BUILDING SUSTAINABLE ENTERPRISES FORUM

CONFERENCE BOARD

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THE CORPORATE GOVERNANCE RISKS AND OPPORTUNITIES

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Introduction

Chairman, ladies and gentleman:

I have been involved in various shades of corporate finance for over 30 years and I have specialised in corporate governance since 1992. In the governance field I've been really impressed by the work done by the Conference Board and I had no hesitation in accepting their invitation to share with you some thoughts on corporate governance risks and opportunities. Well, at least it seemed like a good idea at the time!

I have debated many aspects of sustainability and corporate governance with business leaders around the world. It's fair to say that the topics covered come and go. But I'm convinced at the heart of the discussions there has been a mutual desire to build and develop enterprises that will stand the test of time and do so successfully. Also, as I think we all know, there has been a huge shift in attitudes towards corporate governance and indeed towards sustainability. A decade ago I don't think many of us talked about "sustainable enterprises" but now, in 2005, sustainability is on everybody's agenda. As investors, it's certainly on our agenda.

Corporate governance has an important role to play ensuring enterprises do not become empires – empires that rise and fall, sometimes spectacularly and painfully. Rather its role is to maintain an upward momentum. And this requires leadership and vision. There are risks as organisations get bigger and as they get more process driven. They risk losing the entrepreneurial spark under a welter of well-intentioned but bureaucratic procedures and controls. Sometimes risk averse decision-making processes take hold. Sometimes the enterprises get very arrogant and very complacent as well. These are not the ingredients for long-term success.

Rather successful companies tend to have boards that find the right balance among these and a myriad of other forces in order to drive and direct a successful long-lasting business – it's what I call sustainable governance. In many countries, especially here in Europe, there is now an onus not only on boards but also on investors to behave with sustainable intent. It is important to emphasise that the attitude of investors towards sustainability is very, very, important and it's wrong to assume that all investors take sustainability seriously.

Indeed the growth of the hedge fund industry and the short-term approach taken by many – but not all - of its investors has posed a serious threat to a number of companies seeking to secure their long-term future.

<u>Standard Life Investments</u>

Now let me get the commercial over with.

Standard Life Investments is a relatively new company – we were set up some 6 or 7 years ago - and we are a wholly owned subsidiary of The Standard Life Assurance Company, which plans to float in 2006. That makes it an exciting time for us. Standard Life

Investments is headquartered in Edinburgh and has offices in Hong Kong, Montreal, and Boston. Global reach is very important to us. We manage assets which are now well in excess of £90 billion for a wide variety of clients, at home and abroad - local authorities, corporate pension funds, charities as well as Standard Life's policyholders.

We manage our clients' investment portfolios actively and, especially as most of our clients are long-term investors, we like sustainable enterprises and sustainable enterprises generally like having Standard Life Investments on their share register. Basically we are on the same page. If companies perform well and they honour the spirit of our Corporate Governance Guidelines they know that they can look to us for support. And last but not least, our investment style is 'Focus on Change'. We believe that <u>governance</u> change is one of the key ingredients for long-term success.

Standard Life Investments is serious about sustainability. Indeed our own mission statement is, as shown on the screen, "To build a sustainable and successful global business, delivering exceptional investment performance and service for all our clients". We take sustainability to heart.

<u>Sustainability</u>

So what is a sustainable enterprise? Today I shall leave that to others who are far better qualified than me to answer. But I shall address the question 'Does corporate governance matter'? The factors that sustain long-term corporate returns are, as the Economist recently put it "but vaguely understood". Last November it suggested that some research pointed to a correlation between a company's stance on environmental and social issues and its long-term performance but none as yet shows a causal link between them. The Economist went on to say that until that causality can be established, investors would be left wondering whether sustainability analysis is worthwhile. Ladies and gentlemen, be in no doubt that enlightened investors – and I consider Standard Life Investments one – consider SRI research and governance analysis to be an integral part of the investment process. Such analysis informs investment decisions – and rightly so.

Boards and companies are under increasing pressure to come up with indicators that measure non-financial performance and risks. In the United Kingdom, the Government and the Accounting Standards Board are now well advanced with firm proposals for an enhanced Operating and Financial Review. The new O&FR will move non-financial reporting up several gears. Boards will be required to report to shareholders on a raft of information relating to social, environmental, and geopolitical issues that can materially impact on a company's ability to sustain returns. This will help move sustainability to the centre of the reporting stage. The new O&FR will, I think, be something of a watershed in terms of defining non-financial measures being used to evaluate the performance of boards and executives. You should take a look at the proposals if you haven't done so already.

Now I must say a few words about the importance of change to sustainability. Sustainability of itself is not enough – at least not for us. Investors are looking for <u>successful</u> and sustainable companies. And a <u>successful</u> and sustainable company has to move with the times. Corporate governance provides a framework from the very top of an organisation to stimulate change - and to control its implementation - in a way that is aligned to the strategic goals. That's enough from me on sustainability.

<u>In this Session</u>

In this session I now want to go on to talk about the 'new' governance risks and the 'new' governance opportunities. I'll look at those risk and opportunities as they relate to investors, to stakeholders and to culture.

I also want to touch on some of the 'old' governance risks and the 'old' governance opportunities since these are very relevant to sustainability - as they always were. A proactive approach to governance turns sustainability risks into sustainability opportunities.

I'd be very pleased to answer questions at the end about these and other aspects of corporate governance – such as Sarbanes Oxley or the EC's Corporate Governance Action Plan.

Investors

So let's look first of all at new governance risks being raised by investors.

The globalisation of client portfolios is an irreversible trend that has raised a new set of governance risks. Investors are increasingly keen to diversify risk and, importantly, our clients are increasingly keen to adopt global investment strategies which match their liability profiles. Strategic investment solutions. I think here particularly of pension funds but it relates to other types of clients as well. A consequence of investment portfolio globalisation and indeed of corporate consolidation is that the boards become accountable to everybody but accountable to nobody. Before globalisation, share registers tended to be much more concentrated. It meant that a relatively small number of investors were well placed to hold boards to account and to discipline them when required. With the diversification of investment portfolios this is now much more difficult. Why? With diversification, investors tend to hold a smaller percentage of a company's equity, which dilutes the power of a single investor to exercise influence effectively. And with globalisation, the investor base – such as it is – could easily be 'over there' rather than 'over here'. The bottom line is that the powers of investor influence are diversified and diluted. Consequently boards may turn a blind eye when it comes to addressing and tackling the difficult issues that are sometimes presented by social and environmental aspects of their behaviour. I'm not suggesting this is always the case – far from it – but it is a risk.

For example, leading drugs companies, who generally have very diverse, global share registers, were appallingly slow to respond to the building pressures to distribute drugs in a way that took into account the social implications of HIV and AIDS, especially in Africa. And, to their shame, investors were not holding them to account effectively for their behaviour or lack of behaviour in this area. That said, I am very pleased to acknowledge that the drug companies now have recognised their responsibilities and are responding positively to the pressures. So what is the opportunity? The diversity of shareholdings that arise from the globalisation of investment portfolios can and should enable boards to be far more responsive than they would otherwise be when dealing with sustainability. Why? Because they don't have to be constantly looking over their shoulders to seek the approval or sanction of their larger investors. They are effectively empowered – empowered to take swift and decisive action to deal with the issues of the day. Speed of response can – and often does - create competitive advantage; sustainable competitive advantage.

Shareholder activism - I prefer to call it investor activism - is now part of the corporate governance tool kit. The risk to a sustainable enterprise of investor activism is that investors start interfering. It's worth pointing out that many – but not all - shareholder activists have short-term horizons. Not good news for successful sustainability. But active shareholders come in different shapes and sizes. Not all are short-term. Indeed, I'd like to think that Standard Life Investments is an active investor as well as a long-term investor. We engage with boards to debate a whole range of issues – from strategy to finance; from compensation to CSR – to help develop a mutual understanding of objectives and to exercise influence and discipline when appropriate. Boards shouldn't be afraid to embrace active shareholders. If they can work together, as they often can, they build a bond of mutual trust, which helps to nurture a common understanding of the long-term and sustainable objectives of the enterprise. We are starting to see that bond being forged at new Royal Dutch Shell with whom we engaged more than with any other company last year.

There is a distinction between investor relations and shareholder relations. The distinction is subtle but it is important. Investor relations tend to focus on the needs of portfolio managers at investing institutions whereas shareholder relations tends to focus on the needs of the beneficial shareholders. Leading institutions recognise this difference and, like us, have set up dedicated corporate governance teams to look after their clients needs. Increasingly, UK companies are arranging pro-actively for investors to meet non-executive directors. It's not doing my waistline much good – non-execs like to dine – but it's good to talk! The boards of successful sustainable enterprises invest in shareholder relations – it is critical. Also, investors can have conflicting interests and views – how does the board respond to these differences? Shareholder relations' programmes can at least help to narrow the gap of understanding. These programmes help to build trust.

<u>Stakeholders</u>

We'll hear a lot today from other speakers about stakeholders – non-investor stakeholders. I'm in no doubt that boards are engaging more and more on issues of corporate social responsibility – CSR. I was visited a couple of months ago by David Reed, the Chairman of Tesco. I was struck by the fact that well over half of the issues he raised with me related to non-investor stakeholder and social responsibility matters.

Corporate social responsibility is no longer an optional extra for boards; it is a core responsibility. A failure to deliver on generally accepted corporate social responsibility principles as well as the company's stated policy is a huge risk for companies, especially when they're consumer facing. On the other hand, those companies who perform well in this area - and are seen to perform well - can reap the CSR dividend. Companies, which take an effective approach to CSR, tend to be those who have "good management". And investors like 'good management'.

Stakeholder relations in terms of NGOs are critical. If companies fail to establish effective working relationships with relevant NGOs they face the risk of AGMs being ambushed. Indeed in extreme circumstances NGOs terrorise executives and directors – and even terrorise investors. It's a very serious issue. NGOs sometimes use the media and can damage a company's reputation. But if companies have processes in place to work together with NGOs they may even get stakeholder endorsement of their products or services, which can help to bring competitive advantage. For example, I am told WWF – the World Wildlife Fund - seconded an environmental expert to HSBC and consequently the company recently announced a major initiative to go 'carbon neutral'.

What about reputational risk and reward? I mentioned that NGO's could use the media. This can clearly have a big impact upon reputational risk reward. I'm sure that many of you can remember the damage done by Greenpeace to Shell. Shell was trying to dispose of the Brent Spar oilrig – a massive oilrig - sinking it in a Norwegian fjord. This sparked fury in many quarters. Greenpeace, in particular, captured the media's attention – and used the media to attack Shell where it hurt - the bottom line. Consumers, especially here in mainland Europe, started to boycott Shell's petrol. And it snowballed. And it wasn't just consumers who were boycotting Shell. Mark Stewart Moody - who was then Shell's Chairman, told me Shell had huge difficulties recruiting graduates from Oxford and Cambridge. They didn't want to be seen by their peers as joining a "big bad Shell". The issues were pervasive.

But the governance opportunity comes in using stakeholders to enhance the perception of the brand to help attract customers and to help build a loyal workforce. Employees probably are the most important stakeholders. It's interesting to see HR Directors now being appointed to boards. This is a clear testament to the increasing importance which boards are attaching to employee relations. Just last month, Sainsburys, the ailing UK food retailer, appointed Bob Stack, the HR Director of Cadbury Schweppes, to its board as a non-executive director. The Chairman of Sainsburys, Phillip Hampton, called me when the announcement was going out on the wire because he wanted to emphasise to us and to other leading investors that the employees throughout the group - right down to those in the stores - were being brought into the new strategy for Sainsburys. Bringing in a non-executive director is just one way - but a very important way - of helping to ensure there is an effective debate in the boardroom about employees as stakeholders and as contributors to the company's long-term success.

Culture

And that leads me into the importance of culture. This is clearly recognised by Microsoft, for example, who are big on culture. They are keen to get employees engaged and management is focussed on this.

It's up to a company's board to set the tone from the top. The chairman and his approach to culture is critical. In the UK we have seen the role of the chairman changing significantly. He is no longer regarded as an independent non-executive director. A chairman is a chairman, is a chairman. It is always interesting to ask, "Are you Chairman of the Board or Chairman of the Company?" The answers tell their own stories. In any event, one of a chairman's important roles is to ensure that the right tone is set from the very top of the organisation. Failure to set the right tone is a major risk to a sustainable enterprise. There are many, many examples. An obvious one is Enron. Equally, Shell. The importance of changing the culture has not been lost on Shell's 'new' management. One Company, One Board, One Culture.

Culture has to be embedded into the control environment. A box ticking approach to controls, be they financial or operational, is a key risk to a sustainable enterprise. But if you have the right culture embedded into a control environment you will generally achieve effective ownership of controls. This sometimes takes time but it is essential. This is very true for HSE controls.

Golden Oldies

There are quite a number of governance risks and opportunities which have been around for years. They're not part of the main theme today but they're worth mentioning nonetheless.

First, there's the interface of non-executive directors with executive directors in ensuring that strategy development processes have appropriate checks and balances to ensure strategy focuses on the long-term success of the organisation, rather than just the ambitions of its executives.

Then there are remuneration policies and practices. These are important tools that can influence executive behaviour. Increasingly share incentives are performance linked. That's good news. Generally they are linked to the achievement of financial measures such as ROCE or earnings targets. I think that over time, we are likely to see more incentive schemes linked, in some way, to health and safety and customer services issues. There will always be a place and probably a majority place for the financial measures but we will see more of these sustainability drivers – like health & safety - coming into the remuneration equation – and rightly so, in my opinion.

Also, over time we may see a shift to longer performance periods – longer than the norm of three years – which would align the executives much more with the enterprises long-term success. I commend to you the work done in this area by Mark van Clieaf, a North American business consultant, who is challenging investors and executives to shift their horizons and philosophies.

Co-determination is a fascinating issue. I can see both sides of the coin. On the one hand, it is a great way to involve employees as stakeholders in the heart of corporate decision-making. One the other hand, I am sure we can all think of situations where constitutional co-determination rights have threatened strategic execution. The inability of Corus – formerly British Steel – to sell its Dutch aluminium business to Pechiney in 2002 because of the intervention of the Dutch Works Council and Supervisory Board nearly bankrupted Corus and certainly de-railed the sale.

Conclusion

In the final analysis, a flexible, professional and disciplined approach to corporate governance is a prerequisite for a successful sustainable enterprise.

Governance change is a key component for sustainability. Without change boards will stagnate, companies will stagnate. That's not healthy, that's not what sustainability is about.

In a positive way, engaged and enlightened boards can - and should - turn risks into opportunities. They should be alert to the interests of stakeholders; they should be alert to the key non-financial measures as well as the key financial measures.

A key point is that the buck stops with the board. A board that can make or break a company. The boards of successful sustainability enterprises go beyond box ticking - and they get the governance dividend.

Now, ladies and gentleman that concludes the formal part of my presentation. I have barely scratched the surface on some of these issues and I should be delighted to answer any questions that you may have.