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MOVING SHAREOWNERS TO RESPONSIBILITY

I was born in a suburb of South London called Croydon. It is not famous for very much and many people try to forget they were ever associated with it. However, in the year I was born, 1956, one of its sons did make a mark on corporate governance in the UK. A man called Leslie Brown, Chief Investment Manager of the Prudential, stood up at the AGM of the British Small Arms Company and, in opposition to the Board, demanded the removal of the Managing Director, Sir Bernard Docker, a man who had become infamous for his extravagant lifestyle. Mr Brown carried the day. A day that marked the emergence of the power of the institutional investor over corporate governance.

During most of the half century since then, those institutions have done much to drive good governance. In the UK they have supported our Corporate Governance Code. They have combined together to ensure their voice is heard on major questions such as whether CEOs should also be Chairs and on executive compensation.

But now their influence is in decline and with it the voice of investors, of owners, is weakened. To quote the former UK Financial Services Minister and corporate governance proponent, Lord Myners, the corporation is becoming ownerless. Shareholdings are smaller and more diverse as insurers and pension funds shift out of equity under regulatory

pressure to cover their risks by holding bonds. Shareholders are also becoming more remote. Overseas investors, particularly the sovereign wealth funds, are taking a much greater share of the stock. Look at BP. Most people think of it as a British company, but 40% of its shareholders are American. And the advent of high frequency trading has also created a class of technological shareholder, proud of buying and selling a share in 11 seconds, for whom the issues of governance are wholly irrelevant.

Does this dilution of ownership and the consequent weakening of the investor voice matter? At the UK's Financial Reporting Council we think it does and we are trying to do something about it.

The FRC is the UK's independent regulator of accounting and actuarial standards and of the audit profession, and is the body responsible for promoting high standards of corporate governance. Not surprisingly, we believe that good governance is at the heart of a company's performance and its ability to sustain itself over the long term. We also believe that governance will not remain sound year in, year out unless shareholders pay attention to the quality of governance and exert their influence on the company. That is why we are trying to encourage good stewardship by shareholders to sit alongside good governance. That is the purpose of the new Stewardship Code that we plan to publish at the beginning of next month.

But first a bit of context about the development of corporate governance in the UK.

The first governance standards for listed companies in the UK - the Cadbury Code - were introduced in 1992 following a series of corporate scandals.

The group drawing up that code recognised two things. First, the creation of a flexible code had the advantage of enabling them to set higher, more aspirational standards than hard rules. Almost always, the legislative process sets minimum, not aspirational, standards.

Second, the group recognised that if boards are there to represent the interests of the owners, it should be the owners, not regulators, who judge whether Boards are doing a good job.

This led the Cadbury group to devise the concept of "comply or explain", which allows companies to decide with their shareholders whether or not the specific recommendations in the Code are appropriate for them by putting a legal duty on the Board to explain the reasons for non-compliance to their shareholders. That duty is now enforced through the UK listing rules.

This "comply or explain" approach was only possible because there were certain conditions present in the UK market at the time that could underpin it properly. It was a UK solution to a UK problem. It was not designed for export although it has now been widely adopted in Europe and elsewhere.

The first essential condition that existed in the UK was comparatively

strong legal rights for shareholders - rights of access to information, the right to vote against the re-election of individual directors and significant transactions, and later the right to vote on the executive compensation report.

The second condition was the absence of majority shareholders, a condition the UK market shared with the US but not with many markets in mainland Europe at the time.

The third condition, as I have already mentioned, was the presence of institutions that were willing and able to engage with companies.

Without all of these conditions the 'comply or explain' approach works less effectively. So it is a matter of concern that whilst the first two conditions are still in place, the third - sufficient engagement by institutional investors - is under threat as UK pension funds and insurance companies - the traditional bedrock of 'comply or explain' - now hold only 25% of the market, compared to 40% held by overseas investors. We have also seen the growth in index tracking funds which have encouraged the delegation of voting decisions to proxy voting agencies, and the growth of hedge funds and investors whose strategies are based on trading rather than owning.

These changes in ownership have generated a general anxiety about the nature of ownership and owners' support for good governance that gave impetus to the development of a Stewardship Code.

At the same time, problems in the banking sector in the UK also inspired the development of the Code. Faced with the shocking failure of governance in some banks, the UK Government asked Sir David Walker to look at the governance of financial institutions. He concluded that there had been a lack of proper scrutiny and oversight by shareholders. He recommended that we at the FRC should take responsibility for a new code that placed expectations on investors that they would get engaged.

We were pleased to do so. We believe that this is an opportunity to build a critical mass of UK and overseas investors committed to the high quality dialogue with companies to help improve the governance and performance of companies and, as a result, long-term returns to shareholders. In addition greater transparency about fund managers' engagement policy will assist beneficial owners in setting the terms of their fund mandates and in holding asset managers accountable.

Importantly, from our perspective, the new code will also underpin the 'comply or explain' approach to the governance of companies. Without a critical mass of engaged investors, boards are not held to account, and the call for regulators to take more direct action is hard to resist - with all the implications that has for a loss of flexibility in the way companies are run.

So what does the new Code say? In brief, it contains seven principles. These cover: monitoring of investee companies; escalation of activities to protect or enhance shareholder value; collective engagement; voting policy; managing conflicts of interest; public reporting and reporting to

clients.

For each principle, the Code contains some guidance on how the principle can be met. This includes guidance, for example, on the importance of satisfying themselves that the investee company's board and committee structures are effective as part of the monitoring of their investments, on steps than can be followed when it is felt necessary to intervene, and on disclosing their policies on engagement and voting.

Like the Governance Code, the Stewardship Code will also operate on a 'comply or explain' basis for UK registered fund managers. They will be expected to make clear whether they comply with the code or not and, if not, why not. The UK securities regulator, the Financial Services Authority, will begin consultation next month on how to change its rules to
require this of institutions it licenses.

But why not just require compliance? We recognise that it is reasonable for some institutions to choose not to engage with companies if that does not form part of their investment strategy. We also recognise that some smaller institutions simply cannot afford to put in enough resource.

To make engagement mandatory for these investors would result in more and more contracting out of analysis and voting to proxy voting services. This would increase the frustration felt by companies, who already

complain of box-ticking, and is no substitute for real ownership. 'Comply or explain' in stewardship avoids this problem. As with the original Cadbury Code, the Stewardship Code also needs to set standards of stewardship to which mainstream institutional investors should aspire, not minimum standards.

The Code impacts particularly on fund managers. But we hope that those who award fund management mandates will also send the right signals. Pension funds may not wish to become directly involved in engagement, but we encourage them to mandate their fund managers to do so on their behalf; to vote their shares themselves; or to require their fund managers to use only proxy voting agencies that respect the spirit of the Code. By making engagement part of the mandate they give to fund managers, they can directly contribute to the critical mass of engagement, and so improve the health of governance.

We also hope that investors based outside the UK will commit to the Code. While only UK authorised fund managers will be subject to the 'comply or explain' requirement, we are keen that overseas investors sign up to the Code on a voluntary basis.

We recognise that, in practice, the hard work in engagement is usually done by local institutions. But visible support from overseas investors with significant holdings can make a real difference.

I have focussed on the UK proposals, but we are not the only game in town. Earlier this month the European Commission issued a consultation

paper on the corporate governance of financial institutions which addressed the issue of stewardship codes.

We welcome the Commission's interest in the concept. However, I am sure no international investor would want to report on different national codes in all 27 member states of European Union. We therefore need to find a way to create consistency in – if not standardisation – of codes across Europe and to build mutual recognition amongst the sponsors of other codes. We also believe the "comply or explain" approach, if adopted across the EU, would enable overseas investors to manage any conflict between national standards.

Let me conclude with just one thought. Shareholders in the UK have major rights and major protections against being saddled with the debts and liabilities of the companies they invest in. The law awards these rights, rights that other stakeholders do not enjoy, in recognition of the risks shareholders have taken with their money.

This law and the implied unwritten contract between shareholders and the public have been in place for 160 years. It has survived through decades when capitalism has been under attack because it works and because shareholders have generally acted responsibly. The public has seen pension funds and other institutions exert influence on companies for the greater good – questioning self-serving strategies by executives and promoting good governance.

In the wake of the crisis, Governments and the public at large expect that

responsible, benign and moderating influence to be maintained and intensified. Market pressures may point in the other direction; fund managers may argue that they have no mandate for engagement; pension funds may argue their members' money should only be spent on stock picking skills; traders may see only the vital need to enhance the technology to push ownership periods below ten seconds. All are points with some validity. But if shareholders do not lift their eyes and see that as a result of such views stewardship is weakening and needs to be strengthened, then Governments will conclude that governance must become based on law – and that is not good news for shareholders investing in companies that need flexibility to win in global markets – and the public will conclude that shareholders do not deserve their rights. That the deal is off. So to those who have shareholder rights, I say use them or lose them. And to those who can get engaged, I say now is the time to start. It is in your interests and to the benefit of the companies you own.