

Peter Butler's speech at ICGN - 8 June 2010
Carrots, sticks or codes – How can we make shareowners become good stewards?

1. Working on UK focused solution – needs adaptation elsewhere

Financial Reporting Council (FRC) or an equivalent organisation independent of institutional shareholders should establish, monitor and police a stewardship code. UK specialises in organisations that the rest of the world does not understand but do work e.g. Takeover Panel – In other countries the equivalent of the FRC - may be the appropriate answer for stewardship. It took a financial crisis and complacency of institutional investors before this independent concept was accepted. But the FRC may not have enough powers. UK Government may need to create new laws and/or increase FRC powers to establish a structure in which Stewardship can thrive – we have yet to get our minds round this.

2. Fund managers are part of the problem – not the whole solution

- i) Business model of fund managers does not facilitate stewardship – it is a cost to be minimised which is why governance departments are often cut dramatically in bad times.
- ii) Index Tracking /ETF product models do not facilitate good stewardship.
- iii) Conflicts of interest between different products (long only equities, hedge funds, private equities) create issues
- iv) Lastly but more fundamental. Fund Managers Drive markets forward, bear market troughs to bull market peaks.

In markets of irrational exuberance, fund managers may encourage directors to take risks and make major acquisitions e.g. dot com boom. Royal Bank of Scotland, ABN Amro; this often reverts to excessive caution in bear markets. This tends to promote behaviour patterns by boards that enhance the swings and volatility and makes systemic problems worse. It is often forgotten that Fund managers are agents of shareholders; directors are also agents of shareholders and the whole point of stewardship is to make directors accountable. Similarly share owners must hold Fund managers accountable for good stewardship.

The market mood swings often encouraged by Fund Managers are a capital markets weakness that cannot be handled by direct regulation. The answer has to be that adherence to a stewardship code must be driven by shareowners.

3. This takes us to carrots or sticks?

Where you or I invest our savings directly in stocks there is not a problem; if we want to be absent landlords we can and there is no-one else to blame.

But most of us invest through funds – pension, insurance, mutual funds and our interests are supposed to be protected by a fiduciary (pension trustee, insurance board etc). The stick we need is that fiduciary responsibilities must be legally enforced to ensure good stewardship. Where necessary laws relating to fiduciary responsibility may need to be strengthened.

But the stick is unlikely to be helpful with foreign shareholders (40% UK, 30% Japan, 20% USA & rising). Can you envisage a General Motors employee suing his pension fund for failing to be good stewards of investment in UK's Royal Bank of Scotland? I think not.

There are other sticks that can be used in domestic markets but are difficult to enforce across international borders. The fiduciary responsibility stick is important but I suspect not sufficient.

4. Not all stockholders wish to or should be required to comply with a stewardship code – but we need enough and we need quality of engagement not just quantity.

How? This brings us to carrots, to regulate supply and demand: Simple 1st year economics teaches that if there is not enough supply increase the price. We need to devise mechanisms to reward good stewards with financial or non-financial incentives and ensure foreign stockholders share these benefits. This will both increase the supply of good stewardship and help solve the free rider problem.

It is the principle that there should be carrots or rewards that matters. There are many alternative carrots available all with advantages and disadvantages and the best or least worst to use should be debated.

What are the two issues that would most improve corporate governance?
Direct shareholder representation on Nomination Committee and Independent Audit of stewardship activities.

To summarise:

- i. There is a need for an organisation independent of institutional investors such as the FRC in the UK to establish, monitor and publicise codes
- ii. Fund managers are part of the problem not the whole solution
- iii. Adherence to a stewardship code must be driven by shareowners
- iv. Fiduciary responsibilities of pension fund trustees and other fiduciaries must be legally enforceable
- v. Quantum and quality of good stewardship should be controlled by a market mechanism of rewards
- vi. Quantum and quality of good stewardship requires independent audit and needs stewardship rewards to be cancelled for stockholders who claim to be good stewards but fail to deliver.

- vii. An effective Stewardship Code backed by suitable carrots and sticks on a global basis will take time to implement – say 10 years. We should not be afraid to experiment.

This is the last chance saloon for the Corporate Governance Community. If good governance and stewardship does not reduce the economic impact of the next financial crisis we can say goodbye to codes and comply or explain. The politicians will just provide more and more regulation.

[In a subsequent vote 74% of the attendees voted in favour of global stewardship codes and nearly two thirds of them favoured the introduction of carrots or sticks].

Peter Butler