



ICSA CORPORATE GOVERNANCE CONFERENCE,  
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**KEYNOTE ADDRESS BY STEPHEN HADDRILL:  
LESSONS FROM A CRISIS**

- *Was there a governance crisis?*
- *Lessons for companies – Code changes etc*
- *Lessons for investors – Stewardship Code etc*
- *The international scene*

Was there a governance crisis?

- Clearly there have been governance failings, particularly in the financial sector. But these have not proved to be as widespread as might have been feared in the early stages of the crisis.
- Both the FRC and Walker reviews concluded that, while the regulatory framework for corporate governance needed strengthening, it was not fundamentally broken. Both considered that the Combined Code and ‘comply or explain’ should remain a cornerstone of that framework.

As Walker said: “Combined with tougher capital and liquidity requirements and a tougher regulatory stance on the part of the FSA, the “comply or explain” approach to guidance and provisions under the



Combined Code provides the surest route to better corporate governance practice.

- In addition the FRC concluded that, while some of the weaknesses in governance identified by Walker were also relevant to non-financial companies, the same was not necessarily the case for all of the remedies he proposed. We have only adopted those recommendations we consider apply to all listed companies.
- Both reviews concluded that the key to improvement was more considered application of the existing principles of good governance. The emphasis is on the need for behavioural change and a long-term focus by both boards and investors. Not more process.

Again let me quote from David Walker, "The principal deficiencies in BOFI boards related much more to patterns of behaviour than to organisation. The most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues."

- Critics of the flexible UK approach may consider this complacent. I reject such suggestions. No code or regulation can ever be an adequate



substitute for an effective board. We have to entrench governance in the spirit of the boardroom, not in compliance with rules.

- I would even argue that, for some companies and some investors, compliance with the Code provided false comfort that governance was adequate. And this is very damaging if it discourages boards from thinking about governance in the context of the particular challenges facing their company. Compliance with the Code is not a substitute for proper leadership by the board or proper scrutiny by shareholders.
- Hence the focus on behaviours and the proposals we have made to change the Code to highlight the responsibilities of both boards and investors, and encourage them to step up to the mark.

#### Lessons for companies

- We expect to announce our final decisions on these proposals and publish the revised Code during May. I don't want to pre-empt that announcement today. Consultation closed just over a week ago and we have received well over 100 responses. These are supportive of most of the proposals but still raise many points that need further consideration. So whilst I will set out our proposals in the next few minutes, my remarks



should not be taken as suggesting what the FRC will decide about the responses it has received.

- Building on what I said about not treating compliance as a goal in itself, the first set of changes we are proposing are intended to reassert the primacy of the Code's principles. These are the tenets of good governance and are not subject to comply or explain. The expectation is that they will be applied, the flexibility lies in how that is done.
- We are proposing a number of new principles to highlight issues already addressed by the Code but without the prominence they deserve. These include principles on the role of the non-executive directors and the chairman. The chairman's role is probably the single most important in delivering good governance. Without his or her leadership it is an uphill struggle to put in place the right corporate culture.
- We are also proposing to amend the principle dealing with the balance of the board and selection of non-executive directors. The perception has developed in some quarters that the Code considers independence to be the over-riding criterion in selecting non-executives. That is not the case. It is clearly very important, but so is ensuring there is a proper balance between sufficient knowledge of the company and the sector and openness to diverse views and wider experience. Most importantly, the



composition of the board must be driven by the needs of the company. Hopefully the revised principle makes this clearer.

- Some respondents to earlier consultations expressed the view that it would be helpful to have some non-binding guidance on board composition, roles and development to help them when considering these issues for themselves. This is already provided to some extent by the Higgs guidance, and I am very grateful to ICSA for agreeing to lead on the FRC's behalf an exercise to update the guidance where necessary.
- The final new principle I would like to mention relates to the board's responsibility for risk. With hindsight this was a notable omission from the Code. When Chris Hogg met FTSE chairmen last year it was the issue that came up most frequently in response to the question "what is your board devoting more time to now?". While we have had comments on the proposed terminology - which we will need to look at - in general there appears to be strong support for the new principle. In addition we will be carrying out a limited review of the Turnbull guidance later in the year.
- Moving on to the 'comply or explain' part of the Code, we are also here proposing a small number of new provisions. The majority of these pick up Walker recommendations and address the need to ensure the board is fit for purpose. They include provisions on board evaluation and director



development, both of which will be discussed in more detail later this morning.

- The proposals that have attracted most comment are those relating to the frequency of director re-election. We asked for comments on two options: annual re-election of the chairman, or annual re-election of the board as a whole. Views are divided, as you might expect. Some respondents are concerned that annual elections would encourage short-termism on the part of the board or the shareholders and would risk destabilising the board. Others consider that these concerns are over-stated – pointing out that as on average directors currently receive over 95% support it would take a major change in investor behaviour to bring them about – and that more frequent elections would increase accountability.
- The other main message for companies coming out of our review is the need to improve the way they communicate on governance. This is particularly important when they choose to explain rather than comply with the Code’s provisions. While not ignoring the issue of box-ticking on the part of some investors and voting services, companies do not always help themselves. Reading some reports you would be hard pressed to work out the reason why companies have chosen to deviate from the Code, and in those cases you cannot really blame investors if they are not



inclined to give companies the benefit of the doubt. If you have a good story to tell, tell it.

- But communication goes beyond just explanations. We highlighted in our reports on the Code and the Business Review (“Rising to the Challenge”) late last year the curse of boiler-plate reporting. The FRC believes that clear, company-specific reporting can increase investors’ confidence in the way the company is run and help it stand out from its competitors. Initiatives such as the ICSA/ Hermes Transparency in Governance Awards are raising awareness of this issue as well.
- As with all aspects of governance, good communication is an area where the chairman can and should set the tone. That is why we are encouraging chairmen to make a personal statement in the annual report on the steps they are taking to apply the Code’s principles on leadership and board effectiveness.
- We also recognise that companies are handicapped to some extent by the various reporting requirements imposed on them, and regulators and standard-setters – including the FRC – must take some responsibility for reducing the clutter in annual reports. This is something Bill Knight will pick up later.



## Lessons for investors

- The other limb of communication is engagement. There is not much value in excellent explanation if investors are not listening. There are serious issues about both the quality and quantity of engagement between companies and shareholders, which need to be addressed if the 'comply or explain' approach is to be sustainable.
- The company secretaries among you probably do not need me to recount all the frustrations that are reported to the FRC about how engagement works in practice – the concerns about box-ticking, the difficulty of getting investors to take an interest except in times of difficulty or on the subject of remuneration, and so on. These real problems do need to be addressed, while recognising the constraints that investors are operating under. These issues will no doubt get an airing this afternoon at the session with Alan McDougall of PIRC and Sarah Wilson at Manifest.
- But the quantity of engagement is at least as important. Without a sufficient number of long-term shareholders actively engaging with the companies in which they invest, 'comply or explain' will be seen as ineffectual, the influence of short-term traders over the company's strategy will increase, and we run the risk of regulation.



- Traditionally we have relied on UK pension funds and insurance companies to make ‘comply or explain’ work. But there have been significant changes in the shareholder base in the twenty years since the Cadbury Code with traditional shareholders reducing the percentage of their portfolio held in UK equities and an influx of new players. As a result pension funds and insurance companies now own only 25% of the market, and not all of them are active.
- The desire to see greater engagement by long-term shareholders led Sir David Walker to propose a Stewardship Code for institutional investors to mirror the Code for listed companies. The Government has asked the FRC to take ownership of this code, and we are currently consulting on whether the code developed by the Institutional Shareholders Committee is suitable for this purpose, and on the reporting and monitoring framework that might be built around the Stewardship Code.
- This consultation runs for another month and until we get more feedback on the questions we have raised I don’t think it would be helpful to speculate too much on the outcome. Suffice to say that we are breaking new ground with this initiative. It will be the first such code in the world.
- We are in an equivalent position to that which the Cadbury Committee found itself in 1992 when developing the first code for companies. We



need to be careful to avoid unrealistic expectations about how quickly it might deliver results. And we must not gloss over the real complexities in what we are trying to do.

- One of the issues highlighted by our work on the Stewardship Code is the complexity of the investment chain. Can companies be sure that the intermediaries with whom they deal are representing the long-term interests of the beneficial owners rather than their own interests? Can the beneficial owners be sure that their mandates are being implemented to best effect? What are the respective responsibilities of the different parts of the investment chain?
- These are all big questions to which there are no easy answers. But if the Stewardship Code can help to shed some light on them, and increase the transparency and accountability throughout the investment chain, that in itself will be a benefit. If the result of that increased transparency is that the long-term interests of the ultimate owners – pensioners, policy holders and so on – are conveyed more clearly to companies and pursued more vigorously, then those benefits are potentially significant.



## The international scene

- I have summarised the main developments for listed companies across all sectors in the UK, many of which will be explored in more detail during the course of today's conference. But of course we do not operate in a vacuum. Just as the financial crisis has been an international one, so is the subsequent analysis of what went wrong and the role that governance had to play.
- There is a lot of activity globally at the moment. The OECD is in the process of reviewing its highly influential Corporate Governance Principles. In the USA the SEC is focusing much more than previously on shareholders and is considering measures to rebalance the interests of boards and investors. And most pertinently for the UK, the new European Commission is developing its work programme on which governance can be expected to feature strongly.
- The Commission are expected to issue three separate reports in the next few months: the first specifically addressing the governance of financial institutions, the second reporting on the way in its existing, non-binding Recommendation on remuneration of directors in all listed companies has



been implemented, and the third its response to a report by RiskMetrics on the monitoring and enforcement of national corporate governance codes.

- The Commission is not giving too much away about what we might expect, but it seems clear that there will be proposals for legislation on governance in financial services, and there may be some temptation on the part of the Commission or European Parliament to extend some regulation to other companies as well.
- I think there is also a fair chance that there may be some legislation on remuneration for all companies. If so the impact in the UK may be limited as the Recommendation is largely, but not entirely, consistent with the requirements in the Code and reporting regulations.
- The Commission's intentions in respect of the RiskMetrics report are unclear. But one of its recommendations was that there should be national 'comply or explain' codes for institutional investors, and the Commission are taking considerable interest in the Stewardship Code.
- I hope that in its deliberations the Commission will pay heed to the conclusions of the Walker and FRC reviews with which I started this speech: that any changes should build on rather than abandon the strengths of the existing system - including the central role played by



'comply or explain' – and that the measures considered appropriate for the financial sector will not be transferred to other sectors without the most careful thought and analysis. There must also be recognition of the different board and corporate structures across Europe. Each has its own strengths. And each is familiar to those who work on Boards and to investors. One size does not fit all and the costs of disruption and distraction on Boards must be avoided. And, above all, those responsible for change must recognize that rules are not an end in themselves. The goal is to encourage the right behaviour in the boardroom – openness, probity, clear strategic thinking, selfless stewardship – in the interests of the company and its owners. Law provides minimum safeguards. But in our ever changing global economy which throws up an endless stream of complex challenges, governance needs to be rooted in the directors' personal commitment to strong principles and values, supported by engaged investors. Those are the aims of the UK Corporate Governance and Stewardship Codes. And in view of the record of progress in UK corporate governance, they are aims that I am confident they can and will deliver.