



Address to the ICGN Mid-Year Conference
at the Guildhall, 25th March 2010

1. I want to share with you this afternoon the main points I made in a paper to the FRC Board a few weeks ago regarding the so-called “Stewardship Code”.
2. Both David Walker in his review of the corporate governance of banks and other financial entities and the FRC in its review of the Combined Code agreed that there was a strong and clear need to make engagement between Boards and their companies’ shareholders more effective. The Government also agreed and last November asked the FRC to accept responsibility for a Stewardship Code. We took on this new responsibility, subject to ensuring that such a code can be operated effectively. On 19th January we put out a consultation paper, responses to which we requested by 16th April.
3. I believe this is a project which the FRC has to undertake for a variety of strong reasons. I recognise that it is a considerable challenge, not to be underestimated in terms of difficulty and reputational risk.
4. I want today to outline some key points underlying the FRC’s decision. First, to define engagement; secondly, to comment on the FRC’s position vis à vis investors and the Combined Code; thirdly, to reflect on the investors’ position vis à vis engagement; fourthly, to consider the Combined Code as the basis for engagement; fifthly, to look at engagement from the point of view of corporates subject to the Combined Code; and finally to say something about the FRC’s preparedness for the task of launching and overseeing a Stewardship Code.



Engagement

5. The word “engagement” has become a jargon word in the corporate governance world. To me it means purposeful communication of views between quoted companies on the one hand and investors on the other. It describes two types of current communication. First, a dialogue (at least annual) between a company’s executive management (typically the CEO and the CFO) and shareholders, actual or potential, about strategic matters and short-term financial results. Secondly, exchanges of view on matters of corporate governance between shareholders and one or more non-executive directors (NEDs). These will be ad hoc and at irregular intervals, and possibly non-existent with some smaller companies. “Corporate governance”, by the way, may be defined as what boards exercise. It may be seen as a sort of higher form of management, even though it involves the non-executive directors.

6. Bear in mind two points with regard to engagement. First, that some part of making engagement more effective can and should be achieved by increasing the overlap between the two types. Secondly, that engagement is a fluid concept which the FRC approaches with no fixed notions about process or content or frequency. We are only interested in communication between boards and shareholders which serves better the needs of both sides.



The FRC and institutional investors and the Corporate Governance Code

7. Investors are one of the FRC's three key stakeholder constituencies, the others being the professions (accounting and actuarial) and corporates. In particular, investors play a vital role in relation to the "comply or explain" approach which underpins UK corporate governance through the Combined Code.

8. The FRC is reasonably well placed to conduct an orchestra to bring about more effective engagement between corporates and their shareholders. However, it currently has neither the power nor the resources to take charge of anything but the leadership and co-ordination of the overall effort. Even that will require the proactive co-operation of the FSA, the UK government through the Treasury and the Department for Business, Innovation and Skills, possibly the European Commission, and those parts of the global asset management industry which invest in publicly-quoted UK companies. These parts are represented in the UK by the Investment Management Association (IMA), the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF) and the Association of Investment Companies (AIC). The FRC has close links with all of these in connection with its Combined Code on Corporate Governance. We also have many constructive and valuable relationships with individual large investors, based overseas as well as in the UK, whose comments and guidance we much value on an ongoing basis.



9. The four investor representative associations named above have acted together under the banner of the Institutional Shareholders Committee (ISC), which published in June 2009 a paper on improving institutional investors' role in governance, and subsequently in November 2009 a Code on the Responsibilities of Institutional Investors (the ISC Code).
10. The FRC, having regard to its leadership role in improving engagement but also to its limited powers and resources, made a clear decision last year to build on the work carried out by the investment industry itself through the ISC. The current FRC consultation therefore asks first and foremost whether the ISC Code provides a suitable basis for the proposed Stewardship Code.
11. In the years since the Cadbury Committee Code was published in 1992 a great deal has been achieved in corporate governance. However, the monitoring of corporates by their shareholders is being profoundly affected by some major trends in the investment industry:
 - Increasing internationalisation of shareholdings in UK equities – i.e. UK-based investors own a declining proportion of UK-based businesses and overseas-based investors own more.
 - Decreasing ownership of UK equities by UK-based “long only” shareholders (e.g. pension funds and insurance companies). In two decades their ownership has roughly halved – from 50% to 25%.
 - Increasing competitiveness in the asset management industry coupled with portfolio diversification, both factors making engagement more burdensome in terms of time and cost.



- Intense short-termism, which may be justifiable in terms of success in the asset management industry, but which can be profoundly upsetting to those who are responsible for the long-term success of companies.
12. The FRC is acutely aware of the impact of these trends, which has been indicated by many consultations in recent years and brought to a head by the financial crisis. The study of investor, company and adviser perspectives, which the JCA Group conducted at the FRC's instigation and published last May, is a vivid and helpful commentary on an unstable and unsatisfactory engagement situation. There is scope and time for the FRC to remedy this. But success in doing so cannot be taken for granted, will take years, not months, and will require changed attitudes, practices and policies on both sides of the engagement process.
 13. It is axiomatic that the FRC in its leadership role must be even-handed as between corporates and investors (both UK and foreign) and must not be distracted from whatever is required to promote more effective engagement. We recognise at this stage our insufficiently detailed knowledge of important fundamentals which underlie the approaches to engagement by corporates and shareholders, particularly those of shareholders, given the many parties often involved in the engagement chain and their differing interests.



Engagement and Investors

14. From an engagement point of view, private equity is one thing; public equity is quite another. In the private equity model it is possible to achieve, through a board, substantial agreement on strategy by shareholders and management and powerful financial incentives geared to a common time horizon. In publicly-quoted companies it is an entirely different matter as a result of the distancing between shareholders, directors and management; and also the chain between ultimate beneficiaries and those who actually buy the shares on their behalf.

15. Shares traded in public markets entitle their beneficiaries to votes and dividends but have no liabilities attached beyond losing the value of the share itself. Those who hold all the shares in a company own the company but are not compelled to exercise any of the privileges of ownership and few shareholders (myself included) do so as individuals. However, when shares on behalf of many individuals are aggregated by insurance companies, pension funds, etc. (i.e. “institutional investors”), their combined voting power can be significant enough to influence companies. Why should institutional investors use this power? Because it constitutes an important perspective for companies and investors to absorb with regard to such governance matters as the quality of the board, the hiring, firing and remuneration of directors, major acquisitions or disposals, credibility of strategy, and compliance with the Combined Code. The impact of this perspective, properly absorbed by those with a strong vested interest in company success, ought undoubtedly to be beneficial on balance. Therefore, institutional investors have for many years now been urged to shoulder the responsibility to behave as owners and apply the discipline conscientiously.



16. There is, however, a major problem: to do the job properly requires serious effort and material cost which means that those who take up these burdens are at a disadvantage to the “free riders” who don’t. Naturally this gives rise to all sorts of excuses, evasions and enmities which cause friction between investors. The two most prevalent arguments put forward by investors are that “ownership” implies unbroken engagement and this is at odds with their freedom to sell and walk away; and that their duty is to the beneficiary who, they imply, should not be made to bear the extra costs involved in demonstrating ownership by engagement. Both these arguments have enough validity to be seductive but not, I believe, enough to let institutional investors off the engagement hook.

17. A crucial part of the public equity model is participation in a market which, through continued buying and selling, gives constantly accessible value to the shareholder. The consequence of this is fluidity of company ownership and different time horizons between those managing portfolios of shares for value, who should not be constrained from selling shares and walking away, and those managing the businesses owned by the shares. It is also the case that the time horizon for the ultimate beneficiary (think pensions) can be based on entirely different considerations from those exercised by the professional investors driving for performance. This uncoupling of time horizons is an inevitable feature of the public equity model but its associated impact is not always recognised, which gives rise to charges of “short-termism” made against investors, often with considerable feeling. The buying and selling of shares in equity markets is based on the need for liquidity and/or confidence in better information. If the better information is based entirely on mathematical modelling, there is hardly a motive for engaging; but if it is habitually based on



confidence in better information from analysis and experience about the value of a company, then the fund manager has a case to answer if he is avoiding engagement altogether, but not if he participates and then sells because in his judgement the engagement is not adding value.

18. The argument that the cost of engagement is not in the best interests of the ultimate beneficiary must be tested against the facts and we should not take too readily the fund manager's word for it. There are different parties and interests along the chain between the beneficiary and the fund manager. I am hoping that one of the results of the FRC taking responsibility for the Stewardship Code will be to get a bright light shone on the detailed underpinnings of investment management and that we may thereby see ways of making engagement more effective.

Engagement based on the Combined Code

19. Is the Combined Code an effective enough guide to good practice to justify the weight placed on it by engagement? The FRC's overriding objective is to promote the long term success of companies based on compliance with the spirit of the Combined Code. It is very difficult to prove that following the Code is better than not doing so. But the proposition has been overwhelmingly accepted by almost all respondents to successive consultations, as well as being widely flattered by imitation overseas. We regard active engagement by shareholders representing a substantial part of the share capital (it doesn't have to be a majority) as crucial in supporting the Combined Code via the "comply or explain" approach. So the case for the FRC promoting the Stewardship Code is very strong indeed provided we are satisfied that it will enhance over time the effectiveness of engagement.



Engagement and the Corporates

20. The Corporates have mixed feelings about engagement for various reasons. The messages from shareholders are not always palatable: for corporates, too, engagement can be time consuming and distracting; investors can sometimes appear disconnected as between their corporate governance and fund management aims; and “box-ticking” is as infuriating to corporates as boilerplate is to investors.

21. However, the main reasons for corporates to engage with shareholders are clear and strong: first, the market is the supplier of capital; and, secondly, the share price has to be tended as the barometer of a company’s health and, on occasion, of its independence. There may in addition be supplementary value to be obtained from a wise and engaged shareholder perspective, as there was even in the days before the first corporate governance code. It is interesting how many companies, particularly in the FTSE 100, acknowledge this.

22. Changes in corporate practices should help secure more effective engagement. I am thinking of such things as Chairs attending at least some of the CEO/CFO meetings with investors; Chairs keeping the whole board properly informed about investors’ views; and Chairs personally satisfying themselves that their companies’ governance has been well communicated to shareholders. I do not take acceptance of such changes for granted, but they will, I believe, be less fundamentally difficult to achieve than those confronting investors.



The FRC's preparedness

23. The FRC organisationally has a powerful focus on corporate governance. We have a very strong and widely representative committee of the FRC Board which supervises all the FRC's corporate governance work. Its members between them have a lot of direct experience including in investment management. And Stephen Haddrill, the FRC's Chief Executive, came to us after four years managing the ABI. There may arise a need for even more time, weight and support from senior non-executive outsiders. I believe that the FRC's flexibility and organisation now enable it to cope with this need, if and when the time comes.

24. In general terms we are unsighted at this stage about the quantum and nature of work that responsibility for the Stewardship Code will involve. I hope that feedback from the consultation will give us a much better handle on this, including a sense of the inertia and/or hostility we are likely to encounter and also a better idea of the role the FSA will assume when they and we can best judge our separate appropriate functions.

25. My aim this afternoon has been to give you as clear a picture as I can at this stage of the issues relating to the evolving Stewardship Code, which incidentally will be the first of its kind in the world. I very much hope that over time it will become an indispensable adjunct to the Combined Code and one of which we can all be proud. Interest and support from all those overseas who are placed to contribute in one way or another will be warmly welcomed, as was this opportunity today to talk to such a widely representative audience. Thank you.

Chris Hogg