness is certainly not our aim here either, we are only giving a number of examples.

At the second level we discuss recommendations that imply a system change within the framework of the discussion of long-term engaged shareholdership. The fact that we consider this must not be interpreted as if we are advocating or advising against this course. We address this as a separate subject, because we believe that it represents a new and greater form of complexity. All the pitfalls we have previously identified with regard to complexity of system, roles and rules apply here in full and to do it some degree of justice, this second level requires a more comprehensive discussion. We believe, on the basis of our findings, that a discussion of this kind on the subject of the supervisory board would also be appropriate, but that is outside the scope of this survey.

A start can be made with the suggestions at the first level without delay, if this has not been done already. At the same time, participants can and must take the time to give further consideration to the suggestions at the second level discussed here. What must be avoided is raising expectations with regard to the effectiveness of long-term engaged shareholdership, without sufficient awareness of what the consequences are for everyone in the system.

4. BEHAVIOURAL RECOMMENDATIONS FOR THE SHORT TERM

In this section, we present recommendations that are intended to improve the present system in small steps and can be implemented immediately, if this has not been done already. We present one or more recommendations per participant that illustrate how the relationships within and/or between the participants can be improved.

Management Board

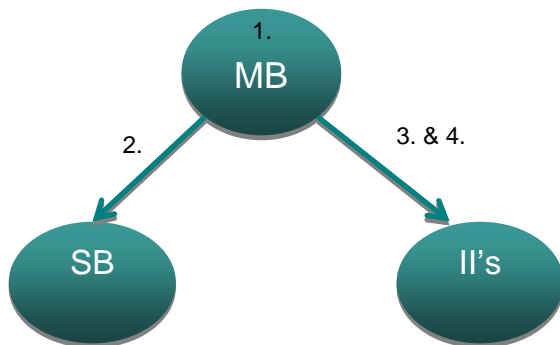


Figure 6 Recommendations for the Management Board

The checks and balances within the management board have been lowered by the transition from a collegial model to a CEO model. Attempts were made to create a more substantial role for the CFO, but this has proved in practice to offer insufficient counterweight. If the chair of the supervisory board does not play a strong role, members of the management board will show loyalty to their boss. The following recommendation addresses the lack of checks and balances within the management board itself.

Recommendation 1:

The chair of the supervisory board should organize a 360-degree review with the MB and discuss this in confidence with the individual members of the MB.

Friction also develops in the relationship with the supervisory board when extra information is requested for example, or when meetings are held with people in the organization. The cause is mostly the management board's fear of losing control, but also the unfamiliarity with the supervisory role of the supervisory board. The response is then the controlled provision of a lot of information, instead of arranging for the supervisory board to speak separately with the relevant expert.

Recommendation 2:

The MB should accept the SB's questions as a consequence of the role the SB is expected to play and provide the information requested as efficiently and openly as possible.

Most friction occurs in relation to the shareholders and at the AGM in particular. The AGM is an annual meeting at which formal business must be settled and where corporate governance issues are mainly discussed. This formal nature is not really compatible with an open discussion of how things stand as regards company strategy and risk management for example,¹³ while it is precisely a

¹³ Also see Breukink en Slagter (2009)

discussion of this kind that shareholders need in order to arrive at a better understanding of the company in which they have invested. It is advisable in this light to hold a number of meetings for all shareholders every year at which substantive themes such as strategy and risk management can be dealt with in greater depth. Even if not all shareholders (can and wish to) attend, this additional clarification of crucial subjects may still relieve some of the pressure on the AGM.

Recommendation 3:

The MB should organize annual informative meetings that are open to all shareholders, at which substantive themes concerning strategy and risk management for example, can be clarified and discussed.

The management board has a lack of understanding of the motives of the heterogeneous group of shareholders (Coyne & Witter, 2002) and conversely, the management board believes that the institutional investors have little interest in company strategy. It is important for the management board, however, to keep a close watch on the changes in the shareholders' group of the enterprise. The different motives of shareholders may mean that shares are being sold for benchmark reasons, but also perhaps, because of a lack of confidence in company strategy. This second reason may be an important indicator of potential problems in future. The following recommendation can help to gain more insight in the event that the company is experiencing substantial changes in the shareholder group.

Recommendation 4:

The MB should permanently study the motives of shareholder groups that buy and particularly sell shares in the company. An attempt should always be made to hold an exit interview in the case of every serious exit by a major shareholder.

Supervisory Board

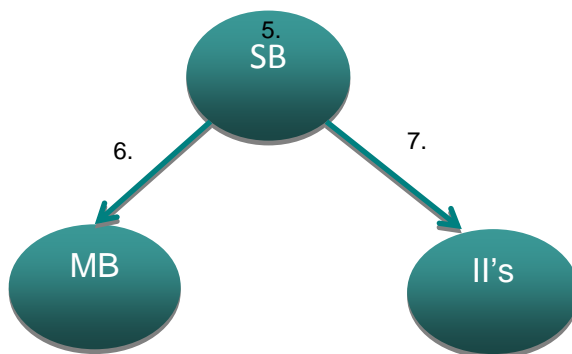


Figure 7 Recommendations for Supervisory Board

The size of the supervisory board and the lack of time and opportunities to meet (certainly when there are international supervisory directors) mean that the supervisory board is not a team and is unable, therefore, to sufficiently counterbalance the management board (Conger & Lawler, 2009).

Recommendation 5:

The SB should invest explicitly in functioning better as an autonomous team by the following means:

- *organize a separate meeting with the complete SB before or after each meeting with the MB;*
- *organize an external session annually with the complete SB, with the objective of increasing quality and effectiveness as a team;*
- *arrange to be assisted by staff (secretary), which (who) only works for the SB.*

There is one obvious member of the supervisory board who might be able to correct “Sun King” behaviour by the CEO and that is the chair. It must be explicitly clear to all engaged stakeholders that the chair of the supervisory board has this role and that he will do everything possible to fulfil this role well. This means that it must be regarded as normal for the chair of the supervisory board to hold discussions on a regular basis with all stakeholders, both in and outside the presence of the CEO. This applies to internal and external stakeholders alike. Participation enables the chair of the supervisory board to see what the reactions are to proposals from and behaviour by the CEO and can speak to him about this later.

If the chair of the supervisory board focuses on this component of supervision, then it is obvious that someone else on the supervisory board will have to be occupied mainly with compliance-specific issues (including the internal governance structure). The vice-chair or the chair of the audit committee could fulfil this function. This does not imply a change in the responsibilities of the supervisory board (the board as a whole has the statutory task of supervising the policy of the management board and to advise the management board), only a clearer definition of tasks within the team.¹⁴

Recommendation 6:

Consider a division of tasks within the SB to the effect that the chair of the SB focuses on the behaviour of the CEO in relation to the internal and external stakeholders. The compliance-specific matters can then be allocated mainly to the vice-chair or the chair of the audit committee.

The price of the lack of a serious relationship with shareholders and communication that is confined to the AGM has to be paid in the event that things go wrong with the enterprise in the eyes of the institutional investors. If there is a conflict, the letter from the institutional investors also lands on the doormat of the chair of the supervisory board. Since lack of contact means that the latter has scarcely any knowledge of what has passed between CEO and shareholders and he has always left things that way, then he has no other choice but to give the CEO his full support, also in situations where institutional investors have a point.

This recommendation is in line with the previous one, therefore, i.e. that the chair of the supervisory board in his position of trust with respect to the CEO must himself have a separate meeting with the major shareholders at least once a year and is also present at the CEO’s meeting with them. This will

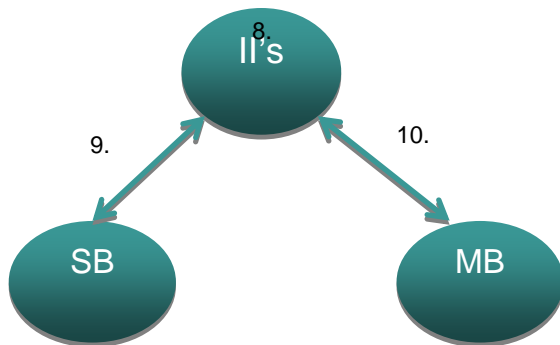
¹⁴ This is not intended as an argument in favour of a single tier management structure.

enable him to sense what the concerns of these shareholders are and also to see for himself how the CEO responds. Signs of problems with shareholders generally become apparent a few years in advance and so it is easy to foresee when and from what quarter the wind or storm may blow.

Recommendation 7:

Arrange for the chair of the supervisory board to speak with major shareholders at least once a year, both separately and in the company of the CEO and/or CFO. This certainly applies to major shareholders who have sold their interest in that year.

Institutional Investors



One of the greatest sources of irritation for all participants is fund managers and governance teams at the same asset manager who operate separately from each other. Although the development of a separate governance team in response to the Tabaksblat code is understandable from the point of view of efficiency, it is increasingly undesirable that they judge companies separately on their governance, independently of strategy and risk management. This leads to the following recommendation.

Recommendation 8:

Institutional investors should create internal cooperation between the governance teams and the fund managers and integrate the two approaches into a single final opinion.

Where the institutional investors are concerned, there is also no serious relationship with the supervisory board or the chair of the supervisory board. The institutional investor sees supervisory directors at the AGM and nowhere else, unless problems have developed in relation to the remuneration policy or a potential hostile takeover. At that moment, the chair of the supervisory board is an extension of the management board and so is no longer the representative of all interests, including those of the shareholder. If the chair of the supervisory board does attempt, however, to build up a more sustainable relationship with major shareholders, the institutional investor should be ready for this and not send any inexperienced and unprepared fund managers as discussion partners. The same conclusion can actually be drawn with regard to the relationship with the members of the management board. Unprepared meetings, the lack of a comprehensive opinion in cooperation with the governance team, and insufficient interest in the company's strategy do not form a basis for a good relationship. Although the strict application of the law on price-sensitive information has limited a true dialogue with the management board, good preparations really can lead to more mutual understanding.

Recommendation 9:

The institutional investors – senior fund managers in collaboration with the governance team – should prepare thoroughly for discussions on strategy, risk management and governance with the chair of the supervisory board and/or CEO and CFO. This applies to both individual interviews and group meetings.

A final component that deserves attention is the role of Eumedion in relation to the management board and supervisory board on the one hand, and proxy advisory services like RiskMetrics and Glass Lewis on the other. There is a perception among management boards and supervisory boards that proxy advisory services base their advice on general voting behaviour guidelines, and these subsequently apply as standards for individual companies. This “box-ticking” mentality, which was rejected by the Tabaksblat committee, is implicitly confirmed. A related concern is that the proxy advisory services, which are American in origin, deal with the proposals on the basis of an American system of standards. Eumedion could reduce the disquiet that companies feel on this subject by building bridges between the companies and the proxy voting services on the basis of its knowledge of the situation in practice in the Netherlands. In that case, Eumedion could contact the company well before the distribution of the agenda for the shareholders’ meeting, in order to discuss possible controversial proposals that could later also play a role in the voting recommendations from the proxy advice services. Where the company is concerned, this means that there also has to be an early exchange of information, in order to make the period of dialogue as long as possible. Eumedion is then able to look for solutions in cooperation with the company, while also being better able to share its opinions on individual companies with the proxy advice services, so that more individual nuance is possible.

Recommendation 10:

Eumedion and companies should enter into dialogue about possibly controversial items where institutional investors are concerned well before the distribution of the agenda for the shareholders’ meeting, so that it may be possible to find a solution for these before the final version of the agenda is distributed. This applies likewise to any voting recommendations from the proxy voting services.

In summary, the objective of these recommendations is to lead to a better understanding of one’s own and each other’s roles by setting up a constructive dialogue with all the participants involved, i.e. institutional investors, management board and supervisory directors.

5. DISCUSSION OF AND RECOMMENDATIONS FOR LONG-TERM ENGAGED SHAREHOLDERSHIP

In view of the increased complexity in the management of a company, it would seem obvious to reduce the complexity that the heterogeneous group of shareholders implies. Concentration on working with a few major shareholders with a long-term focus is in keeping with this strategy. Political parties and society are also explicitly calling for more shareholder engagement from institutional investors and a long-term orientation.¹⁵ The idea of long-term engaged shareholdership has been derived from the notion that there is a much greater ability at family businesses and in the case of investment by (old-style) private equity houses to solve the agency problem between owner and capital provider. The capital providers mostly have their own supervisory director, are actively occupied with the strategy of the enterprise and make much more effort to work with the management to create value.

Although we stated previously in our survey that we would exercise reticence with regard to system changes, we would like here to at least contribute to the discussion and to indicate what we believe to be the consequences of and necessary conditions for a change of this kind.

Apart from the substantive discussion of the possible desirability, feasibility and efficacy of changes to the system in order to encourage long-term engaged shareholdership, the first part of our survey leads us to argue in favour of compliance with a number of crucial criteria for the process of dialogue and decision-making in this context. There must be at least sufficient attention and scope for thorough consideration, in advance, of the effect measures will have on the roles, behaviour and perceptions of the various participants involved and for these to be taken into account when making the decision.

5.1 Long-term engagement

Most important of all is for long-term engaged shareholders to have confidence in the following:

- the long-term strategy of the company,
- the extent to which the management board is capable of achieving this,
- the way in which and the regularity with which the management board communicates about this,
- the way in which supervisory directors can support and monitor the management board in this respect,
- the involvement of institutional investors in all of this.

The success of long-term engaged shareholdership¹⁶ requires a much more intensive relationship between the institutional investors, management board and supervisory directors, which means a substantial investment in time and money by all participants.

¹⁵ More or less the same is meant by shareholder engagement in both the Netherlands and the UK, but the call is based on different perspectives. In the Netherlands, the institutional investor is mainly being called to order to behave in a socially responsible manner once more and to ensure with a number of engaged institutional investors that activists are given no opportunity to lay siege to the enterprise. In the UK, it is mostly the enterprise that is being called to order and the engaged institutional investors are regarded as important parties that can bring the entrepreneurs back into line by means of sharp supervision and dialogue.

¹⁶ A study by De Jong et al (2007) calls into question whether this is not more tokenism in the Netherlands instead of the addition of real value to the enterprise.

Part of long-term engagement is that the institutional investor has its internal organization in order. This goes further than the measure referred to in the recommendations that the fund managers and the governance team should collaborate on each enterprise and that this should result in an integrated decision. Among other things, it requires extra investments in people, because fewer enterprises can be monitored per fund manager. Time, attention and quality must be invested in knowledge in order to take part in a substantive strategic dialogue with the enterprise and more legal support will be necessary. This essential dialogue with the company will have to be organized with a number of long-term engaged institutional investors, in order to have a strong enough voice.

Recommendation 11:

The institutional investor whose aim is long-term engaged shareholdership should invest substantially in people and training inside its own organization, in order to be a genuine discussion partner for the enterprises.

This also requires in turn that all supervisory requirements are carefully met with regard to price-sensitive information and acting in concert. Before the AFM tightened the reins, communication was good between major insurers in particular and Dutch companies, and proceeded properly in compliance-specific terms. The reactions of the AFM with respect to enterprises and institutional investors have made both parties diffident and have ensured that there is no longer any exchange of information that is needed to acquire and retain confidence.

Recommendation 12:

It is recommended as a necessary pre-condition for long-term engaged shareholders that the AFM drafts clear best practice rules for the market, such that an intensive collective dialogue is possible between management and supervisory boards with long-term engaged shareholders. Eumedion can assume a coordinating role on behalf of its members.

On the other hand, by no means every company is eager for meddlesome institutional investors. In the Netherlands, companies are calling more often for long-term shareholders, but not necessarily for **engaged** shareholders. The Tabaksblat Code and the reduction in the number of anti-takeover measures have led to explicit interference by short-term active shareholders and companies would now like to defend themselves against this. It should be borne in mind, however, that major shareholders had already voted with their feet in many cases and pulled out as shareholders in that period, partly because of the feeling that the management board was still insufficiently conscious of the fact that the existing corporate policy could not survive the increasing globalization. This gave activists their chance, with all the attendant consequences. Seeking long-term shareholders alone, without accepting engagement, will not work any more, therefore, with these potential major shareholders.

The recent experiences of insurers and specialized asset managers with long-term engagement at smaller and a few medium-sized enterprises are encouraging, however. Management boards and supervisory boards do not want meddlesome institutional investors at first, but mutual confidence grows if the institutional investors take a more “entrepreneurial” attitude. The companies themselves will have to ensure that the chair of the supervisory board is the focal point for the institutional investors, in addition to the CEO and/or CFO. They too will have to devote more time and energy in communicating more clearly about governance, risk management and strategy, without infringing external supervisory requirements. Supervisory directors will have to become better informed and really know what is going on in terms of both content and control. In short, considerable extra investment is required of members of the management board and supervisory directors as well.

Recommendation 13:

Management and supervisory boards who aim to retain long-term engaged shareholders, should be open to suggestions from these shareholders and invest time and energy in worthwhile communication on strategy, risk management and governance, within the limits set by the AFM.

It is dubious whether long-term engaged shareholders provide a new balance between short-term and long-term orientation for the multinationals with a large market capitalization, such as Shell or Unilever. The scale of the enterprise, the corresponding scale of the investment for the institutional investor and the diversity of objectives among various international institutional investors may mean that this instrument of engagement is not powerful enough. The relatively sizeable presence of Anglo-Saxon investors at larger companies complicates even more the understanding of the allocation of roles between enterprise and shareholders. Anglo-Saxon investors envisage a completely different role for the management board and supervisory board than continental European investors. They are more attached to the strong CEO model, which is increasingly being questioned in continental Europe, and also have much less difficulty with what they regard as the modest remuneration for executives in continental Europe. In other words, ideas on how a management board and supervisory board must operate in order to be successful differ widely between Anglo-Saxon institutional investors and institutional investors from continental Europe.

The encouragement of long-term engaged shareholdership in large (listed) companies is more complex and the added value less obvious. It requires more time and consultation and we argue in favour of a differentiated approach as a consequence. Although we do not rule out the possibility that long-term engaged shareholders may eventually also achieve success at larger companies, it seems obvious to gain experience with such a radical system change at small and medium-sized enterprises first.¹⁷

Recommendation 14:

Focus consideration of the introduction of long-term engaged shareholdership at Dutch pension funds on the smaller and medium-sized listed companies in the first instance.

5.2 Compensation for long-term engagement

In order to make this concept successful in any way at all, it is necessary to offer institutional investors a form of **compensation** for all implicit and explicit costs that have to be incurred, while other institutional investors – who do not wish to commit to this – have a “free ride”. The explicit costs have already been named, the implicit costs are the potentially attractive short-term return. It is not an unequivocally empirically proven fact that active shareholdership produces a greater return (Karpoff, 2001) and there is by definition a higher potential return in the short term. The great advantage of adhering to the more short-term oriented strategy is that the institutional investor does not have to implement any major changes in its own organization. It does not have to explain to its end clients, therefore, that something is going to change. If long-term shareholdership is not offset by any real compensation, the disappointing results in the short term will inevitably give rise to both internal and external discussions of this policy.

¹⁷ This is in line, incidentally, with the philosophy that the added value of share selection is greater at smaller and medium-sized (less well-known) companies than at larger companies, because the market for larger shares is more efficient.

Much has been written in the last two to three years about possible instruments that could serve as compensation (or incentives) for the long-term engaged shareholder and this discussion has not been closed yet.¹⁸ In our comments we focus very specifically on the usefulness of the instrument for Dutch pension funds, because they could, by their nature, be long-term investors and also because they feel the most political pressure to make this switch. This also means that we disregard advantages that certain instruments might have for the other participants. We naturally attempt to tie in with previous national and international discussions as much as possible, which is why we confine ourselves here to the most important instruments with their advantages and disadvantages. Roughly the following options, individually or combined, are put forward in the sources consulted:

- A. Stewardship¹⁹: comply or explain
- B. Loyalty voting rights and/or loyalty dividend
- C. Earning voting rights
- D. Attendance/voting fee
- E. Preferential prudential treatment for 5% interests

A. Stewardship: comply or explain

The idea in the UK is to bring about long-term engaged shareholdership by forcing institutional investors to state explicitly by means of a code whether they are participating or not (“comply or explain”), and to have those who want to participate sign a Stewardship statement in addition to the combined code. The reasoning is that the ultimate end client himself will choose engaged fund managers or pension funds. Since it is not yet clear at all that end clients will make this choice, this is not real compensation either.

The discussion in the UK is moving towards and focusing in terms of a solution in the direction of more voting rights or a tax cut on dividend. More voting rights with the help of two types of share has been heavily criticised in the interim, because the experience in Euroland is perceived as being bad and attention is focusing on the easing of the burden of the dividend tax.²⁰ The idea is that shareholders who keep shares for a longer time will receive a tax advantage on dividend tax. This instrument is not relevant for Dutch pension funds, which have complete tax exemption.

B. Loyalty voting rights and/or loyalty dividend

Additional voting rights and extra dividend have both been put forward several times in the past. The idea is that shareholders will be entitled to additional voting rights or extra dividend if they keep shares for a longer time and this should then, in principle, provide an incentive to hold onto the shares for a longer time in order to receive these privileges. This is solved technically by allowing the company to issue two types of shares and the shares on which this loyalty advantage is given are registered, so that the company also knows precisely who the long-term shareholders are.

Reasoning from the point of view of compensation for institutional investors, extra dividends are a more direct advantage for the return on the portfolio than additional voting rights. Being able to exercise more power does not lead directly to a higher return, extra dividend does. The greatest disadvantage, however, is that investment decisions will no longer be taken exclusively on the basis of strategy, risk management and quality of management board and supervisory directors, which is and remains the core task of the institutional investor. This fundamental disadvantage – apart from the technical problems of introduction and the departure from the one share, one vote principle – is too great for this to be seen as durable compensation for long-term shareholdership.

¹⁸ Maatman (2007), Abma (2009), de Jongh (2009)

¹⁹ Myners (2009), Walker (2009), Hall, J. & Th. O'Malley (2009)

²⁰ Opposition grows to “two-tier” share plan (FT August 2, 2009) and Shareholder rights (FT August 3, 2009)

C. “Earning” voting rights

This measure would mean that shareholders do not receive voting rights until some time has passed. Voting rights have to be earned first, which is to the advantage of long-term shareholders over short-term shareholders. This is “punishment” as it were for short-term behaviour and should induce institutional investors to become long-term investors. The same applies here as to the previous point, however. The exercise of more or less power via voting rights does not lead directly to a better return. An additional disadvantage is that investment decisions will no longer be taken exclusively on the basis of strategy, risk management and quality of management board and supervisory directors.

D. Attendance/voting fee

An attendance or voting fee is a limited bonus paid if a shareholder exercises his voting rights, so that a more representative decision-making process can take place at AGMs. In the case of long-term engaged shareholdership, it should not really be necessary to give an extra incentive to come and vote. That should be a triviality. The fee, therefore, is more of a useful addition that can ensure in the short term that many more institutional investors solve the technical problems they have with voting, because there is a payment that offsets the costs incurred. In view of the size of the payment envisaged, however, it offers insufficient compensation for the transition to long-term shareholdership.

E. Preferential prudential treatment for 5% interests

The great difference between pension funds and other Dutch institutional investors is that, in terms of taxation, pension funds are already exempt from tax on investment returns and that the other Dutch institutional investors can only achieve this by investing in a 5% interest in the company (participation exemption). In essence, it could be stated that the other Dutch institutional investors already receive compensation for long-term engaged shareholdership and pension funds do not as yet. The argument then, is that investment in 5% participating interests is the equivalent of long-term engaged shareholdership.

Experience with investments of this kind makes it clear that having and keeping a 5% interest is so comprehensive that engagement is absolutely necessary, because too much capital is at stake. It is not necessary in that case to devise an extra rule about what long-term actually is. After all, the accumulation and phasing-out of an interest on this scale is prolonged and expensive. A decision to invest in a 5% stake requires an investment horizon of at least ten years, but it is not necessary to hold the stake for ten years or even two years. If the company’s strategy does not work and repeated dialogue with the management board and chair of the supervisory board does not lead to the desired result, the investment can be phased out and a stake in a different company accumulated. The advantage of equating long-term engagement with a 5% participating interest is that the institutional investor makes the investment decision for the long term on the basis of strategy, risk management and quality of management board and supervisory directors.

It is desirable to arrive at preferential prudential rules that give both groups of institutional investors (those who do and those who do not benefit from the 5% participation exemption) the same attitude to investment as much as possible, because that makes collective long-term shareholdership more simple. After all, only a collective will be able to accumulate a substantial enough interest to have any real influence on the management board of the enterprise.

Recommendation 15:

Offer compensation to pension funds and consider doing this in the form of preferential prudential treatment by lowering the risk for a portfolio consisting of 5% interests in the Financial Assessment Framework of the DNB, compared with the risk for shares in general.

As a consequence, a portfolio that consists of these 5% stakes will form a different investment category in which it is more favourable to invest when seen from the risk perspective. This means that - even if the return on a portfolio of this kind lags behind broad market indices in certain periods – the risk reduction argument is strong enough for continued adherence to the long-term policy. This measure is relatively simple to implement and creates the same kind of preference for 5% interests as applies to other Dutch institutional investors who do have the tax advantage.

The portfolio will have to meet preconditions defined by the pension funds and preconditions defined by the DNB. The considerations are investment-specific in the case of the pension funds, and are based on the Financial Assessment Framework in the case of the DNB. Most of the preconditions run parallel to each other. The most important thing is that it has to be a portfolio in which the risks relating to sectors, countries and currencies are limited, which means that preconditions must be set out with regard to a minimum number of shares, a minimum sector representation, not only Dutch shares, but also shares from Euroland, etc. The disadvantage of this is that the investment in a portfolio of this kind is so substantial that most pension funds cannot afford it and so a strategy of this kind is only feasible for investments in 5% stakes in small and medium-sized companies in continental Europe. Even then, the investment may prove too great and this preferential prudential treatment will have to apply to pooled portfolios and/or portfolios outsourced to third parties.

Recommendation 16:

The DNB should enter into consultations with the industry in order to give a concrete shape to the details of preferential treatment of this kind. Eumedion can undertake a coordinating role on behalf of the pension funds.

6. CONCLUSION AND FOLLOW-UP

In the last few years tensions have increased in the relationships between institutional investors, supervisory directors and management board, due to the consequences of two successive crises. This qualitative survey has made a contribution to the discussion of which measures can be taken to improve the relationships between them.

The most important finding is that Institutional investors, supervisory directors and management board find it difficult to understand and to respect how their own roles and those of the others have changed in recent years. This has led to incomprehension and mutual distrust. Although there is an inclination to choose modification of the roles as a solution, this will not lead to a good result, in our opinion, if time and attention are not explicitly devoted to mutually explaining and becoming accustomed to the new roles. This is why most of the recommendations focus on the short-term improvement of the relationships between the parties by initiating an effective dialogue.

Additional recommendations have been formulated in response to the discussion of the changing of the role of institutional investors into long-term engaged shareholdership. The argument is that, in this new role, the institutional investor would have a better understanding of what drives an enterprise and would therefore be able to form a better team with the management board and supervisory directors of that enterprise. Other shareholders who are more focused on the short-term will then be able to exert less influence on the company's strategy. All of this can work if the regulatory authorities (and legislators) create conditions that will also enable this new whole to actually function.

Long-term shareholdership requires much time and effort from all participants and must be embraced by everyone, therefore, if it is to have a chance of success. The conditions essential to success have been defined by institutional investors themselves, management boards and supervisory boards, the regulatory authorities and Eumedion. An important essential condition is the compensation that institutional investors receive for the time and effort associated with long-term engaged shareholdership.

In this survey we set out a suggestion for a form of preferential prudential treatment and further exploration of this suggestion and any other forms of preferential prudential treatment is recommended, in cooperation with the DNB. In addition, cooperation with the AFM is necessary in order to reach agreement on best practices with regard to dialogue between institutional investors and the enterprise and on acting in concert for the group of collective long-term shareholders. Long-term shareholdership requires intensive communication and collaboration if it is to succeed. Eumedion could, with its members, take the initiative for consultation with both parties.

Finally, we recommend that a real discussion be commenced about the role of supervisory directors in the present situation. What could and should be the shape of any more comprehensive changes in membership, time-use and functioning of the supervisory board? Practically all of those we interviewed dealt with this subject and described it as an important theme and an item on the agenda. In this survey we have confined ourselves to recommendations in the present situation, but we can envisage more drastic changes. We would therefore like to call on the parties involved (association of chairmen of supervisory boards) to respond accordingly.

7. SOURCES

It was decided, in consultation with the client Eumedion, to interview representatives of institutional investors, members of management boards, supervisory directors, regulatory authorities and interest groups. In addition to the formal interviews, preview presentations for INSEAD and SEP (the Dutch Society for the Study of Economic Policy) were used, a round table organized by Eumedion and countless exchanges of views with individuals.

Interviews

Name	Roles
Ir. A.P. (Annet) Aris, MBA	Adjunct Professor Strategy and Management, INSEAD; various supervisory directorships /supervisory functions
Drs A. (Adri) Baan	Former management board member; various supervisory directorships /supervisory functions
Drs F.W.H. (Frederik) van Beuningen	Investor Teslin Capital Management BV; member of Eumedion Board
Dr Ir R.J.A. (Rene) van der Bruggen	Chairman Board of Management Imtech
Prof. dr K. (Kees) Cools	Professor Corporate Finance, University of Groningen; partner Booz & Company
Prof. dr J. (Jean) Frijns	Former investor APG; former chair Monitoring Committee; Professor of Investment Studies, VU University Amsterdam
Prof. drs C.A.J. (Cor) Herkströter	Former management board member; various supervisory directorships /supervisory functions
Drs P.C. (Piet) Klaver	Former management board member; various supervisory directorships /supervisory functions
Prof. mr R.H. (Rene) Maatman	Member of management board AFM; Professor of Asset Management, Radboud University Nijmegen
Drs R. (Roderick) Munsters	CEO Robeco; chair Eumedion
Mr J.M. (Jan Maarten) Slagter	Director VEB
Drs J.B.M. (Jos) Streppel	Former management board member; various supervisory directorships /supervisory functions; chair Monitoring Committee
A.P.M.(Ada) van der Veer - Vergeer	Independent management consultant; various supervisory directorships /supervisory functions
Dr N. (Nout) Wellink	President Governing Board DNB
Ir. K.S. (Klaas) Wester	President and CEO Fugro
Prof. mr J. (Jaap) Winter	Professor of International Company Law UvA; partner De Brauw, Blackstone Westbroek

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Appendix A RESEARCH ASSIGNMENT EUMEDIION

Erasmus University Rotterdam
Attn Prof. Dr A. Kemna (H14-21)
P.O. Box 1738
3000 DR ROTTERDAM

Phyleon
Attn Prof. Dr E. van de Loo
Jan van Nassastraat 16
2596 BT the Hague

Subject: Research assignment Eumedion
Our reference: 2009.022
Schiphol, 27 April 2009

Dear Ms Kemna and Dear Mr van de Loo.

The recent financial crisis has caused great damage to institutional investors. Institutional investors are being confronted with significant falls in share prices at the companies in which they invest and with losses on bonds and debentures. In addition, various listed companies have announced that they will be paying less dividend to shareholders or cancelling the payment of dividend altogether. In the media, however, the role of shareholders is also referred to as part of the explanation of the causes of the financial crisis. Some shareholders are said to have been mainly interested in achieving short-term results and to have had no interest in long-term value creation.

Against the background described above, the Board of Eumedion has a need for a qualitative study of the roles defined in the law and in the Tabaksblat Code for members of management and supervisory boards of listed companies and shareholders on the one hand, and the perceived roles of these corporate bodies on the other.

Issues that may be addressed in this context are the following.

- What are the roles that members of management boards, supervisory directors and shareholders (should) play, according to the law and the Tabaksblat Code, and how does this work out in practice?
- What are the roles of members of management boards and shareholders on the one hand and of supervisory directors and shareholders on the other? Have these roles changed in recent years?
- How do contacts proceed between listed companies and their shareholders? Are there legal or practical impediments to these contacts?
- Do the listed companies know the activist investors and other important shareholders?
- What factors have contributed to the fact that members of management boards and supervisory directors have sometimes lost sight of the aim of long-term value creation?
- Are shareholders mainly focused on the short term? Has this increased in recent years and how did this happen, if it did?
- To what extent does an area of tension exist between members of the management board and supervisory directors with regard to giving detail and substance to shareholders' interests and how is this dealt with?

- What do investors expect of companies so that they (can) once more develop long-term ties with these companies?
- How can institutional investors be encouraged, if necessary, to commit to a company for a longer time?

The survey must ultimately demonstrate whether the participants experience an expectation gap on both sides and how this gap can be bridged. This may lead to recommendations addressed to (institutional) investors, members of management boards, supervisory directors, the legislators and regulatory authorities.

The intention is that you interview a number of management board members and supervisory directors of listed companies, as well as a number of institutional investors and analysts, and the Dutch financial regulatory authorities. What is required is not fundamental academic research, therefore, but a study of the behaviour of the actors associated with listed companies.

Yours sincerely,

Drs. Rients Abma
Executive Director

Appendix B LIST OF RECOMMENDATIONS

B.1 Recommendations to support the present situation

Recommendation 1:

The chair of the supervisory board should organize a 360-degree review with the MB and discuss this in confidence with the individual members of the MB.

Recommendation 2:

The MB should accept the SB's questions as a consequence of the role the SB is expected to play and provide the information requested as efficiently and openly as possible.

Recommendation 3:

The MB should organize annual informative meetings that are open to all shareholders, at which substantive themes concerning strategy and risk management for example, can be clarified and discussed.

Recommendation 4:

The MB should permanently study the motives of shareholder groups that buy and particularly sell shares in the company. An attempt should always be made to hold an exit interview in the case of every serious exit by a major shareholder.

Recommendation 5:

The SB should invest explicitly in functioning better as an autonomous team by the following means:

- *organize a separate meeting with the complete SB before or after each meeting with the MB;*
- *organize an external session annually with the complete SB with the objective of increasing quality and effectiveness as a team;*
- *arrange to be assisted by staff (secretary), which (who) only works for the SB.*

Recommendation 6:

Consider a division of tasks within the SB to the effect that the chair of the SB focuses on the behaviour of the CEO in relation to the internal and external stakeholders. The compliance-specific matters can then be allocated mainly to the vice-chair or the chair of the audit committee.

Recommendation 7:

Arrange for the chair of the supervisory board to speak with major shareholders at least once a year, both separately and in the company of the CEO and/or CFO. This certainly applies to major shareholders who have sold their interest in that year.

Recommendation 8:

Institutional investors should create internal cooperation between the governance teams and the fund managers and integrate the two approaches into a single final opinion.

Recommendation 9:

The institutional investors – senior fund managers in collaboration with the governance team – should prepare thoroughly for discussions on strategy, risk management and governance with the chair of the supervisory board and/or CEO and CFO. This applies to both individual interviews and group meetings.

Recommendation 10:

Eumedion and companies should enter into dialogue about possibly controversial items where institutional investors are concerned, well before the distribution of the agenda for the shareholders' meeting, so that it may be possible to find a solution for these before the final version of the agenda is distributed. This applies likewise to any voting recommendations from the proxy voting services.

B.2 Recommendations for the discussion of long-term engaged shareholdership*Recommendation 11:*

The institutional investor whose aim is long-term engaged shareholdership should invest substantially in people and training inside its own organization, in order to be a genuine discussion partner for the enterprises.

Recommendation 12:

It is recommended as a necessary pre-condition for long-term engaged shareholders that the AFM drafts clear best practice rules for the market, such that an intensive collective dialogue is possible between management and supervisory boards with long-term engaged shareholders. Eumedion can assume a coordinating role on behalf of its members.

Recommendation 13:

Management and supervisory boards who aim to retain long-term engaged shareholders, should be open to suggestions from these shareholders and invest time and energy in worthwhile communication on strategy, risk management and governance, within the limits set by the AFM.

Recommendation 14:

Focus consideration of the introduction of long-term engaged shareholdership at Dutch pension funds on the smaller and medium-sized listed companies in the first instance.

Recommendation 15:

Offer compensation to pension funds and consider doing this in the form of preferential prudential treatment by lowering the risk for a portfolio consisting of 5% interests in the Financial Assessment Framework of the DNB, compared with the risk for shares in general.

Recommendation 16:

The DNB should enter into consultations with the industry in order to give a concrete shape to the details of preferential treatment of this kind. Eumedion can undertake a coordinating role on behalf of the pension funds.