

## **APPENDIX C: KEY EXTERNAL DEVELOPMENTS**

This briefing covers: the weak equity market and the links with US corporate governance reforms; the Hermes Principles; the World Summit on Sustainable Development; and asbestosis.

### **The weak equity market and the link with US corporate governance reforms**

Based on the percentage fall in the Dow Jones Industrial Average and the duration of this fall, this crash is one of the most serious since 1900. Whilst there is on-going debate about how much of the fall in the market is related to corporate governance failures in the US, the Brookings Institution, for example, estimates 25%, there has been a powerful response by legislators and regulators, most notably the Sarbanes-Oxley Act. This legislative and regulatory focus on issues including auditor independence, financial disclosures and conflicts of interest is being paralleled by legal action against broker analysts for alleged conflicts of interest. Most recently, the Securities and Exchange Commission has also focused on the role of investment managers by proposing mandatory disclosure of voting policies and practices. Whilst generating much activity and news, these approaches do not address some fundamental concerns about the underlying governance culture, notably the absence of board independence as a result of combined chairman-CEO, the non-expensing of stock options (which is thought to have been a major reason for why management focussed short-term financial engineering) and the fact that risk assessments often do not take into account factors which put at jeopardy long-term value creation. The debate about for whom companies should be run and how has yet to find a consensus expression in the thinking of US pension funds, let alone the full range of US institutional investors.

### **The Hermes Principles**

Hermes, which is owned by the pension fund of BT Group, has adopted principles that make clear that it favours company management taking a long-term approach to creating shareholder wealth. Although many fund managers have explained the corporate governance systems that they find re-assuring, the new Hermes principles is a significant development in that it describes the “proper goals of a public company” and implicitly, the trade-offs that it expects companies who are genuinely committed to long-term value creation to make. The Principles state that “as a long-term diversified investor, we oppose companies behaving in a way which knowingly passes costs on to other companies and to the tax payer, and as such is socially or environmentally unacceptable, or unethical. It makes no sense if business success is achieved by creating other costs (‘externalising costs’) which the beneficial owners of companies will ultimately pay for.” Specialist media commentary has ranged from describing this as having an “irritating motherhood ‘n’ apple pie flavour” (City Comment, The Daily Telegraph, 22.10.02) through to “not just a clarion call to the corporates, but to the pension fund investors themselves to behave like real owners. Perhaps, if that had been the case in the past decade, we would not be quite in the same mess we now are” (Editorial, *Investment & Pensions Europe*, November 2002, Volume 6, Number 10).

### **The World Summit on Sustainable Development**

The summit agreed the scale of the challenges facing global society (ranging from HIV/AIDS, climate change and growing concerns about access to water) and the potential impacts on global markets. A major conclusion was that public-private partnerships would have to be made to work better, and this will place greater emphasis on corporate social responsibility performance.

### **Asbestosis**

Despite efforts to minimise the impact of litigation, the cost of asbestos exposure continues to grow in the US and, increasingly, in Europe. This is affecting companies, driving many to bankruptcy, and also the global insurance sector. Although asbestos related cover has been excluded since the 1970's, the costs to the insurance sector has been rising and is not expected to peak until 2005 in the US and later in Europe. Current estimates are liabilities in the US will reach \$60 billion, and in Europe up to \$40 billion.

Two noteworthy features of this development are:

- The time lag between the first description of the problem (the first case of asbestos-related death appeared in medical journals in 1924, the first asbestos injury lawsuit was filed in 1966, the first asbestos-related bankruptcy was in 1982) and this issue becoming a headline concern for most analysts and institutional investors. One reason for this time lag is that claims are still continuing to grow more than 25 years since peak asbestos use.
- The potential that lawyers may use experience gained during these claims, the increasingly litigious nature of society, and the growth in no win/no fee class actions to pursue claims for perceived injuries resulting from other corporate activities. Examples of sectors, which could face future challenges, include those associated with climate change (where campaign organisations are already trying to target companies that can be portrayed as being “laggards”) and the telecom sector (if an incontrovertible link is made between mobile phone use and damage to health).