**Speaking notes for CII conference – April 5, 2011 (30 mins including questions)**

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- Thank you very much for the invitation. I want to talk mostly today about the new UK Stewardship Code for investors because it is something we have pioneered in the UK and which we hope will have some international resonance, but I also want to spend some time setting the context for the Code because it tells us quite a lot about the impact of the financial crisis on corporate governance and the way in which we think about the capital markets. (Slide 1)
- Now we all know that failures of corporate governance did not actually cause the financial crisis. There were plenty of other more important factors, but governance failures did contribute to its severity because boards of banks failed to challenge managements when they were pursuing a reckless business model and shareholders failed to hold boards to account for not doing so.
- This means policy-makers could not ignore governance when they started to look at how to respond. They were confronted with the realisation that the so-called agency problem, which arises when owners of businesses delegate the management of their company to professionals whose interests are not automatically aligned to their own, really was a big problem. Adam Smith, it turns out was right when he said all those years ago that "folly, negligence and profusion must always apply in the management of the joint stock company." (Slide 2)
- That, of course, does suggest a response from policy-makers, but there was another conclusion that was widely drawn, namely that

investment had become very short term in focus. One of the accusations levelled against the investor community was that shareholders were driven by the desire to seek short term returns and that they were thus pushing banks and everybody else to gear up recklessly.

- This is turn may have been driven by a number of factors: the tendency of asset managers and their clients to measure performance against short term benchmarks, unrealistic expectations of return deriving from a desperate desire to make good shortfalls in pension funds, and the tendency of the market, driven quite strongly by the sell-side to seek profit from trading in ever more liquid markets.
- It is clearly not up to me to tell you about what happened in the US. You know all that already, but I do want to make one observation, which is that while the analysis I have just described was broadly shared on both sides of the Atlantic the response over on this side of the ocean has been remarkably different to that in Europe.
- In the US there has been a pretty strong attempt to address the agency problem by giving shareholders more rights, for example on say-on-pay and access to the proxy, even though these have been fiercely fought over in the debate on the Dodd-Frank Act. By contrast, in Europe, where shareholders have long enjoyed critical rights, notably to dismiss directors, the debate has gone in the other direction.
- It has been about whether the rights of shareholders as providers of capital to hold companies accountable should be replaced by more regulation. Just consider what some people were saying:
- David Wright, then a very senior official in the European Commission has argued that shareholders failed completely in their obligation to hold boards of banks to account, and has warned that public support in Europe for what he calls liberal capitalism will collapse if a similar crisis occurs again.

- Paul Myners, a Treasury minister in the last Labour government, said shareholders' unwillingness or inability to exercise their rights had left corporations "floating ownerless in a vacuum."
- And it was not just British voices. I well remember at the ICGN conference in Amsterdam in the spring of 2009, that shareholders were given a resounding drubbing by Wouter Bos, then Dutch Finance Minister for their part in the crisis.
- Finally the European Commission, in a discussion document on governance in banks last summer stated that the model of shareholder control had been "severely shaken, to say the least."
- You will nowadays find some in Europe saying that it should not be axiomatic that shareholders have control rights. One additional reason for this is that the way in which technology has allowed trading strategies to develop and economic and control rights to be unbundled in the derivatives market means that ownership does not mean the same as it used to.
- People are asking why shareholders should have rights when it is no longer clear exactly what title to a share confers by way of ownership. The ultimate absurdity is seen by some in Europe as High Frequency Trading. Once you hold a share for only a nanosecond you can't really claim to be an owner of the company, but if you follow this argument to its logical conclusion you are suddenly potentially in the excruciating business of having to divide the world up into good owners and bad owners.
- Now I am only the messenger here. I am not making these points necessarily because I agree with them, but because we are living in a world where such arguments are being made by politicians with real potential consequences for what I call the shape of capitalism.
- I know there is also a tendency, of which some of us in the UK are sometimes inclined to indulge, to presume that to presume that everybody in continental Europe is a crypto-communist and just

waiting to pounce on the first opportunity to undermine a robust wealth-creating capitalism and I am certainly pretty worried about the consequences for Europe in terms of future economic growth of drawing some of the conclusions that people are tempted to draw in market regulation as well as company law. But, despite all this, I have to say that the critics do have a point

- First, it is true that there has been an increasing trend to short-termism. In that regard we may have neglected the need to nurture a market which can provide long term capital. Secondly it is undoubtedly the case that the crisis revealed the extent of the agency problem. If lack of governance can help cause banks to spin out of control, then presumably the same can happen to companies in other sectors too.
- It is worth looking at another background factor. Thanks to changes in capital requirements and accounting rules, the UK insurance and pension fund industry is no longer the player it used to be in the equity markets (Slide 3). Whereas twenty years ago these funds owned about half the market, and formed a core group of long term owners. Now their share is down to around a quarter. The figures from our office of National Statistics are not precisely accurate, but there is little doubt that ownership patterns have shifted dramatically.
- The Stewardship Code which we launched last summer is an attempt to address these issues in ways which allow us to preserve the rights of those who provide capital and minimise the need for regulation either of companies or markets. If we can make companies properly accountable and improve the governance chain, we won't need so much regulation, we can secure the rights of providers of capital and we can make the markets work better.
- So the Code seeks to refocus a critical mass of shareholders away from the short term and reliance on returns gained by trading, and, by encouraging them to be more engaged with companies, to hold their boards to account again in ways that means we will not need so much

regulation in the future. It contains seven principles which are set out in the slides(Slides 4,5).

- Essentially this content was worked up by the investment industry itself. The Financial reporting Council was asked by the UK government to assume a role as sponsor to give it some independent status and ensure a quality response. We consulted widely and, having found that the community welcomed this, we took the code on without much change because we felt it was imperative to get started.
- It is voluntary in the sense that nobody is compelled to apply it, but UK regulations do now require that all those who are authorised to manage funds in the UK must state publicly whether or not they apply it. The mere fact of having to consider such a statement does force fund managers to consider it, and the result has been that considerable numbers have decided to apply it.
- We now have over 150 signatories (Slide 6), accounting for about 40 per cent of the equity market. Of the top 30 investors in the UK equity market, 25 are signed up and four of the remainder are sovereign wealth funds, about whom a little more later.
- We are very pleased and grateful that we have support from significant US investors, including a firm letter of support from Calpers, while a number, including Fidelity, State Street, Capital and BlackRock have become signatories. This lends credibility to the effort and has created a base which policy-makers in Brussels cannot ignore.
- But having signed people up we clearly cannot stop there. If people just file away the Code and don't do anything then we will be caught out. Next time there is a crisis people will say that the investment community was not serious about its commitment to change and the political pressures will return with a vengeance.
- We are looking here to achieve three main objectives ( see slides). First a discernible improvement in the quality of the relationship between companies and their shareholders. This involves a greater willingness

on both sides to discuss strategy and important governance issues like risk management. It is not sufficient for fund managers simply to evaluate a share price simply on the basis of future earnings projections. These projections will be worse than useless if they ignore risks the company is running and not addressing.

- A better relationship will lead to also to companies understanding better what their core shareholders want and protect them from predatory speculation. That is in every body's interest in the sense that it moves us away from short-term knee-jerk trader-driven responses to specific situations.
- We are of course fortunate in the UK that we feel less constrained by disclosure regulations. This is not because private, market sensitive information is exchanged in company dialogue. It is not, and nor should it be. But we do make a distinction between what companies say, which must be to the market as a whole, and what their shareholders say to them. There is nothing wrong with shareholders expressing a view about strategy or risk management to companies, or challenging a business model that concerns them. It is important that companies then listen. A common feature among the banks which failed in the UK was that they were not willing to listen to such challenge.
- To achieve a better relationship such as I have described would be a real prize with tangible benefits that go beyond the heat of the political debate. Personally I believe that this is what makes the effort worth it. Capital markets will work better if there is an atmosphere of trust between those that take funds and those that provide them and that requires an ability for grown-up dialogue and a capability to handle the occasional challenge.
- The second objective is to build and nurture a critical mass of committed shareholders willing to behave as owners. Unless we can do this, companies will indeed be floating ownerless in a vacuum and,

because they are not accountable to shareholders, we shall have to resort to more prescriptive regulation of every body. Hence the third objective – to satisfy policy-makers that we are on top of the situation.

- How are we setting about delivery? Well, this requires a very diplomatic approach. Because the Code is voluntary, we cannot force people to adhere to it. The desire to do so must come from within the market. On the other hand, if we don't exert some pressure, the market will walk away anyway.
- One answer is to get the support of asset owners. We have had strong commitment from our own defined benefit pension funds as well as from some overseas groups, including as I mentioned Calpers and the Australian Council of Superannuation Investors. Commitment of owners matters a lot because they determine the mandate received by asset managers – a theme which is taken up in today's Green Paper on corporate governance from the European Commission.
- We also have had some good support from the UK life insurance industry, traditionally a significant owner of equities, though both the pension funds and the insurers these days own much less than they used to, so we are looking at other owners, the defined contribution schemes and the sovereign wealth funds which, by some counts, own over ten per cent of the UK equity market.
- SWFs are very reticent about making public statements on engagement or on signing up individually. This is perfectly understandable, if a specific fund in the Middle East or in Asia is known to have a large stake in a company which faces a controversial vote, it will inevitably be asked questions about its position which could be awkward given its government status.
- Yet all the SWFs we have spoken to have been sympathetic to the aims of what we are trying to achieve. After all, engagement is about securing long-term value for those who are in for the long-haul. So we need to find a way of enabling the SWFs to lend support which still

leaves them feeling comfortable about their profile. We have a way to go on this but we are working on it.

- The other plank of our strategy is to engage with the market about what it is doing, monitor closely ourselves, take stock of the monitoring done by others and eventually produce an annual report which will help steer best practice. This means in part entering dialogue with the top levels of the industry and encouraging them to deliver the right culture and approach to investment decision-making.
- I hope over time the Code will therefore have a significant impact on investor behaviour. It will never prevent another crisis – exuberance will always have a habit of becoming irrational - but it could help limit the damage. Insofar as it has now become embedded in UK practice, we would of course be grateful if all investors in our market recognised this and responded, but we recognise that one size does not fit all.
- That said, I should like to leave you with two thoughts.
- One is that the crisis should prompt some thinking about what it means to own shares in a company. The control rights that go with those shares do make them more than just a trading instrument. We all need to think very carefully about stewardship and fiduciary obligations. We have developed a particular UK solution, but stewardship is an issue worth considering everywhere.
- Stewardship requires holders to consider how they exercise those rights both because individual decisions will have an impact on other holders, for example, by saddling them with a weak and conflicted management, and more important, how those rights are exercised will have an impact on those on whose behalf the investment is being made. We cannot get away from the fact that UK institutional investors voted in favour of the acquisition by RBS of ABN-Amro cost their beneficiaries a lot of money. That is something which all those involved in investment need to avoid.

- Second, I said at the beginning that whereas the inclination in the US was to strengthen shareholder rights in the wake of the crisis, the inclination in Europe has been to question whether shareholders deserved to have them at all. It is a cautionary tale with application to everybody. If you do have rights you must use them responsibly. Complacency such as we saw in Europe threatens to incur a heavy price.