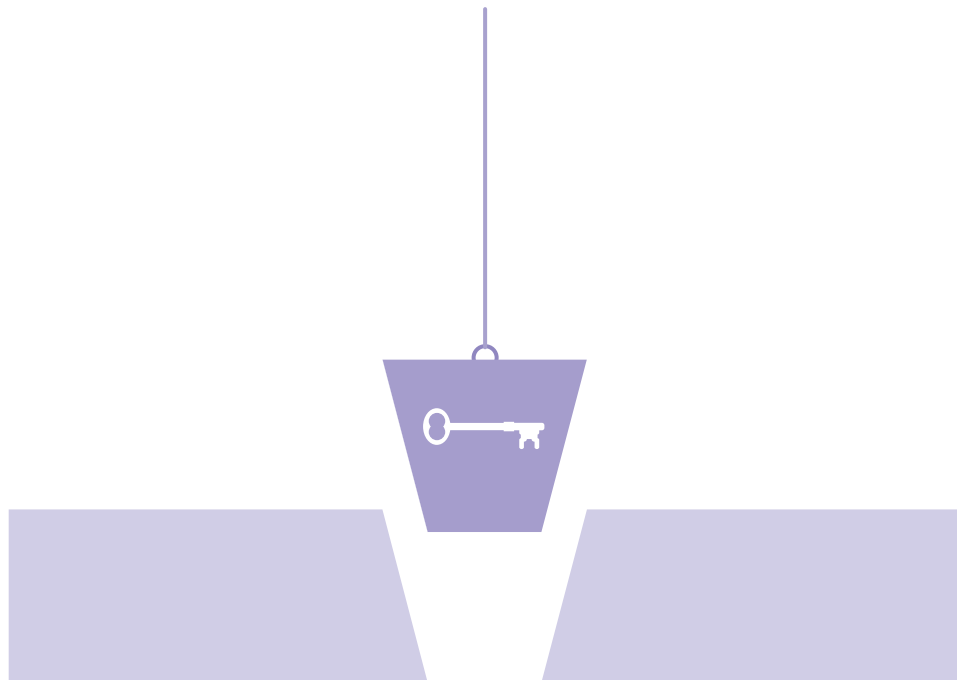


# Tomorrow's Corporate Governance:

Bridging the UK engagement  
gap through Swedish-style  
nomination committees



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# Foreword

The financial crisis has once more reminded us that we need effective challenge in the boardroom. This in turn depends upon the joint exercise of stewardship by boards and major shareholders.

In the aftermath of two major policy reviews in the UK, there is now widespread acceptance that there has been a failure of stewardship and a search has commenced for practical solutions to bridge the engagement gap.

The difficulty now lies in identifying tangible measures that will have a direct impact, particularly in an economy such as the UK where the shareholdings have become very dispersed. How can shareholders be persuaded or forced to hold company directors to account? In the UK and the US nobody pretends that the annual general meeting of shareholders achieves this. The recent debate about stewardship and “ownerless corporations” has arisen because it is widely felt that the other mechanisms for dialogue between companies and their shareholders have not achieved it either.

Corporate leaders need the freedom to lead, but they also need to hear contrary voices and be accountable for their performance and behaviours that underpin that performance. That accountability is a central aspect of engagement by the owners in most private, family or employee-owned businesses. How do we replicate it in the dispersed shareholding model?

The idea for this study emerged from a series of conversations in 2008 and early 2009 between Tomorrow’s Company and Cevian Capital. The conversations followed the publication by Tomorrow’s Company of its 2008 *Tomorrow’s Owners* report which drew attention to the importance and neglect of stewardship by major shareholders. Cevian, one of Europe’s most experienced activist investors, shared its ‘war stories’ of active ownership and engagement with company boards management teams and fellow shareholders in several of Europe’s major markets. As a business-led think-tank with an agenda-setting track record in corporate governance, Tomorrow’s Company was especially fascinated by Cevian’s description of the governance climate in Sweden, Cevian’s original home market.

In an intriguing twist, it emerged that it was the work of Sir Adrian Cadbury and his 1992 report on governance which first stimulated the evolution of Sweden’s shareholder-led nomination committee system. It seemed to Tomorrow’s Company that there might be lessons and solutions relevant to the UK and other markets where shareholdings are widely dispersed. While the Swedish system is, of course, different from the UK system, we believe that the examples and experiences described in this brief study may help investors, policymakers and boards in their search for those solutions. This project will have achieved its purpose if its recommendations accelerate the process of fresh thinking and experimentation in the UK and elsewhere.



**Mark Goyder**  
Founder Director  
Tomorrow’s Company



**Harlan Zimmerman**  
Senior Partner  
Cevian Capital

# Executive summary

Directors serve as the agents of a company's shareholders. Their duty is to promote the best interests of the company. It is the shareholders who elect the directors for the system to work properly in the long-term. In the interests of those shareholders, it is essential that they find and elect the right people to serve on the board.

In the UK there is a lack of commitment on both sides to the investor-company relationship and there are weak incentives for engagement. Many of the larger shareholders in Sweden believe engagement with companies promotes long-term value creation. In Sweden there is a stronger tradition of commitment by major shareholders. This study looks at developments in Sweden over the last 15 years which have strengthened engagement from which valuable lessons can be learned. At the heart of these developments is the proliferation of shareholder-led nomination committees and the impact that has had on company boards.

There are differences in composition between Swedish and UK boards. The UK unitary board brings together executives and non-executives. In Sweden the board is primarily made up of non-executives, and the CEO is sometimes but not always a member. This may make a Swedish board look similar to a supervisory board in Germany. However, as in the UK, a Swedish board has the operational responsibilities of a unitary board. In Sweden, as in the UK, directors owe their duty to the company, and are accountable to shareholders.

In both systems nomination committees (NCs) are the body with responsibility for finding the right people to serve on boards.

In the UK the NC is a sub-committee of the board. It is made up of board members. It is usually chaired by the chair of the board. Board candidates are proposed by the board's NC to the company's Annual General Meeting and, in the vast majority of cases, are elected as a matter of course.

In Sweden, the NC is not made up of board members, but is usually composed of four or five of the largest owners of shares in the company, together with the non-executive chair of the board. It has its mandate from the shareholder's meeting. In addition to recommending to the shareholders at the Annual General Meeting who should join the board, it also recommends the structure and amount of remuneration for each director. The shareholders then make the decisions. The remuneration of executive management is handled separately by the board.

This report looks at what the UK can learn from the Swedish system and whether a similar approach would work in the UK.

This is timely given the reviews of corporate governance which have taken place in the UK in the course of 2008 and 2009. The search is on for stronger shareholder engagement and for a more diverse and challenging boardroom.

## Our findings

The Swedish pattern of ownership is different from that in the UK or USA, but in recent years those differences have diminished. The caricature is that ownership is dominated by four or five controlling family shareholders. However, today these owners are only part of the picture. Local pension funds, mutual funds, international investors and others play their part alongside investment and family groups. The rate of turnover of share holdings in Sweden has also increased significantly in the last twenty years and is much closer to that experienced in London or New York.

Attitudes to ownership are different in Sweden. The shareholders' meeting stands at the peak of a governance hierarchy and can, if necessary, issue instructions to the board. Boards are subordinate to the AGM and the company's executive management is subordinate to the board. Only one executive can sit on the board. Swedish shareholders traditionally have a more prominent and proactive role and this is particularly reflected in the way the nominations process has developed. In the UK the NC is a sub-committee of the board. In Sweden it is a servant of the AGM.

NCs have evolved over 15 years, although they have only been a formal requirement since 2005. They were originally a Swedish application of the recommendations for the UK in the 1992 report by Sir Adrian Cadbury.

The experience from Sweden is that:

- active shareholder engagement in the nomination process has increased confidence in the board function and increased the expectation that the board members will look to further the interests of the company and the shareholders;
- what started as a publicly-declared opportunity for shareholders to participate in the NC process has come to be seen as a responsibility to do so. This has stimulated shareholders to become more engaged and provided a public opportunity to demonstrate that they are being good stewards of their investments; and
- the NC process has brought shareholders together, in a forum that prompts them to think harder about pursuing the interests of all shareholders and to collaborate to this end.

But the system is not without difficulties.

The skills and priorities needed to be a good NC member are different from those of being a good fund manager or governance expert.

Some shareholders, especially international ones, decline to take up a place. Some worry about the possibility of being made an insider through their participation. Shareholder participation does not eliminate differences of view between shareholders and these differences can come out in the NC.

The Swedish system is still evolving as those involved deal with the difficulties.

## Would shareholder representation on nomination committees work in the UK?

Nomination committees that are more directly representative of shareholders could play a part in the improvement of the quality of governance and stewardship in the UK.

The key to the success of the NC process in Sweden is the willingness of institutional shareholders to participate, and the development over time of suitably qualified and experienced people to represent shareholders on nomination committees. The key benefit of this participation is being able to influence board composition in a thoughtful way and so improve the accountability of the directors to the shareholders. The arrangement gives directors a renewed mandate each year from shareholders whose participation becomes proactive rather than reactive.

In principle, there is nothing under the current 'comply or explain' arrangements of the UK's corporate governance code to stop a company listed in the UK from implementing the arrangements which operate in Sweden.

In practice, just as the Swedish system evolved in stages, it might therefore make sense for UK companies to experiment – first by inviting major shareholders to nominate representatives to serve on their existing nomination committees.

The nomination committee is an obvious starting point for experimentation but it is not the only one. Some companies may choose other channels for shareholder participation. The SEC has proposed changes to the conduct of board elections to permit shareholder proxy access in the United States and the 'voto di lista' arrangements in Italy provide another option.

**The most important learning for the UK from the Swedish experience is that if stewardship is to take a leap forward, it needs to be part of some formal process in which major shareholders engage with companies and start to work together in a more proactive way than is experienced at present.**

**The choice is not between a shareholder-led nomination committee and no change. It is between this solution and other stewardship solutions. Those who oppose innovation in this area need to come up with their own ideas for making stewardship real.**

# Agenda for action for the UK

## For listed companies

1. **To take the initiative to include shareholders on the board nomination committee, possibly to the point of forming a shareholder-led nomination committee, on which the Chairman and perhaps the Senior Independent Director (SID) would sit.** The benefit of this change is that it would create a systematic involvement for major shareholders in the process of nominating board members.

## For institutional investors

2. **Fund managers to recruit, train and support suitably qualified people to sit on nomination committees as their representatives.** This cadre may be drawn not only from current fund managers and governance specialists, but also from former chairmen or directors of listed companies, those with experience of board membership of listed or private companies and others with relevant experience from for example the accounting, legal and investment banking professions.
3. **Over time, a body such as the Institutional Shareholders Committee to facilitate and promote the use of nomination committees as a beneficial innovation in terms of encouraging stewardship.** The benefit of this intervention would be to overcome some of the resourcing obstacles which discourage such engagement at present. Initiatives could include:
  - taking a lead in promoting experiments, using common criteria for evaluation and stimulating the exchange of good practice; and
  - promoting co-ordination between major institutions to encourage burden-sharing, involving major international investors including sovereign wealth funds.

## For pension funds

4. **Re-examine their contracts with index and other fund managers. As clients they have the opportunity to specify the level of active engagement by these funds in the nomination process.** The benefit of this recommendation, especially if applied collectively, is that it would create momentum for and innovation in stewardship by making engagement by index and other fund managers a client requirement.
5. **Pool their efforts through National Association of Pension Funds (NAPF) or other bodies to ensure that fund managers are more effective in participating in the nomination committee experiments.** This will help create a systematic involvement behind governance innovation.

## For policy makers and standard setters

6. **The Financial Reporting Council (FRC) to promote the annual re-election of boards and chairmen as suggested in the recent review of the Combined Code, but link the annual re-election with the recommendation that boards engage major shareholders in the nomination process.** The benefit of this change of emphasis is that annual re-election is no longer seen as a shortening of time horizon, but is seen as a way of making director evaluation and re-election part of a systematic process of review and continuous improvement.



# Part 1: Background

*Developments in corporate governance have focussed on the activities and accountability of the board to shareholders, an approach that can be described as board-centric.*

The first Tomorrow's Company report in 1995 helped lead to a reformulation of the duties of directors in the UK around the obligation to promote the success of the company.<sup>1</sup>

Since then Tomorrow's Company has made the case that:

- in the UK all directors have the same obligations and that executive directors should have separate contracts for their role as board members;<sup>2</sup>
- non-executive directors need to spend more time getting to know the business;<sup>3</sup>
- the gap between stated values and actual behaviour in a company should be a crucial focus for boards;<sup>4</sup>
- the investment system needs to be changed so as to better align the intermediaries with the interests of their ultimate clients and better hold companies to account;<sup>5</sup>
- the stewardship of companies is a responsibility shared by directors and shareholders; and<sup>6</sup>
- better governance depends on a culture of constructive challenge, greater diversity of thinking and experience, and a stronger emphasis on behaviour.<sup>7</sup>

Directors are the agents of a company's shareholders, charged with promoting the best interests of the company. If the shareholders' interests are to be served it is essential that they find and elect the right people to serve on the board, and ensure that the company is run in their long-term interests. Developments in corporate governance have focussed on the activities and accountability of the board to shareholders, an approach that can be described as board-centric.

In the UK there is a lack of commitment on both sides to the investor-company relationship and there are weak incentives for engagement. A summary of the obstacles highlighted by recent research appears overleaf.<sup>8</sup>

Nomination committees are the body with responsibility for finding the right people to undertake this role. In the UK the NC is a sub-committee of the board, usually chaired by the chair of the board. In Sweden a group of shareholders make these judgements. Is there anything that the UK and other countries with similarly dispersed patterns of shareholding can learn from the Swedish arrangements for shareholder-led nomination committees?

That is the question that Cevian Capital and Tomorrow's Company agreed should be studied. As part of the study, we have interviewed and consulted over 20 people who are close to or have been involved in the Swedish system. They include non-executive directors, investors, nomination committee members, evaluation consultants, pension fund managers, regulators and corporate governance specialists.

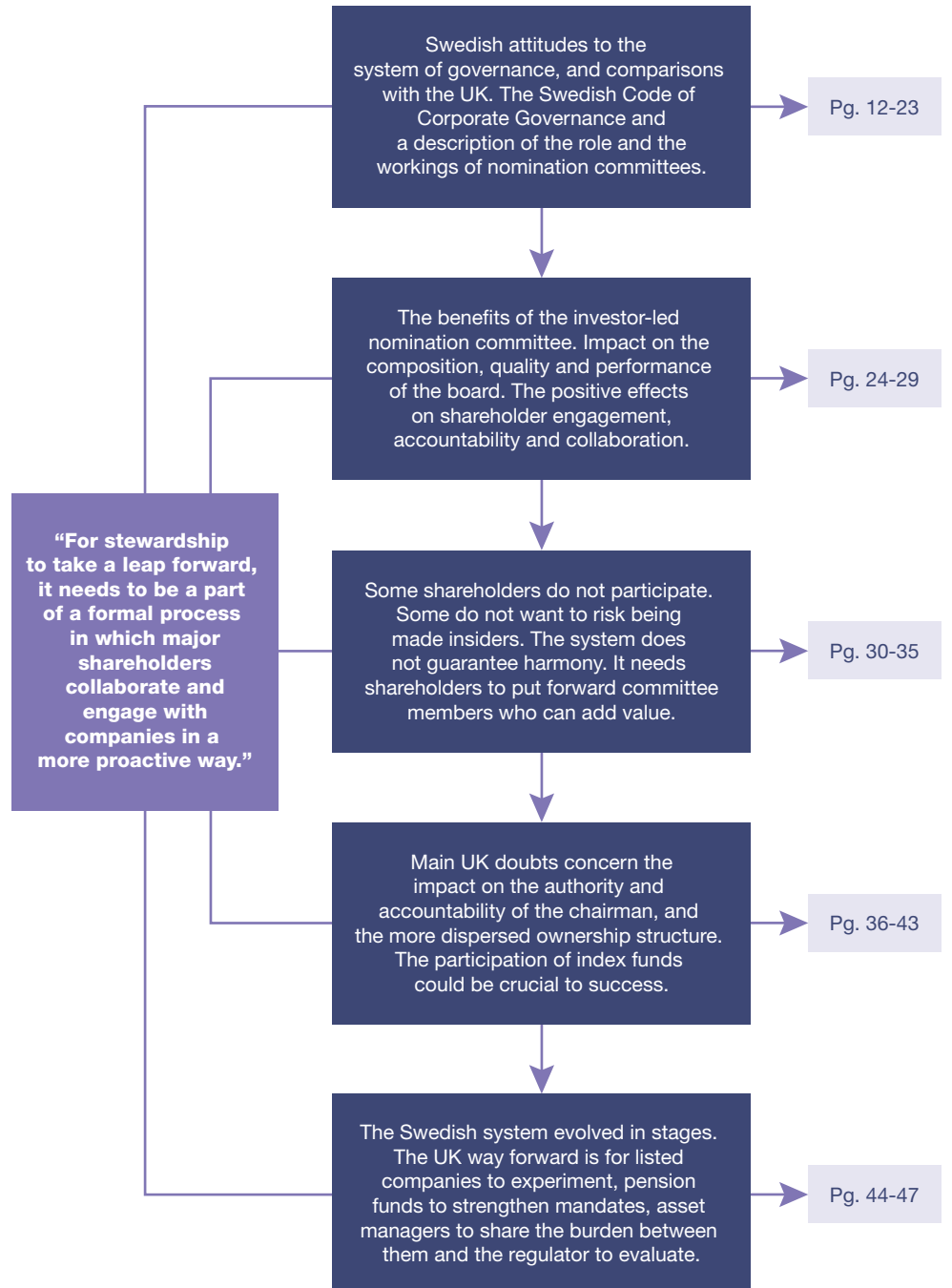
The report summarises the perceptions and experiences of those involved in the evolution of this system over the last 15 years. This leads to some conclusions about the relevance of the experience to the UK and to some recommendations for governance innovation in the UK.

The same principles have relevance for other countries which operate with a highly dispersed system of shareholding and which are concerned to encourage the exercise of stewardship.

## Obstacles to greater engagement

| UK company perspective   | UK investor perspective  |
|--|--|
| <b>A lack of commitment to the investor-company relationship</b>   |  |
| <ul style="list-style-type: none"> <li>• Investors are unwilling or unable to engage actively</li> <li>• An inappropriate level and quality of person representing a shareholder</li> <li>• A box-ticking approach to compliance by investors</li> <li>• Inconsistent positions within some investors</li> <li>• Investors engaging only when specific problems have arisen, which have tended to focus on remuneration rather than wider strategic issues</li> <li>• Limited or no assurances that any engagement relating to personalities or relationships will be discreet and confidential</li> </ul> | <ul style="list-style-type: none"> <li>• A perceived lack of transparency by companies</li> <li>• Companies too often spin messages to shareholders rather than have genuine dialogue</li> <li>• Companies divide and rule – “you are the only investor to say this”</li> <li>• Resistance from some chairmen, CEOs or boards to engagement</li> <li>• Hubris or complacency about the board’s strategy</li> <li>• The threat that criticism or negative votes will reduce subsequent access to the company or lead to a fall in the share price, damaging the interests of the end investor, to whom there is a clear fiduciary duty</li> </ul> |
| <b>Weak incentives for engagement</b>  |  |
| <ul style="list-style-type: none"> <li>• Some investor concerns appear closely tied to short-term stock price performance</li> <li>• The interests of those institutions seeking to engage may not coincide with those of other shareholders</li> <li>• Governance specialists with whom a company might engage are often not influential in decisions to buy or sell their stock. There is little advantage to companies in engaging with these people when the fund managers make buy/sell decisions without reference to these issues</li> </ul>  | <ul style="list-style-type: none"> <li>• Little willingness to support the cost of such effort and free rider benefit</li> <li>• Confrontations and problems could generate adverse publicity</li> <li>• Potential legal and procedural barriers to exercising governance rights, such as concert party rules</li> <li>• Difficulties ascertaining the beneficial ownership of shares held in nominee accounts</li> <li>• Difficulties for individual shareholders to have any impact</li> <li>• Current performance measurement mechanisms tend to discourage governance activity</li> </ul>  |

## The structure of the report



# Part 2: The Swedish governance system

*Holdings were dispersed and the institutions did not effectively engage – a situation not unlike that faced by the UK today.*

**The Swedish governance system is different from that of the UK in the way it focuses responsibility between shareholders and directors.**

**In Sweden the shareholders take more responsibility for the future of the company. In the UK, this responsibility lies much more with the board. The Swedish approach to governance can therefore be best described as ‘owner-centric’, in contrast to the ‘board-centric’ approach of the UK.**

## Shareholders in the Swedish system

In terms of the composition and turnover of its listed company shareholders, Sweden differs from the UK, but the differences are a lot less than they were 20 years ago.

There is a caricature of the Swedish system of governance. People imagine four or five controlling families, whose disproportionate control over major companies is compounded by preferential voting rights or other devices which the experts describe as ‘control-enhancing mechanisms’. This might have been a fair reflection of the position in the 1980s when a limited number of owners held controlling stakes in many of Sweden’s major listed companies.

In 1990, Swedish financial institutions held 46% of the shares in the Swedish market, but had much lower shares of the voting rights.<sup>9</sup> Institutional investors might have been consulted from time to time. But their holdings were dispersed and the institutions did not effectively engage – a situation not unlike that faced by the UK today. The controlling owners effectively appointed the board.

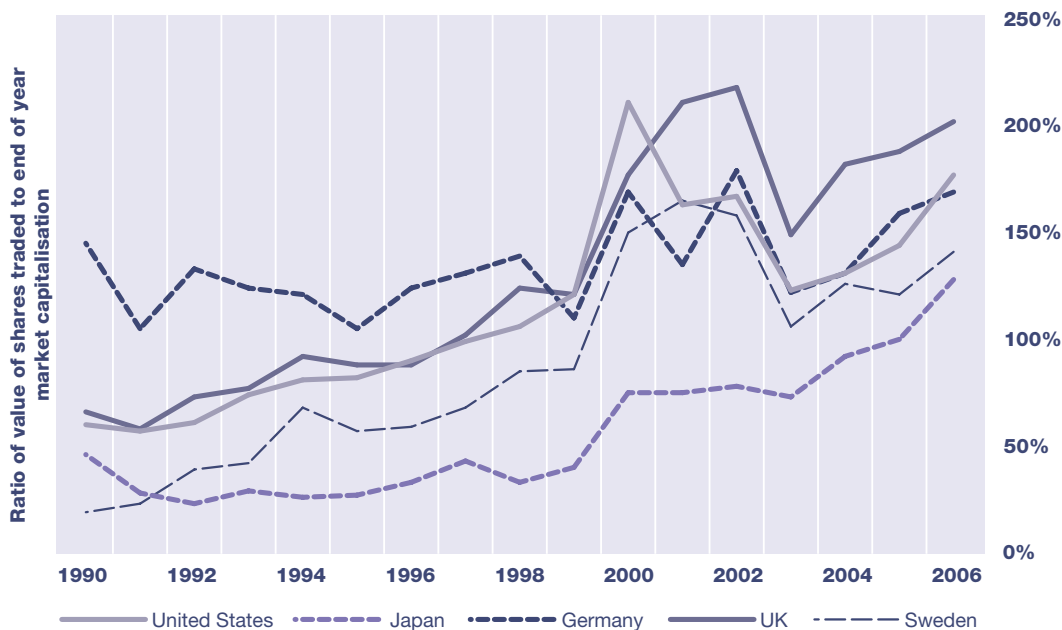
Today the controlling owners are only part of the picture. Swedish pension funds, mutual funds and industrial holding companies are commonly among the largest shareholders of companies. As well as the local institutional shareholders, foreign institutions own a significant proportion of the market. More than one in six of the population own shares directly and there is a much wider indirect involvement through individual pension savings accounts.<sup>10</sup>

**Table 1: Comparison of UK and Swedish shareholders**<sup>11</sup>

| Shareholder                       | Sweden (2007) | UK (2006) |
|-----------------------------------|---------------|-----------|
| Foreign investors                 | 38%           | 40%       |
| Private financial enterprises     | 27%           | 44.4%     |
| Private non-financial enterprises | 9%            | 2.7%      |
| Individuals/households            | 16%           | 12.8%     |
| Public sector                     | 8%            | 0.1%      |
| Not identified                    | 2%            | 0%        |

The Swedish market experiences short-term pressures similar to those in other markets – the investment performance of fund managers is under regular review and some shareholders argue for the need to be able to deal in a company’s shares at any time. From being a market with one of the lowest levels of churn in the early 1990s, share turnover has increased to be a similar level to that in other developed country markets (see Chart 1 on page 14).

Chart 1: Stock market turnover 1990-2006



A longstanding element of the legislation in Sweden has been to recognise the importance of active ownership. The Swedish Companies Act 2005 (and the 1975 Act before that) sets out a clear hierarchy of governance.

At the peak of this hierarchy stands the shareholders' meeting which can, if necessary, issue instructions to the board. Boards are subordinate to the AGM and the executive subordinate to the board – so it may be said that the Swedish system is 'owner-centric'.

The Swedish Companies Act has been designed to protect minority shareholders. Any shareholder can include an item on the agenda for a shareholders' meeting and there is a strict obligation to treat all shares equally, unless prescribed otherwise in the articles of association. In addition, a decision may not be made that might give undue advantage to some shareholders at the expense of the company and of other shareholders.

The attitude of shareholders to governance and their responsibilities to the company contributes to the success of the Swedish model. Many of the larger shareholders believe engagement with companies promotes long-term value creation. A number of those interviewed for this study referred to a positive public expectation, spearheaded by the media, that investors will be engaged stewards of the companies they invest in.

*Boards are subordinate to the AGM and the executive subordinate to the board – so it may be said that the Swedish system is 'owner-centric'.*

Figure 1: The hierarchy of the Swedish corporate governance model



*In both the UK and Sweden the responsibilities of the directors are the same: they owe their duty to the company, and are accountable to shareholders.*

## The Swedish Corporate Governance Code

Like many other countries, Sweden suffered from the corporate scandals in the period following the 'dot-com bubble'. During 2004 the Swedish government's Commission on Business Confidence and Business Representatives reviewed governance arrangements and concluded that, to maintain international confidence in the Swedish stock market, it was important to adopt a corporate governance code ('the Code').

The Code sets out good practice and companies are expected to comply with its provisions or explain why different arrangements have been adopted. From 1 July 2005, the Code applied to the 100 largest companies on the Stockholm stock exchange. An updated Code took effect on 1 July 2008, applying to all stock exchange-listed companies.

The Code was developed with the following guiding principles in mind:

- creating good conditions for active and responsible ownership;
- establishing a clear and well-balanced division of roles and responsibilities between owners, boards and executive management;
- ensuring that the principle of equal treatment outlined in the Swedish Companies Act is applied in practice; and
- creating a maximum of transparency towards shareholders, the capital markets and society in general.<sup>12</sup>

A further revision to the Code took effect on 1 February 2010 which implemented revised arrangements for assessing the independence of directors and for the remuneration of the directors and the executive management in line with EU recommendations.

## Boards and directors in the Swedish system

In both the UK and Sweden the responsibilities of the directors are the same: they owe their duty to the company and are accountable to shareholders.

Swedish company boards are entirely or predominantly non-executive. They are responsible for:

- managing the company's affairs in the interests of the company and all shareholders;
- establishing the company's strategy; and
- appointing, evaluating and if necessary dismissing the CEO and ensuring there are appropriate controls in place.

The board can delegate operational responsibility, but retains duties to do so responsibly and with appropriate monitoring. The day-to-day operation of the company is the responsibility of the CEO, who is prohibited from chairing the board and can be dismissed by the board without stated cause.

The Swedish board is not, therefore, just a supervisory board as exists in Germany, but has the operational responsibilities of a unitary board.

The Code sets out the provisions governing the size and composition of a board including:

- limit to the number of executives on the board to one;
- a requirement for the majority of members of the board to be independent of the company and its management; and
- a requirement for at least two members of the board to be independent of the major shareholders (defined as owning 10% or more of the shares or votes).

What about the background of board members? Some will have held senior executive posts in the past. Some will be employee representatives appointed through co-determination arrangements.<sup>13</sup> In their role as directors they are expected to be actively engaged and work to promote the interests of the company and its shareholders. They are also expected to acquire the necessary knowledge of the company's operations, organisation and markets and to request whatever information is necessary for the board to make well-founded decisions.

The emphasis on active ownership is reinforced in Sweden by the clear governance hierarchy mentioned earlier. Annual re-election of directors is stipulated in Sweden, but has only been adopted by a minority of UK companies. This is the context for the difference in approach to director nomination.

## The development of nomination committees in Sweden

Nomination and remuneration matters in Sweden are dealt with by a committee of shareholders making recommendations to the AGM.

In the 1980s and early 1990s, a limited number of large owners – ‘controlling shareholders’ – had control of the ownership of many major listed companies.<sup>14</sup>

In the Swedish context the term ‘controlling shareholder’ does not refer to a shareholder with 51% of the shares. It refers to a leading shareholder whose stake is enhanced by differential voting rights and other so called ‘control enhancing mechanisms’ and who therefore has sufficient shares to make them the dominant influence. But, as Per Lekvall, Executive Director of the Swedish Corporate Governance Board, acknowledges, controlling shareholders have on the whole fulfilled the responsibility that came with this power:

*“Controlling shareholders have been expected, both by other shareholders and by society at large, to take a special, long-term responsibility for the company by holding on to his or her shares in less prosperous times for the company and by taking an active part in the governance of the company, including taking seats on the board.”<sup>15</sup>*

The controlling shareholders held a relatively small proportion of the shares in the market. Although they were active shareholders, there was little transparency about how people were nominated on to company boards and there was general concern that an ‘old boys’ network’ operated.

*Nomination matters in Sweden are dealt with by a committee of shareholders making recommendations to the AGM.*

*Institutional investor participation was not universal, but increased as a consequence of peer and media pressure.*

By contrast, the behaviour of other Swedish institutional shareholders, such as pension funds and mutual funds, could be perceived as similar to that seen in the UK now. They owned nearly half of the shares in the market but the holdings were dispersed and little effort was made to engage. Underpinning this behaviour, there were two implicit assumptions: first that if there was an issue, the controlling shareholder would resolve it; and secondly the controlling shareholder had the same or similar interests to the rest of the shareholders, so there was no need to be more engaged. In other words, many shareholders were free riders.

In its 1992 report, on the Financial Aspects of Corporate Governance, the Cadbury Committee in the UK noted that non-executive directors should be selected with the same impartiality and care as senior executives. Cadbury recommended that a nomination committee should be set up to carry out the selection process and make proposals to the board.<sup>16</sup>

This initiative was picked up by the Swedish Shareholders' Association, who lobbied for greater transparency in the board nominations arrangements in Sweden as a way to improve the competence of the boards and to offset the power of the controlling shareholders.

The blocking by institutional shareholders of a proposed merger between Volvo and Renault in 1993 made shareholders in Sweden realise how powerful they could be. The first activist fund in Sweden appeared within two years. Pressure grew on other shareholders to become active, as the media started to criticise passive shareholders that did not take action in underperforming companies.

As the decade passed, companies began to adopt the NC concept, but with one key difference. The committee was appointed by the shareholders and composed predominantly of major shareholders or their representatives. This enabled institutional investors, who could have significant holdings in a company, to be more involved. Institutional investor participation in these informal arrangements was not universal, but increased as a consequence of peer and media pressure.

At the time the Swedish Corporate Governance Code was developed, NCs were already operating voluntarily in many companies and were included as an element of good practice. Rule 2 sets out the formal requirement on the appointment and remuneration of the board (and also of auditors):

*“The shareholders’ meeting’s decisions on election and remuneration of the board of directors and the auditors are to be prepared in a structured, clearly stated process governed by the shareholders that provides conditions for well-informed decision-making.*

*The sole task of the nomination committee is to propose decisions to the shareholders’ meeting on electoral and remuneration issues and, where applicable, procedural issues for the appointment of the following year’s nomination committee. Regardless of how they are appointed, members of the nomination committee are to promote the interests of all shareholders. Members are not to reveal the content and details of nominations discussions unduly.”<sup>17</sup>*

Early experience with the Code highlighted concerns that some NCs were used to discuss, for example, dividend strategy or the company’s financial structure, and that the views of all shareholders were not necessarily being taken into account. The Code was changed in 2008 to address these issues.

## A nomination committee in action – TeliaSonera

TeliaSonera (TS) is a leading telecommunications company operating in the Nordic, Baltic and Eurasian countries. The company was formed in 2002 through the merger of the former state telecom monopolies in Sweden and Finland, both of which were privatised via listing prior to the merger. Although the company is widely-held in Sweden and Finland, the Swedish and Finnish governments are the company's two largest shareholders (37.3% and 13.7% respectively for 2008). In 2008, TS was active in 20 markets, had 135 million subscribers and a market capitalisation in excess of €20 billion.

Cevian Capital developed a view that the company was significantly underperforming its potential. The board had been in place for some years and Cevian felt that its composition was inappropriate for the challenges faced by the company. The company's announcement of plans for a large "green field" project in Spain was seen as "off-strategy" by many investors and heightened market concern about the stewardship of the company. In mid 2006 Cevian bought shares in TS and became the fifth largest shareholder with a stake of around 1.6%. Cevian was then invited to join the NC alongside the four largest shareholders and the chairman of the board.

The work of the NC proceeded with new urgency and resulted in a conclusion that the board lacked experience in operational management, service delivery and change management. At the request of the NC, an extraordinary general meeting was held in January 2007, following which, the work and recommendations of the NC were presented and published on the TS website ([http://www.teliasonera.com/about\\_teliasonera/corporate\\_governance/nomination\\_committee/work\\_of\\_the\\_committee](http://www.teliasonera.com/about_teliasonera/corporate_governance/nomination_committee/work_of_the_committee)).

Shareholders overwhelmingly supported the NC's recommendation that five of the existing directors should be replaced with four new individuals with the desired experience. Each of them was independent of the company and its shareholders. Within a year, the revised board had appointed a new President and CEO and the company embarked on a dramatic operational improvement plan.

TS has a significant and growing business in Eastern Europe and is expanding in Eurasia. Through the board evaluation process, in 2009 the NC concluded that the board would benefit from more experience of conducting business in emerging markets. The committee recommended that one person should be added to the board to bring this experience, undertook a search and identified a professional whose candidacy was proposed to (and ultimately supported by) the company's annual general meeting.<sup>19</sup>

## How nomination committees operate

The NC is tasked with recommending candidates to be members of the board. This includes which member is to be chair of the board, and the fees and other remuneration for each member of the board to a shareholder's meeting, normally the annual general meeting. It also makes recommendations on the election and remuneration of the company's auditor.

The committee is required to have at least three members, who are either appointed directly by the shareholders' meeting or through a procedure specified by the meeting. A number of checks and balances are built into the composition of the NC:

- a majority of the members are to be independent of the company and its executive management;
- at least one member is to be independent of the company's largest shareholder or group of shareholders acting in concert;
- the chair of the board is prohibited from being the chair of the committee;
- directors must not form a majority of the committee;
- only one director member can be dependent on a major shareholder in the company; and
- the chief executive officer and other members of the executive management are expressly prohibited from being members.

*The outcome from the NC process is typically a joint recommendation from the committee members, not just a majority.*

The company is required to announce the names of the members of its NC on its website no later than six months before the AGM, to keep these details up to date and to disclose if a member represents a particular owner. The Code also requires each committee to publish details of how shareholders can provide them with comments and suggestions. The members of the NC are required to be open to different views and find solutions that take account of them. They owe a duty to shareholders as a whole.

The outcome from the NC process is typically a joint recommendation from the committee members, not just a majority. However, reaching that conclusion may not be straightforward as committee members have to set their own opinions aside while exercising judgement on behalf of all shareholders.

If a shareholder thinks an issue has not been appropriately addressed they have two options – raise a counter-proposal at the AGM or raise the issue again with the NC elected for the following year.

The committee's recommendations are presented in the notice of the AGM and on the company's website. A statement is also placed on the site explaining the recommendations and providing information on the candidates they have nominated for election or re-election and their relationship with the company. The explanation should focus on how the proposals will lead to a board composition that is appropriate for the company's operations, development and circumstances, how the proposed board is expected to exhibit diversity and breadth of qualifications, experience and background and also how the company is striving for equal gender distribution on the board.

The ultimate authority for appointing the board of directors rests with the AGM. At the meeting the chairman of the NC makes a presentation on its work, its conclusions about the competences needed on the board and the logic behind the recommendations. If shareholders are not satisfied with these recommendations, they have the right to make counter-proposals at the shareholders' meeting. Counter-proposals were a feature of shareholder meetings twenty years ago or so, but now are rare.

In most companies the shareholders forming the NC will account for 15-25% of the votes to be cast, and in some cases over 50% of the votes. This has the consequence that many NCs can act with the confidence that their recommendations are likely to get sufficient support.

*The NC usually comprises representatives of the four or five largest shareholders and the chairman of the board.*

## Selecting committee members

Each nomination committee recommends to the annual general meeting a process for selecting the members of the following year's committee. For about 30% of companies, the NC will suggest specific shareholders to constitute the committee. In most cases the committee proposes the criteria and process that should be employed.

The NC usually comprises representatives of the four or five largest shareholders and the chairman of the board. When shares are owned by different legal entities within an investment group such as BlackRock (formerly BGI) or Aviva, the normal practice is for the holdings to be aggregated together.

There are occasions when shareholders other than the four or five largest are proposed as members of the committee. For example:

- a representative of smaller shareholders can be invited to participate;
- to provide continuity, a member of the previous NC may be asked to stay on even if it is no longer one of the largest shareholders;
- shareholders with similar views on corporate governance may seek to reduce the number of committees they both sit on, so that their resources can cover more companies; or
- some shareholders, commonly but not exclusively overseas institutions, decline to take up a position on a NC.

Shareholders will change their stakes in companies and there can be a number of shareholders with similar stakes. From year to year, therefore, different shareholders may be on the nomination committee. In the extreme, a complete change in the membership of a committee is possible.

The members of the NC will select a chairman from among the shareholder representatives. This need not be the largest shareholder, as factors such as geographical proximity to the company can be relevant as well. The chair of the NC takes responsibility for managing the work of the committee. Early consideration will be given to how much the board is going to need to change, whether the committee will use any external advisers and to assess whether the committee will be handling sensitive information, so that potential committee members can understand the likelihood of becoming an insider during the process.

*The board has the responsibility for dealing with the challenges the company faces.*

*The NC's responsibility is to build a profile of the characteristics needed to address those challenges.*

## Informing the recommendations

### Selection

The board has the responsibility for dealing with the challenges the company faces.

The NC's responsibility is to build a profile of the characteristics needed to address those challenges and to set out the attributes that are required in any new director. Skills and experience will be part of the profile, but the character of the person, their commitment, energy and integrity and their willingness to speak their mind will also be factors to consider.

The key elements of the committee's work are:

- understanding the strategic opportunities and challenges facing the company;
- building a profile of the experience and attitude required of prospective directors;
- considering the existing board members and the evaluation of the board over the prior period;
- matching the profile required with the details of the people wishing to continue as board members and identifying the gaps; and
- undertaking a selection process driven by the preceding analysis.

The chair of the board provides the committee with an analysis of the company's strategy and the results of the board evaluation. This should set out the contribution each director makes, the dynamics within the board and whether there are any particular capabilities or experience that need to be added to the board.

The committee will look both at the immediate situation faced by the company and at succession issues, and will consider if further analysis is needed. Each director will be considered as an individual and as part of the board.

In some cases committee members will interview each director to help them make their own evaluations and to get input from different perspectives.

In undertaking their evaluation, boards are most likely to use an external consultant once every two or three years. There may also be a need to use a consultant every year if the situation is more complicated. The repeated use of the same consultant can raise concerns among investors that the conclusions may lose their objectivity, as the consultants may be influenced by a desire to be consistent with previous evaluations or by the relationships built up with individual board members.

Search and selection consultants may be used if committee members consider that the network of potential directors they know is not deep enough, to get ideas that are not obvious or if particular skills or experience are required. Selection procedures can include one or more in depth interviews with the potential director and talking to people who have worked or served on boards with the individual.

## Remuneration

Remuneration arrangements are handled by two separate bodies. The NC is responsible for the remuneration that goes with the appointment of the directors, and a separate sub-committee of the board deals with the remuneration of executive management.

Each company is required to have formal and clearly stated processes for deciding on the remuneration and other terms of employment for directors. The aims of the remuneration arrangements are to ensure that the company has access to the competence required at an appropriate cost.

The nomination committee has the responsibility for proposing the remuneration arrangements for the directors. Directors can participate in share and share-price related incentive schemes, but packages for non-executive directors cannot include share options. The board is required under the Code to establish a remuneration committee to deal with the principles for remuneration and other terms of employment for the executive management. This includes monitoring and evaluating any programmes for variable remuneration, the application of remuneration guidelines set by the annual general meeting and the remuneration structures and levels in the company. Remuneration committee members are appointed at the shareholders' meeting and are to be independent of the company and its executive management.

External remuneration consultants can be used by the board provided there is no conflict of interest regarding other assignments the consultant may have for the company or its executive management.

Further detail about the differences between the UK and Swedish systems are provided in the appendix.

*The NC is responsible for the remuneration that goes with the appointment of the directors.*

### Changing the Structure of Remuneration

As well as proposing who should be the company's directors, the nomination committee is responsible for recommending the remuneration of the Board of Directors. This means that Swedish nomination committee members are in the middle of discussions regarding the structure of remuneration to Board of Directors.

Note: The sole task of the Nomination Committee is to propose decisions to the shareholders' meeting on electoral and remuneration issues and, where applicable, procedures for the appointment of the next year's nomination committee. Investor AB launched a new compensation system for board members in 2008, which had some potentially controversial elements to it. In addition to the meetings within the Nomination Committees informal meetings were used to discuss the proposals and modify them from the feedback received.

Source: Interviewee no. 7, member, nomination committee.



# Part 3: Benefits of shareholder-led nomination committees

***This part of the report outlines the benefits attributed to the Swedish approach to nomination committees and the factors that make the committees effective.***

The four areas identified are:

- influencing the composition, quality and performance of the board;
- enhanced shareholder engagement;
- enhanced transparency through the investment chain; and
- enhanced collaboration.

## **Influencing the composition, quality and performance of the board**

*“When I am asked has the Swedish Code led to any major improvements in corporate governance, the most obvious improvement is how nominations to the board are carried out. And how the boards are nominated and elected really is the core question of corporate governance. And in this very crucial matter, it has meant a dramatic improvement in just a few years.”*  
(Interviewee no.1, industry commentator)

*This reminds board members that they have been put in their post by shareholders, and owe their ultimate loyalty to the company.*

The primary task of the NC is to propose new board members. For some shareholders, the nomination committee is seen as a way of directing the company towards long-term value creation, even if the shares may be sold in due course:

*“It’s very important for us to see to the best interests of the company and to nominate directors that can be on the board even if we sell our shares. We are an investor that might reduce our holdings but some day in the future we might come back. We have a long-term view for the company; I think that is the most important thing.”* (Interviewee no. 2, investor)

This comment is significant because it indicates that the owner of shares has an interest in improving performance across time and across the system as a whole, irrespective of the current weight of their holding in one company.

The Swedish approach also has the potential to provide more effective performance management where board members are concerned. The quality of governance can be undermined if relationships become too cosy. Regular individual feedback is a key to good performance management, supported by a thorough board evaluation. In Sweden shareholders are running the nomination process, and reviewing the board evaluation with the chairman. It is the shareholder representatives who, with the chairman, make annual recommendations on the continuance or removal of each director. This reminds board members that they have been put in their post by shareholders, and owe their ultimate loyalty to the company, and this should not be compromised by any sense of personal loyalty to a chairman who becomes a close working colleague.

The discipline of an annual review by shareholders also creates the opportunity for remedial action at the level of an individual director before things are allowed to go too far. This is a more refined instrument for a shareholder. It allows for a considered and systematic investor discussion of the board and each of its members by shareholders. It offers a channel through which performance may be improved long before the point is reached where an investor needs to consider selling the shares it owns in the company:

*“The strength [of the system] is to engage the ultimate shareholders of the company in contributing to the direction of the business. We force the shareholders to become much more active in one of the key decisions as a shareholder which is to elect a board. And it also puts extra pressure on the board of directors to fulfil their duties. It puts a well designed hierarchy in place that will enhance the performance of the business and therefore create more value for the shareholders.”* (Interviewee no. 4, investor)

Under the Swedish model the larger shareholders have the opportunity to influence the board strategically at a relatively low cost when compared with the expense and time involved in other engagement approaches which require ad hoc co-ordination of other shareholders, let alone a US-style proxy contest.

For some shareholders, there is a straightforward financial logic behind committing the resources to being involved in nomination committees:

*“We do it because we think it gives in the long-term a better profitability for our fund. We think our fund will perform better. We think it will give added value to our fund holders.”* (Interviewee no. 2, investor)

The Swedish system operates on a cycle from one annual general meeting to the next, so directors can only be sure of their tenure for twelve months at most. This could provide an incentive for short-term actions. However, this is rarely seen as an issue in practice. Instead, the annual cycle is viewed positively as a regular opportunity for shareholders to confirm they are happy with the direction the company is going. Two factors contribute to this outcome.

First, the members of the nomination committee usually are taking a longer-term view and are not striving for quick gains. Discussions about board composition will consider how to ensure the board has the right balance between people who understand the history of the company and people who can bring in fresh perspectives.

Secondly, the hierarchy in the Swedish system makes it clear that a NC is not taking over the job of a board. Strategic decisions are delegated to the board and the shareholders have no say in those decisions, but trust in the directors flows from the nomination committee having the chance to assess the directors and make sure that they have the necessary skills, integrity and attitude.

*The annual cycle is viewed positively as a regular opportunity for shareholders to confirm they are happy with the direction the company is going.*

### **A nomination committee in action**

A company wanted to make the board more international, so the nomination committee decided to add two additional board members from the US. One name came from one of the company’s investors with a recommendation, but a major evaluation was not completed for either candidate. After a couple of meetings it was clear that one director was a good addition, but the other one was not – it seemed that his personal reputation was more important than developing the company. The chairman of the board had to go to the nomination committee after less than a year and tell them that this director could not stay on the board. The committee took the difficult decision to do this, but only after some tough conversations, particularly as he had been recommended by one of the committee members.

The nomination committee had made a bad choice, but also made use of the process to put it right. The fact that the committee had to go back each year worked to the company’s advantage.

*“The Swedish system is not a perfect system. It is just a case of doing it as well as possible. But at least the nomination committee system avoids selection on the basis of a “boys club” based upon whom you happen to know.”*

Source: Interviewee no. 3, member, nomination committee.<sup>18</sup>

*The Swedish system exposes the board's analysis to challenge from shareholders.*

## Evaluating performance

The Code requires the board of directors to evaluate its work annually, using a systematic and structured process. The evaluation is primarily a tool for improving the board's working methods and efficiency, but the evaluation report also has to be placed at the nomination committee's disposal.

The regular evaluation cycle has established an expectation among shareholders and directors that performance will be reviewed. Board members know they are being evaluated by their principals and that the committee will look at who should be on the board.

This puts pressure on board members to do a good job if they want to continue to serve on a board and can lead to the prompt removal of non-performing directors:

*"It is likely that one or two members of a board will be changed each year – a renewal process. The reasons for removing a board member can range from a conflict of interest; to sleeping at board meetings; to not being prepared or not adding anything to board conversations. This last one is the most important as we don't want people who are not productive. It compares well with the old system, where it was possible not to contribute, particularly if you were a friend of the chair. Now it is impossible for a strong chair to protect a non-performing director on a board for more than two years. You can give people a chance, but in the second year, you must perform or you're out. Improving the quality of directors is the main benefit." (Interviewee no. 5, industry commentator)*

## Enhanced shareholder engagement

Fifteen years ago the level of engagement by many shareholders was low. Institutional investor attitudes in Sweden at that time were similar to that seen in the UK and US now. That has changed.

Now there is a clear understanding among many shareholders in the Swedish market that engagement is an ongoing responsibility, focused on making the board as effective as possible. The nomination committee arrangements not only provide a regular and rigorous evaluation process, they also create a systematic opportunity to enhance the performance of the board long before their shortcomings hit the company's share price:

*"In many countries the owners only get involved once there is a crisis, a scandal or a clear failure. And that is too late. It's much better if owners can get involved in order to make sure that the company does not fail. That is the big improvement from the owners having to be involved on a regular basis. It's more of a proactive role than a reactive one and that I think is very beneficial." (Interviewee no. 6, investor)*

The Swedish system requires a board member, usually the chairman, to explain both the challenges and opportunities faced by the company and the results of the board evaluation exercise to the NC members in a confidential and honest discussion outside of the boardroom. This exposes the board's analysis to challenge from these shareholders, who may have different perspectives on the future of the company.

This additional scrutiny can bring the following advantages:

- assumptions about the company's future are more likely to be made explicit, as those presenting the company's strategic position and the board evaluation can be challenged by informed outsiders;
- the chair has the opportunity to gain information and feedback from other sources; and
- directors have greater clarity about their accountability.

## Enhanced transparency and accountability through the investment chain

The Swedish Shareholders' Association pressed for the development of nomination committees to increase the transparency of the nomination process and to challenge a perceived 'old boys' network' that operated within the boards of major companies. There is broad recognition that this objective has been achieved, as shareholders, and others, can find out who is on the NC when the committee starts work, and how to get in touch with the committee to register views:

*"If you go back four or five years there was a great debate about the way boards were nominated with many people thinking that this was done in a very non-transparent way. People didn't know who was doing the work and how it was done. It was much talk about 'old boys' networks', hunting parties and things like that. This whole debate has almost vanished now and it's generally thought that the nomination for listed companies' boards is carried out in a much more systematic, structured and professional way than before. And this is to a very large extent the effect of the increased use of nomination committees." (Interviewee no. 1, industry commentator)*

Improved disclosure has meant that interested parties can also assess whether the institutional investors are using this opportunity to engage with the companies they invest in to influence the future of their investments. There is an incentive for the institutions involved in the NC process to consider carefully the strategic challenges faced by the company, the quality of the directors they recommend and whether the remuneration package could incentivise a board to take on too much risk:

*"If the shareholders don't believe the remuneration schemes are the right ones, then they should voice their concerns to the company, primarily to the chairman of the board, or to the nomination committee or at the general meeting, and make sure the remuneration schemes are changed accordingly. ... There is a much better understanding of these issues among shareholders nowadays than there was two or three years ago." (Interviewee no. 6, investor)*

As one of our interviewees observed, this approach is a far more satisfactory route to achieving influence over pay than the formulaic voting approach mandated from the USA by proxy agencies with little understanding of a company's context.

The change in the level of engagement is attributable partly to the evolution of the nomination committee and partly to the peer and media pressure that has been applied. The composition of nomination committees is public information. The media and an informed public expect large shareholders to take an active interest. They can identify which institutions are taking up these responsibilities and analyse which ones are associated with companies that perform badly:

*"From a cultural heritage of relatively strong, visible owners, it's always been viewed as a good thing to be an active and responsible long-term shareholder. The passive shareholder that votes with their feet, is anonymous and faceless has always been viewed negatively. There's been no respect for passive shareholders." (Interviewee no. 4, investor)*

The resulting pressure has led to much greater engagement and a more professional approach to the task of governing companies from both shareholders and directors.

*The resulting pressure has led to much greater engagement and a more professional approach to the task of governing companies.*

*“You suddenly feel you have a responsibility and if you don’t fulfill that responsibility in a good way you may be criticised. Or you may be criticised for putting an investment in a company where you didn’t see the train coming. So I think you become engaged and I think that is for the benefit of all.”*  
(Interviewee no. 6, investor)

*The NC facilitates relationships between the institutions so that broader issues can be discussed in other forums.*

A consequence of the Swedish approach is that the commitment of the major shareholders to good governance is on display to the market. This gives clients and other shareholders another dimension for assessing the performance of fund managers and how they are adding value. They can identify those committed to stewardship and those which are paying lip service. They can see which investors are associated directly with the governance of well-run companies and how well a committee member is promoting the interests of all shareholders. Beneficial owners can then build up pictures of which shareholders they can trust to be suitably engaged and, by implication, which companies may need closer scrutiny because of a lack of engagement.

## Enhanced collaboration

It is widely accepted that if shareholder stewardship is to work in capital markets with dispersed shareholding, then there will be a need to have better arrangements for collaboration between institutional shareholders. This can take a variety of forms, from informal discussions between shareholders to formally acknowledged concert parties. Some fund managers and some beneficial owners may contract with a third party to exercise engagement responsibilities on their behalf.

In the UK the Institutional Shareholders’ Committee Code on the Responsibilities of Institutional Investors includes the principle that institutional investors should be willing to act collectively with other investors where appropriate. In the past collaboration only has started once a serious problem has been identified.

Once an investment institution agrees to participate in a nomination committee under the Swedish Corporate Governance Code, it is then immersed in a systematic process of engagement with the board and collaboration with other shareholders. The NC’s terms of reference oblige each member to act in the interests of all shareholders, not just the sponsoring owner.

This ensures that minorities have a larger say in the direction of the company and puts a brake on the power of a controlling shareholder.

The arrangements provide a mechanism for a constructive dialogue among the members, where the sharing of different perspectives can give the committee a better understanding of the company.

Some committees go beyond the requirements of the Code and hold informal meetings with other shareholders in advance of the AGM to explain their recommendations. Informal conversations may also take place to gain support for proposals that a committee thinks may be controversial, or when there is a dispersed shareholding structure. The NC is also a natural channel for concerns about board remuneration.

An informal culture of working together has developed which goes beyond the workings of the nomination committee and helps to facilitate ad hoc activity. Several Swedish investors told us that the NC facilitates relationships between the institutions so that any broader issues can be discussed in other forums.

# Part 4: Issues and difficulties

*Some shareholders are criticised for not putting appropriate resources into the NC and most foreign investors do not participate.*

***The Swedish system is not a panacea for all engagement issues.***

***Some shareholders, especially international ones, decline to take up places on nomination committees. Some worry about being made insiders. Shareholder participation does not eliminate differences of view or of time horizon between shareholders and these differences can come out in the NC.***

***The skills and priorities needed to be an effective NC member are different from those of being a good fund manager or governance expert, and some major shareholders have needed to recruit new and different people to enable them to participate effectively. The role played by the company chairman in describing the dynamics inside the boardroom is both sensitive and crucial and NC members need to be skilful in balancing support for that chairman with detachment from his or her perspective.***

***The Swedish system is still evolving as those involved deal with these issues and difficulties.***

## Participation

### Differing levels of participation

An effective nomination committee is central to ensuring that companies have effective boards. But active participation does not happen automatically in Sweden.

Companies tend to invite the largest shareholders to become members of the NC on the assumption that they have the largest stake in the success of the company. The largest shareholders may have a different perspective. In some funds a 4% stake in a company may only be 0.1% of the fund's portfolio and so they may see little incentive to engage.

Some shareholders are criticised for not putting appropriate resources into the NC and many foreign investors do not participate. When asked to explain his unwillingness to participate, a governance specialist from a large international fund manager based in London answered that the system did not work very well because the committees were dominated by Swedish investors. On the other hand, an experienced Swedish fund manager with wide NC experience told us that he had seen international representatives participate and help NCs obtain the best board candidates from across Europe.

If committee members are not active and engaged, then there is a risk that the company chairman may become too powerful, or the authority may lapse into the hands of the controlling shareholder, as used to be the case in Sweden.

As institutional ownership becomes more international, some people have worried that it may become more difficult to convene face to face meetings. Some companies have held meetings of the NC in London to make it easier for overseas investors to participate.

In some cases, institutions, particularly those based outside Sweden, may decline to participate because they wish to retain the freedom to trade a company's shares. This is discussed later in the report.

## Different agendas and time horizons

An institutional investor's willingness to get involved in the governance of a company will depend on its perspective on the likely duration of its relationship with that company. If a major institutional investor is planning a long-term presence in a market, it is likely to have long-term holdings in some companies. From this, it is a short step to being involved in governance issues in those companies.

Consensus is not a prerequisite for a successful NC. There can be differences of opinion about board composition, company performance or time horizon, but there does need to be agreement on the company's underlying business logic. We heard in an interview with a shareholder about a case where the shareholder wanted to replace existing board members but could not get their preferred candidate on the board. As a result the shareholder abstained from voting at the AGM.

The NC can provide a unifying process, as the committee members know they will need to reach a conclusion among themselves. Most shareholders recognise the value of co-operation, as they have a similar target – getting the right board in place, so that company performs well in the long run.

In the Swedish market as in the UK, some investors may pursue short-term strategies or feel pressure from their clients who monitor their performance on a short-term basis. Investment strategy is not taken into account when inviting shareholders to be members of a NC. If a short-term owner has a large enough stake to be a nomination committee member they can be invited to join:

*“Sometimes you get the impression from the general debate that it is considered ugly or wrong to be a short-term owner. In my opinion there should be room for different types of investors on the capital market, and I think it is perfectly alright to be a short-term owner. But what it means is that you probably don't get involved in the governance of companies to the same extent as a long-term owner can be.”* (Interviewee no. 1, investor)

*There can be differences of opinion about board composition, company performance or time horizon.*

The Swedish system does not do away with conflicts over time horizon. These conflicts occur in all systems. The Swedish approach means that the conflict is now acknowledged and discussed by a group which is obliged to act for all shareholders, rather than in private meetings or even in the media. A shareholder with a short-term strategy can influence the discussions at the NC, and may succeed in getting a sympathetic director appointed to the board, but only when they have convinced the NC and ultimately, the AGM. There has been at least one case where a hedge fund won representation to the board of a company with dispersed ownership and successfully pushed for higher leverage and dividends that subsequently left the company in a poor financial state.

Ultimately the success of the NC model does depend on the existence of a large enough body of investors who take their stewardship responsibilities seriously. But the requirement to form an NC can work to stimulate such engagement. The very existence of the shareholder-led NC has challenged investors to decide whether they are serious about participating:

*“But I think overall large shareholders in these jurisdictions where nomination committees have been formed have understood that being a large shareholder of the company does not only entail rights, but also entails an obligation to take responsibility for how the company is governed and making sure the company has the right set of directors. That is a responsibility that the shareholders have to face and they cannot just shy away from it. And I think that is a pretty good development because that means that there are some people who the board of directors need to answer to.”* (Interviewee no. 6, investor)

*The Swedish Shareholders' Association has proposed that the criteria for being invited to serve on a NC should include knowledge and experience.*

## Becoming an insider

There will be circumstances when the shareholders represented on the NC may become insiders; for example, the unexpected replacement of a CEO or chair. But for most shareholders the risk of being an insider does not materialise very often and when it does, it is a risk they are willing to bear.

Some shareholders decline to get involved because they want to retain their freedom to sell their shares. For a committee to operate effectively, shareholders need to think through in advance their position on being in receipt of sensitive information that could make them insiders, as it is not always clear at the outset whether the information provided by a board will be market sensitive.

There have been cases in which a NC had to be adjourned and reconstituted a month later because the matters which needed to be discussed required participants to agree to become insiders and not all members could agree to this:

*“In one nomination committee we wanted to discuss the strategy of a company that may have to make some changes in both their short-term and long-term strategy. The insider issue started at the very first meeting because one person was very opposed to that. We said we’re sorry but we can’t decide whether this is market sensitive or not, but we really need to discuss the business strategy and the changes that will come up. He ended up leaving the committee and we had to start all over again, which gave us a five week delay before we could form the committee again.” (Interviewee no. 7, Chair, nomination committee)*

Another way of dealing with the insider problem is to create a ‘Chinese wall’ between the person nominated and the investment institution which nominates them. The nomination committee member can then operate in a trusted environment, clearly pursuing the long-term interests of all shareholders without being diverted by any obligation or opportunity to advise fund managers about sensitive information.

## Being an effective member of the nomination committee

The quality of the decisions made by a NC depends on the quality of the people involved, each member is expected to contribute to the work of the NC in the same way that each director is expected to bring something to the board. This may mean that they offer insights that lead to a more rounded understanding of the company and how it should develop, or they may introduce board candidates from their different networks. The Swedish Shareholders’ Association has proposed that the criteria for being invited to serve on a NC should extend beyond the number of shares represented to include knowledge and experience and this point was reinforced in our interviews.

The chairman of the board occupies a key position in the Swedish system. While not permitted to be chair of the NC, the board chairman is a pivotal source of information about the prospects for the company, overseeing the board evaluation process and reporting the results to the committee. In briefing the NC, the chair presents a picture of the dynamics and teamwork within that board.

While there is a formality to the board evaluation process, especially where external consultants are used, there will always be a degree of subjectivity in interpretation. There is a risk that the chair will only hear what they want to hear in the course of an evaluation. The chair's perspective on particular issues can significantly affect the conclusions reached by the NC.

Members of the NC, therefore, need to retain independence from the chairman of the board. They are likely to have been following the company for some time and should be able to bring their own opinions to the table. It is also becoming more common for the shareholder members of the committee to meet on occasion without the chair of the board and to interview directly other members of the board and management, so that they can add to the picture the chair is presenting.

An effective committee needs a complex mix of skills and knowledge. Their members need to be both sceptical and supportive – testing the information presented and making their own judgements about company strategy, the quality of the individuals on the board and the ability of a new director to make a positive contribution to a board:

*“We need to have knowledge about these companies to be respected in the nomination committees. And I think we have to have a humble approach to these questions. There are very often complex issues regarding the performance of an individual board member that you have to address very seriously.”* (Interviewee no. 2, investor)

Initially there was a lack of understanding in some quarters of what makes a good board and the capabilities needed to be a good nomination committee member:

*“When they started there was a lot of box-ticking in the nomination committees – making sure that the board had experience in marketing, general managing, distribution, production, logistics and so forth. Whereas now there is much more talk about the capabilities of the board members and about the attitudes and personal characteristics that mean they are contributing to the board in a good way. You need to get both right.”* (Interviewee no. 6, investor)

## Finding the right people

An effective process requires commitment from the major shareholders, both in focusing on the long-term prospects for the company and having the right people to put the time and effort into the process. One of the early lessons for some institutions was that the skills and experience needed to evaluate the performance of a board are different from the financially oriented experience of a fund manager.

Another criticism, often levelled at the controlling shareholders, is that the same person may be nominated to the boards of several of the largest companies in Sweden at the same time as they hold an executive position in a company. This raises questions about the time commitment possible from the individual.

*The skills and experience needed to evaluate the performance of a board are different from the financially oriented experience of a fund manager.*

In response, larger institutions with a significant number of companies to cover have developed their organisations to ensure they have the right people involved, often appointing a 'head of governance' to co-ordinate resources, who will work closely with the financial analysts. Institutions are also recruiting more experienced industrialists or ex-CEOs, as well as lawyers and corporate governance experts.

Finding the right people and setting up co-ordinating arrangements can take time. However, once they are in place the demand on resources is usually manageable:

*"I'm head of corporate governance so it's part of my job to ensure the committees are covered. The other people that represent us (the investors) are actually the fund managers and the head of Swedish equity. It's part of their job to take one or two committees in which we are large owners because they place the bets. So it doesn't take a lot of resources for a company to do it. It's just part of the fund manager's job to be on the committee. If you get a very messy situation it will take a lot of time but usually it doesn't take that much resource." (Interviewee no. 9, institutional investor)*

The Swedish system does not require a formal evaluation of NCs but messages about a committee member's contribution can get back:

*"If you are in a committee and there is one person who is really not up to it that will typically be communicated in the system and it would also go back to the institution where he's coming from. ... There are good feedback loops on that that will take care of and sort out the problem. But these days, they show up every now and then but it's much less frequent than before. And this was really the key criticism of the system in the beginning that you had all these people with no experience and no knowledge." (Interviewee no. 4, investor)*

Part 5:  
Can shareholder-  
led nomination  
committees  
work in the UK?

***There is nothing to prevent any UK company from inviting shareholder representatives to participate in its existing nomination committee or even adopting a shareholder-led nomination committee. There remain a number of objections that need to be considered but each of these can be overcome.***

## UK objections to the Swedish system

Three arguments have commonly been used to defend the current UK nomination committee arrangements in preference to a model with greater shareholder engagement.

### **The chairman and non-executives have the knowledge and the shareholders do not**

*Some chairs and NEDs feel that they have a better sense of the needs of the company and dynamics of the board than shareholder representatives ever could.*

The first argument is that some chairs and NEDs feel that they have a better sense of the needs of the company and dynamics of the board than shareholder representatives ever could. They will, therefore, be able to make a better assessment of the skills and characteristics required.

Given the current extent of shareholder involvement, this is clearly true. But in Sweden the benefits – especially in terms of shareholder knowledge and understanding – have grown with time. The criterion for judging this change is not its effectiveness in the first year. By becoming involved in the NC process shareholders will gain the necessary experience over time by getting a better sense of the needs of a company and the dynamics of a board in a way that a family or private equity investor would regard as essential.

It is true that chairs and NEDs are closer to the board members, knowing them better and seeing them in action at close quarters. But it is precisely this closeness that becomes the issue, exposing boards to the risk of group-think, a lack of objectivity, an excessive sense of loyalty to established colleagues, and a tendency to recruit ‘people like them’:

*“Current obstacles to boardroom excellence include the lack of frequency, rigour and independence associated with the evaluation of boardroom performance – this can lead to complacency and insularity of thinking... Actors and sports stars are subject to well-established practices aimed at ensuring the very highest levels of achievement. They are chosen from a very competitive, rigorous and quite open selection process, involving detailed scrutiny of performance; frequent feedback throughout performance is the norm.” Stuart Tunstall, Lucid Associates<sup>20</sup>*

External assessment and challenge is essential to achieving the highest performance standards. The process needs a degree of informed detachment. Shareholder involvement can provide that detachment and, in the process, increase shareholder understanding.

The contribution of the shareholders on a nomination committee depends on the quality of people chosen for that role. Major institutions would need to devote the resources needed to hire experienced people, for example former board members, or people with a mix of investment and corporate experience. Sensitivity to people and performance issues is also important if NCs are to help the company and its chairman to do a more effective job in getting the existing board to perform well and to help recruit future talent.

The Swedish model gives the chair the opportunity to set out the details of the company's strategic position and of the board evaluation for scrutiny by the shareholders, who can then provide insights and challenges from their perspectives. The committee is also free to obtain views from the other directors on the dynamics within the board. The process means that the strategy and the board evaluation are tested from a variety of perspectives and so has the potential to be more resilient.

## The chairman is accountable

The second argument is that the chair of the board must be in charge of nominations if they are to be accountable for the performance of the people appointed to the board. A development of the argument is that the chair needs control so that they can ensure that the individuals on the board will work well together.

Discussions with chairs around this point have highlighted differences in perception between Sweden and the UK.

In Sweden the chair starts from the assumption that the nomination process is ultimately the territory of the shareholders through the mandate given by the AGM. The chair contributes to that process in order to ensure that there is the best possible board to work with.

The perspective of a UK chairman starts from their responsibility and authority as chair of the board. Nominations are seen as a function that comes under the remit of the board. The argument is looked at from the perspective of the board, with shareholders being seen as 'outsiders' to that process.

A chair ultimately derives authority from the shareholders. Why then should chairs feel compromised by having those shareholders to whom they are accountable shape or at least participate in the nominations process?

No chair can be wholly objective about relationships within the board while being a part of the board. The Swedish system helps the chair have a more objective perspective. Shareholder representatives can offer fresh perspectives. Rather than undermine the chair's position, the effective operation of a shareholder-led model could strengthen their authority by offering a much clearer picture of what major shareholders think and a much more effective channel for resolving differences with them. It could also make it less personally invidious for the chair to deal with necessary changes in the composition of the board; especially where they have known the board member in question for many years.

In the UK system, the senior independent director (SID) is an important channel of communication with investors, especially if part of the problem on the board is thought to concern the performance of the chairman. A SID might be invited to join the chairman on a shareholder-led NC. If not it would be sensible to ensure that the SID meets separately with the NC.

Thinking further ahead it would be interesting to speculate how much time companies might save on short-term investor relations activity if they knew through the operation of the nomination committee that they enjoyed widespread investor confidence in their strategy.

*A chair ultimately derives authority from the shareholders. Why then should chairs feel compromised by having those shareholders participate in the nominations process?*

## The structure of shareholdings

The third challenge to adopting the Swedish approach is the structure of shareholdings in the UK. Shareholding is more dispersed. Institutions running tracker funds could have relatively significant holdings, while institutions running nominee accounts could appear to be significant shareholders when their total interest is only the result of aggregating many smaller holdings.

## Tracker funds among widely dispersed holdings

Ownership concentration is higher in Sweden than in the UK. One study ascribes 46.9% of market capitalisation in Sweden to companies where one shareholder holds more than 20% of the voting shares, compared with 23.6% in the UK.<sup>21</sup> Moreover, one or two large institutions running index tracker funds, such as Legal & General and BlackRock (formerly Barclays Global Investors), are often one of the largest holders of a company's shares, with assets running into hundreds of billions of pounds.

Tracker funds are described as 'passive investors' because they follow the benchmark. Their business model is based on keeping costs to a minimum. But by the same token these funds tend to hold their stake the longest and the restrictions on their ability to sell a holding means they, and their clients, have greatest interest in improving the performance of companies and the system as a whole. These funds are among the largest funds in the UK and so their representatives could be on the NC for a majority of the listed companies in the UK. This could give them influence over most director nominations in the UK, but could also place a significant burden on the resources of a small number of these institutions.

In order to test this concern, we reviewed the most recently disclosed shareholdings for a random selection of 25 companies from the FTSE 100 – 17 of the 25 companies had disclosed holdings accounting for between 9.1% and 90.9% of a company's shares. As Table 2 overleaf shows, it is reasonable to expect that a nomination committee including the top five shareholders would represent more than 20% of the votes to be cast for over half of the companies in our sample.

In Sweden, there are examples where the NC only accounts for a small proportion of the votes to be cast at an AGM. In these cases, the NC sometimes decides to spend time in advance of the AGM discussing their recommendations with other shareholders. In the UK, it will be even more important to follow the Swedish example of collaboration between major investors so that each plays their part in representing the interests of all shareholders by sitting on NCs.

*In the UK, it will be even more important to follow the Swedish example of collaboration between major investors.*

**Table 2: Aggregate of disclosed shareholdings for a selection of FTSE100 companies<sup>22</sup>**

| Company               | No of disclosed holdings | Aggregate percentage of shares disclosed | Percentage of shares held by top 5 shareholders | Legal & General on nomination committee? | BlackRock/BGI on nomination committee? |
|-----------------------|--------------------------|--|---|--|--|
| Amec                  | 5                        | 21.49                                    | 21.49   | Yes                                      | Yes                                    |
| Cobham                | 5                        | 26.49                                    | 26.49   | Yes                                      | Yes                                    |
| Compass               | 3                        | 14.09                                    | NA  | Yes                                      | Yes                                    |
| Diageo                | 2                        | 9.11                                     | NA  | Yes                                      | Not known                              |
| G4S                   | 2                        | 15.88                                    | NA  | Yes                                      | Not known                              |
| Johnson Matthey       | 5                        | 30.57                                    | 30.57   | Yes                                      | Yes                                    |
| Liberty International | 8                        | 46.95                                    | 34.97   | No                                       | No                                     |
| Lonmin                | 8                        | 64.21                                    | 52.54   | No                                       | No                                     |
| Rentokil Initial      | 8                        | 49.96                                    | 38.87   | No                                       | No                                     |
| Rio Tinto             | 5                        | 29.37                                    | 29.37   | Yes                                      | Yes                                    |
| SAB Miller            | 6                        | 55.54                                    | 52.76   | Yes                                      | No                                     |
| Segro                 | 4                        | 17.15                                    | NA  | Yes                                      | Yes                                    |
| Thomas Cook           | 7                        | 90.88                                    | 83.54   | No                                       | Yes                                    |
| Unilever              | 3                        | 12%                                      | NA  | Yes                                      | Yes                                    |
| Vedanta               | 3                        | 63.31                                    | NA  | Not known                                | Yes                                    |
| Whitbread             | 5                        | 24.67                                    | NA  | Yes                                      | Yes                                    |
| Wm. Morrison          | 8                        | 40.4                                     | 29.2  | Yes                                      | No                                     |

The table also illustrates the potential impact of and on Legal & General and BlackRock. Legal & General held more than 3% of the shares of 15 of the 25 companies reviewed in the analysis above and could be on the NC for at least 12 of these companies if the top five shareholders were involved. Similarly, BlackRock had disclosed holdings in 10 of the sample companies and could be a NC member for at least these ten. Because of the scale of assets held by these institutions, any additional costs are likely to be small as a proportion of portfolios running into hundreds of billions sterling – a few basis points at most. Fifteen other institutional investors had disclosed holdings in our sample, but each institution’s group appeared no more than four times.

To make a shareholder-led NC work would require institutional investors in the UK to work together to become effectively engaged, indeed, far from dispersed holdings being a reason for not experimenting with such a system, this could be an argument in favour. The nomination committee could be the catalyst and the focal point that is needed to turn a vague and theoretical commitment to engagement into real and effective stewardship, company by company.

*Effective engagement is likely to need serious co-operation between investment funds.*

## The resourcing of engagement

The analysis of disclosed shareholdings illustrates the potential bias in resources required and suggests that effective engagement is likely to need serious co-operation between investment funds. There are several possible approaches that could be considered.

Index-tracking fund managers are the most likely shareholders to be involved in a nomination committee, yet minimising investment costs has been, so far, central to the business model and proposition of a tracker fund. This brings the resources issue into sharp focus. If the UK could find a way of stimulating and resourcing the active involvement of the major tracker funds in the nominations process, then as the analysis above demonstrates, the difficulty around dispersal could be overcome for a significant number of FTSE 100 companies.

All asset managers and beneficial owners face the difficulty that, in the marketplace as it is currently structured, there is felt to be too little reward for shareholder engagement. There are two potential solutions.

The first is that pension funds and other clients of fund managers start to specify engagement in the nomination committee process as part of the contract. This would require a co-ordinated push by pension funds. If enough customers demand a service, then suppliers will turn their efforts to delivering it at an acceptable price. Clients of all funds, including tracker funds, would specify the level of engagement they wanted from their fund managers and agree an explicit fee for these activities. This money would be used to support the stewardship activities of the fund, such as the involvement in board nomination processes. The fund manager would report regularly to its clients on these stewardship activities and their impact.

The resource issue will in the end have to be tackled. It would be better for the investment industry if the beneficial owners acted decisively together to insist on engagement. If pension funds and other beneficial owners prove unequal to this task, the second potential solution is for government and the regulator to intervene, following the logic that stewardship is a public good.

The state could, therefore, take the initiative needed to stimulate the major funds to change their business model to include an explicit stewardship function. It could do this through guidance on the fiduciary duty of pension funds and asset managers. But to kick-start the process some incentives may well be required – for example the suggestion of a levy on all funds with exemption for those who do make an investment in the necessary staff.

There are other policy suggestions for dealing with this problem that were described in the recent Tomorrow's Company publication '*Defining, Differentiating and Rewarding Stewardship*'.<sup>23</sup>

No one institution should be expected to have sufficient people with the right skills, experience and attitude to engage effectively with every company. There could also be conflicts of interest if a shareholder is on the NCs for several competitors in a sector. This is where a body such as the Institutional Shareholders Committee could give leadership. Such a body might place a restriction on the number of committees on which a shareholder is represented, or on the number of committees chaired by any one institution. It might also oversee arrangements for coordinating the nomination committee activities of a number of shareholders. In time it may be desirable for this to be the responsibility of a UK equivalent of the Council of Institutional Investors in the United States.

## Small shareholdings and nominee accounts

Nominee accounts raise a different issue. An asset manager may have a significant holding in a company through aggregating the interests of many independent beneficial entities. In this case, it may be necessary for the nominee company to identify the largest holding for an individual beneficial entity and – if the holding is large enough – for the beneficial entity to be represented on the committee.

In 2009, Bill Cash as UK back bench MP proposed a parliamentary motion that would create separate shareholder committees for representatives of smaller shareholders.<sup>24</sup> This move was a response to a feeling that large institutions did not have the same interests as smaller shareholders, and the latter needed a direct channel of representation. It was supported by the UK Shareholders Association (UKSA).

This is an attempt to address the issue of smaller shareholder engagement but in the process it drives a wedge between different groups of shareholders. One of the attractions of the shareholder-led NC is the requirement that members of the NC act in the interest not just of themselves but of all shareholders. If NCs (or any other shareholder-led committee) were established in the UK, it would be much better to experiment with the involvement of representatives of smaller shareholders, for example through a place on the NC, or failing that to give UKSA reasonable access to the chair of the nomination committee so that account is taken of its views.

## How shareholder participation in nomination committees might work in the UK

Shareholder participation, focused on the selection and nomination of non-executive directors (NEDs) could play a part in the improvement in the quality of governance and stewardship in the UK. The Swedish experience is a significant working example of a mechanism by which major shareholders can work together, and with the company's chair to exercise stewardship. This recognises that shareholders have a long-term interest in and responsibility for the performance of the board and through that the performance of the company. Within his report, Sir David Walker describes as follows the issues on which fund managers should focus:

*“Apart from major specific issues related to remuneration policies... and matters of principle such as appropriate safeguarding of pre-emption rights, the focus of fund managers in the monitoring part of their engagement initiative in normal circumstances, where there is no event or development to cause specific concern, should relate to:*

- *familiarisation with and assessment of the quality and capability of the leadership of the company, most prominently covering the chairman and CEO;*
- *satisfaction to the greatest extent possible that the board and its committees are appropriately composed and function effectively;*
- *understanding and broad endorsement of the company's principal strategies and objectives, including in particular the approach to remuneration and its risk appetite; and*
- *appraisal of the company's performance in delivering the agreed strategy and acting on this as required.”<sup>25</sup>*

*The Swedish experience recognises that shareholders have a long-term interest in and responsibility for the performance of the board.*

*A NC with shareholder representatives could provide the mechanism for such scrutiny and communication.*

Sir David's recommendations also included an expectation that there will be communication with major shareholders about the board evaluation and the process for identifying the skills and experience required to address and challenge adequately key risks and decisions that confront, or may confront, the board.<sup>26</sup> UK institutional investors still have to find a way of meeting these recommendations. A NC with shareholder representatives could provide the mechanism for such scrutiny and communication.

The Swedish model also has the potential to address a weakness in the UK system. Currently the directors choose who joins them on the board and set their remuneration. The Swedish system places these functions clearly in the hands of the shareholders, the principals who carry the greater financial risk.

The key elements of good practice observed in the Swedish system – reviewing company strategy, evaluating board performance, developing a profile and search process driven by a gap analysis – should be familiar to NC members and other directors in the UK. The annual review process of evaluation, nomination and election adopted in Sweden increases individual accountability and places greater pressure on the directors to meet performance expectations.

An annual election cycle is only employed by a minority of UK companies at present, but the Swedish experience echoes comments made by the Financial Reporting Council (FRC) that moving to the annual re-election of directors has not encouraged short-termism or generated other destabilising effects.<sup>27</sup> In the Swedish system the shareholders involved in the nomination process have, for the most part, been looking at the board required for the longer-term.

In Sweden shareholders are perceived as the real authority in the company, with the ultimate responsibility for its performance. This contrasts with the UK system, where the approach of major shareholders is to see shares less as a share in the ownership of a living company and more as the constituents of a share portfolio. It is sometimes described as the difference between asset ownership and asset allocation. Most shareholders have preferred to keep themselves at a distance from companies and to preserve their freedom to trade the shares they own.

Sweden may be different from the UK, but it is not as different as has sometimes been imagined by outside commentators. At the time when NCs were first introduced in Sweden, the country's system was facing many of the same problems of shareholder inaction that are currently being discussed in the UK.

Experience from Sweden suggests that a mechanism such as a shareholder-led NC can offer a bridge to connect institutions which want to exercise stewardship in a more constructive way with the chairman and boards of the companies whose shares they own.

The system also has the potential to improve the willingness of pension funds and asset managers to engage in the first place, because it makes much more obvious to the outside world who is and who is not exercising stewardship. Pension funds and other beneficial owners can, if they choose, specify in their mandates the part that they want their asset managers to play in this process, and begin to hold them accountable.

# Part 6: Conclusions and recommendations:

An agenda for the UK

*The experience from Sweden is that active shareholder engagement in NCs has increased confidence in the board.*

The financial crisis has brought into stark reality the need for effective challenge in the boardroom, and for the effective exercise of stewardship by boards and major shareholders.

In the aftermath of two major policy reviews there is now widespread acceptance that there has been a failure of stewardship, and a search for practical solutions.

Having explored the model of nomination committees in Sweden, we believe that the pro-active involvement of major shareholders is one important way – albeit not the only way – in which stewardship and board performance in the UK could be strengthened.

The innovation at the heart of the Swedish system of NCs was originally stimulated by the 1992 report by Sir Adrian Cadbury.

The experience from Sweden is that active shareholder engagement in NCs has increased confidence in the board and increased the expectation that the agents will look to further the interests of the principals. The increase in transparency has also improved trust between shareholders and provided a mechanism for shareholders to demonstrate that they are being good stewards of their investments.

Suitably adapted, shareholder-led nomination committees could therefore play a part in the improvement of the quality of governance and stewardship in the UK.

The key to the success of the NC process in Sweden is the willingness of the institutional owners to participate, and the availability of suitably qualified and experienced people to represent shareholders on NCs.

The key benefit to them is that they can influence board composition in a thoughtful way and so improve the accountability of the directors to the shareholders. The arrangement gives directors a renewed mandate each year from shareholders whose participation therefore becomes proactive rather than reactive.

An additional benefit is that the process brings different investors together and stimulates them to think harder about pursuing the interests of all shareholders and to collaborate to this end.

The Swedish system evolved in stages and it would be consistent with UK governance traditions to begin with company experimentation. Appropriate criteria should be devised for the evaluation of the experiments. The criteria should be derived from the observable benefits of the Swedish approach, and based on the Walker recommendations of the areas in which shareholders should be involved:

1. have these innovations improved the composition, quality and performance of the board in general and NEDs in particular?
2. have they enhanced shareholder engagement, in particular in contributing to:
  - the assessment of quality and capability of the leadership of the company?
  - the effective functioning of the board and its committees?
  - shareholder understanding and endorsement of the company's strategy and objectives?
  - shareholder appraisal of the board's performance in delivering the agreed strategy?
3. have they enhanced transparency through the investment chain, giving beneficial owners more confidence that asset managers are exercising appropriate stewardship on their behalf?
4. have they enhanced collaboration between different shareholders, making the shareholder body more effective in holding boards to account?

Any listed company today can, if it chooses, invite its largest shareholders to help it form a nomination committee and report these arrangements under the current 'comply or explain' system. Businesses and investors often say that we should keep the regulator out of areas that are best served by market innovation and business leadership. Here is a perfect opportunity for such innovation. The current reviews have clearly established that the status quo is not an option. If shareholder participation in the nominations committee is not the answer, then institutional investors need to say what better route they propose in order to deal with the current stewardship deficit.

# Agenda for action for the UK

## For listed companies

1. **To take the initiative to include shareholders on the board nomination committee, possibly to the point of forming a shareholder-led nomination committee, on which the Chairman and perhaps the Senior Independent Director (SID) would sit.** The benefit of this change is that it would create a systematic involvement for major shareholders in the process of nominating board members.

## For institutional investors

2. **Fund managers to recruit, train and support suitably qualified people to sit on nomination committees as their representatives.** This cadre may be drawn not only from current fund managers and governance specialists, but also from former chairmen or directors of listed companies, those with experience of board membership of listed or private companies and others with relevant experience from for example the accounting, legal and investment banking professions.
3. **Over time, a body such as the Institutional Shareholders Committee to facilitate and promote the use of nomination committees as a beneficial innovation in terms of encouraging stewardship.** The benefit of this intervention would be to overcome some of the resourcing obstacles which discourage such engagement at present. Initiatives could include:
  - taking a lead in promoting experiments, using common criteria for evaluation and stimulating the exchange of good practice; and
  - promoting co-ordination between major institutions to encourage burden-sharing, involving major international investors including sovereign wealth funds.

## For pension funds

4. **Re-examine their contracts with index and other fund managers. As clients they have the opportunity to specify the level of active engagement by these funds in the nomination process.** The benefit of this recommendation, especially if applied collectively, is that it would create momentum for and innovation in stewardship by making engagement by index and other fund managers a client requirement.
5. **Pool their efforts through National Association of Pension Funds (NAPF) or other bodies to ensure that fund managers are more effective in participating in the nomination committee experiments.** This will help create a systematic involvement behind governance innovation.

## For policy makers and standard setters

6. **The Financial Reporting Council (FRC) to promote the annual re-election of boards and chairmen as suggested in the recent review of the Combined Code, but link the annual re-election with the recommendation that boards engage major shareholders in the nomination process.** The benefit of this change of emphasis is that annual re-election is no longer seen as a shortening of time horizon, but is seen as a way of making director evaluation and re-election part of a systematic process of review and continuous improvement.

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**Mark Goyder**  
Founder Director  
Tomorrow's Company

# Appendix

Differences between the UK and Swedish systems of nominating directors

| Corporate Governance system           | Sweden   | UK  |
|---------------------------------------|--|---|
| Purpose of Corporate Governance Code  | <p>The main aim of the Swedish Code of Corporate Governance is to improve confidence in Swedish listed companies by promoting positive development of corporate governance in these companies. Another aim of the code is to provide an alternative to legislation (Code document, p5).</p> <p>Guiding principles for the code are that it:</p> <ul style="list-style-type: none"> <li>• Creates good conditions for active and responsible ownership;</li> <li>• Establishes a clear and well-balanced division of the roles and responsibilities between owners, boards and executive management;</li> <li>• Ensures that the principle of equal treatment outlined in the Swedish Companies Act is applied in practice;</li> <li>• Creates a maximum of transparency towards shareholders, the capital markets and society in general.</li> </ul> | <p>The Combined Code on Corporate Governance is published by the FRC to support these outcomes:</p> <ul style="list-style-type: none"> <li>• Contributing to better company performance by helping a board discharge its duties in the best interests of shareholders;</li> <li>• Facilitating efficient, effective and entrepreneurial management that can deliver shareholder value over the longer-term; and</li> <li>• Promoting confidence in corporate reporting and governance.</li> </ul> |
| Typical ownership structure           | Many companies have major shareholders, so that top 4 or 5 shareholders can account for more than 20% votes.   | Dispersed shareholding is the norm, with each company having few holdings above the 3% mandatory disclosure limit.  |
| Understanding of role of shareholders | Top of a hierarchy; owners; need to take responsibility.   | Capital allocators; companies as suppliers of returns.  |

| How the nomination committee (NC) operates | Sweden  | UK  |
|--|---|---|
| Origins                                    | Cross shareholdings unwound during early 1990s. Informal arrangements established, often led by dominant shareholders. Some concerns of old boys club. SSA* lobbied for a more transparent process, drawing on Cadbury Report provisions.   | Cadbury Report included provisions for the establishment of a nominations committee, under a principle that there should be a formal and transparent procedure for the appointment of new directors to the board. |
| Responsibilities under CG Code/law         | <i>The sole task of the nomination committee is to propose decisions to the shareholders' meeting on electoral and remuneration issues and, where applicable, procedural issues for the appointment of the following year's nomination committee. Regardless of how they are appointed, members of the nomination committee are to promote the interests of all shareholders.</i> | Lead the process for board appointments and make recommendations.   |
| Recommendations made to                    | AGM   | Board   |
| Composition                                | Committee of major shareholders, usually 4 or 5, plus company chair. In some cases a representative of smaller shareholders is included.<br><br>Majority of members to be independent of the company and its executive management.<br><br>Members of the board of directors may not constitute a majority of the committee.   | Majority of the members should be independent non-executive directors.  |
| Committee chaired by                       | A representative of one of the major shareholders, usually the one with the largest holding.  | The chairman of the board unless dealing with the appointment of a successor or an independent non-executive director.  |
| Public information                         | Details of the members of the committee are announced six months before the AGM. How to contact them is publicised through the company website.<br><br>The chairman of the committee makes a formal report to the AGM.  | Terms of reference should be made available.<br><br>Separate section of the annual report should describe the work of the committee. The members of the committee should be identified in the annual report.      |

\*SSA: Swedish Shareholders' Association

| How the nomination committee (NC) operates     | Sweden   | UK   |
|--|--|--|
| Types of shareholder involved                  | <ul style="list-style-type: none"> <li>• Family owners</li> <li>• Swedish institutions have got involved over time</li> <li>• A few foreign institutions</li> </ul>  | None   |
| Process for determining participation in an NC | <p>Decided at AGM; either</p> <ul style="list-style-type: none"> <li>• shareholders specified at AGM; or</li> <li>• process for determining later in year</li> </ul> <p>Variations are possible; e.g. the inclusion of additional members.</p>                         | Not specified  |
| Shareholder democracy                          | <p>Formal mechanisms for all shareholders to provide input.</p> <p>Formal, explicit responsibility to all shareholders.</p> <p>Report and recommendations to the AGM.</p>  | Shareholders vote on election to board at first AGM after appointment and on re-election at intervals of no more than three years.   |
| Process (headline)                             | <p>Understand strategy and challenges.</p> <p>Board evaluation.</p> <p>Gap analysis to generate profile.</p> <p>Search process.</p>  | <p>Evaluate the balance of skills, knowledge and experience on the board.</p> <p>In the light of the evaluation, prepare a description of the role and capabilities required for a particular appointment.</p> <p>Explanation to be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or non-executive director.</p> |
| Board evaluation                               | <p>The board of directors is to evaluate its work annually, using a systematic and structured process, with the aim of developing the board's working methods and efficiency. The results of this evaluation are to be made available to the nomination committee.</p> | <p>The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.</p> <p>Proposed requirement that evaluation of the board should be externally facilitated at least every three years.</p>  |

# Sources and notes

- <sup>1</sup> Tomorrow's Company. *RSA Inquiry Tomorrow's Company: the role of business in a changing world*. RSA. London, 1995.
- <sup>2</sup> Ibid.
- <sup>3</sup> Ibid.
- <sup>4</sup> Tomorrow's Company. *Tomorrow's Innovation, Risk and Governance*. Tomorrow's Company. London, 2009.
- <sup>5</sup> Tomorrow's Company. *Restoring Trust: Investment in the twenty-first century*. Tomorrow's Company. London, 2004.
- <sup>6</sup> Tomorrow's Company. *Tomorrow's Owners: Defining, differentiating and rewarding stewardship*. Tomorrow's Company. London, 2009.
- <sup>7</sup> Tomorrow's Company. *Tomorrow's Innovation, Risk and Governance*. Tomorrow's Company. London, 2009.
- <sup>8</sup> This analysis draws on the findings of the Financial Reporting Council, *2009 Review of the Combined Code: Final Report*, December 2009; Sir David Walker, *A review of the corporate governance in UK banks and other financial industry entities*, November 2009; and JCA Group, *Corporate Governance and the Effectiveness of Shareholder Engagement*, July 2009.
- <sup>9</sup> Data on shareholding by class of shareholder since 1983 is available from Statistics Sweden, [http://www.scb.se/Pages/Product\\_6459.aspx](http://www.scb.se/Pages/Product_6459.aspx), accessed January 2010.
- <sup>10</sup> Source: Statistics Sweden, "Households' share portfolios rose in value", 26 August 2009.
- <sup>11</sup> FESE (2008), *Share Ownership Structures in Europe*. Available from <http://www.fese.eu/en/?inc=art&id=8>, accessed March 2010.
- <sup>12</sup> The Swedish Corporate Governance Board (2008), *The Swedish Code of Corporate Governance*, p6.
- <sup>13</sup> The nomination committee has no involvement in the selection of the employee representative directors. However, once appointed, the employee representatives have the same duties and responsibilities as directors appointed by the shareholders' meeting; i.e. to serve the best interests of the company as a whole.
- <sup>14</sup> In 1990, the ownership of 17 of the 25 largest industrial firms in Sweden included a shareholder who appointed the CEO and was active on the company's board. (Source: Jan Glete, 1994, *Nätverk i näringslivet: Agande och industriell omvandling i det mogna industri-samhället 1920-1990 [Corporate networks: Ownership and industrial restructuring in the mature industrial society]*, SNS Förlag, Stockholm, cited in Peter Högfeldt, *The History and Politics of Corporate Ownership in Sweden* in Randall K.Morck (Ed.), 2007, *A History of Corporate Governance around the World*, National Bureau of Economic Research, Chicago).
- <sup>15</sup> Per Lekvall, 2009, *The Swedish Corporate Governance Model* in *The Handbook of International Corporate Governance*, Institute of Directors, London, p372.
- <sup>16</sup> The Report of the Committee on the Financial Aspects of Corporate Governance, December 1992, paragraph 4.15.
- <sup>17</sup> The Swedish Corporate Governance Board, *The Swedish Code of Corporate Governance*, Rule 2, applicable from 1 February 2010.
- <sup>18</sup> *Tomorrow's Company interview*.
- <sup>19</sup> Sources: Tomorrow's Company interviews; Nomination Committee reports from TeliaSonera website, [http://www.teliasonera.com/about\\_teliasonera/corporate\\_governance/nomination\\_committee](http://www.teliasonera.com/about_teliasonera/corporate_governance/nomination_committee) (accessed January 2010).
- <sup>20</sup> Same as no. 6. p45.
- <sup>21</sup> Peter A. Gourevitch and James Shinn 2005, *Political Power and Corporate Control – The New Global Politics of Corporate Governance*, Princeton University Press, Oxford pp 16-18.
- <sup>22</sup> Data collated in December 2009 and based on the most recent annual report or website disclosure by each company. The companies without any disclosed shareholders were Antofagasta, BAE Systems, Barclays, Bunzl, International Power, Marks & Spencer, Rexam and RSA.
- <sup>23</sup> Tomorrow's Company. *Tomorrow's Owners: Defining, differentiating and rewarding stewardship*. Tomorrow's Company. London, 2009.
- <sup>24</sup> The Protection of Shareholders Bill was a Private Member's bill presented to Parliament on 17 March 2009. The Bill did not make further progress. For details, see <http://services.parliament.uk/bills/2008-09/protectionofshareholders.html> (accessed March 2010).
- <sup>25</sup> Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities*, November 2009, paragraph 5.30.
- <sup>26</sup> *ibid*, Recommendation 13.
- <sup>27</sup> Financial Reporting Council, *2009 Review of the Combined Code: Final Report*, paragraph 3.26.

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*“I greatly enjoyed reading this excellent report on the potential relevance of Swedish experience.*

*While I believe that the recommendations in my own report point us in the right direction, there is much more to be done in the UK on shareholder engagement and stewardship and this work on the Swedish model is a very interesting example for further exploration.”*

**Sir David Walker**, Chairman, Review of Corporate Governance of UK banks and other financial institutions

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*“This report does an excellent job of describing how the Swedish approach works and how it might be introduced in the UK. I believe it will provoke a productive debate on how shareholder stewardship can make a real difference to corporate governance.”*

**Paul Strebel**, Sandoz Family Foundation Professor and Director High Performance Boards Program IMD

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*“I was intrigued to read this study of the Swedish system, and its implications for our own drive to improve stewardship by investors in the UK. There are many questions about the practicalities but they need serious thought and this report will stimulate just the practical discussion that we now need.”*

**Lindsay Tomlinson**, Chairman, NAPF



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Tomorrow's Company has published numerous influential reports that have informed and continue to help shape the actions of companies and governments in the UK and beyond.

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