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Chris Hodge
Corporate Governance Unit
Financial Reporting Council
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Dear Mr Hodge,

RESPONSE TO CONSULTATION ON THE REVISED UK CORPORATE GOVERNANCE CODE

Hermes is one of the largest pension fund managers in the City of London. Hermes Equity Ownership Services respond to consultations such as this one on behalf of many clients, including the BT Pension Scheme, the BBC Pension Trust, the BAE Systems' pension schemes, the Lothian Pension Fund, all UK, the National Pension Reserve Fund of Ireland, Canada's Public Sector Pension Investment Board, Australia's VicSuper, PNO Media Stichting Pensioenfonds, of the Netherlands and PKA of Denmark (Only those clients which have expressly given their support to this response are listed here).

Hermes welcomes the proposed UK Corporate Governance Code as a further development in corporate governance in the UK and indeed internationally. We believe that the existing Code has played an important role in improving corporate governance standards and that the new code will further refine those standards and will encourage directors, boards and the owners to ensure the long term success of companies. We have played a significant role both in developing the Combined Code and in engaging with companies on their governance arrangements as part of our work to ensure the long-term success of the companies in which our clients invest. We see this consultation and the new Code as an important tool in protecting and enhancing the interests of our clients' beneficiaries.

We welcome the emphasis encouraging appropriate behaviour, culture and the tone from the top that the consultation is attempting. The majority of our remarks concern how further tweaks to the proposed Code, not least in the disclosure requirements for companies may assist in achieving this goal and reducing the fungus of boilerplate.

Notwithstanding our general support for the code we have serious reservations about both the annual re-election of the chair and the annual re-election of all directors. We believe that the current regime, of each director standing for election every three years is preferable because of the unintended consequence of the options, including annual elections becoming a substitute for long-term, committed and painstaking engagement between companies and their owners over time.

We answer the specific questions in the consultation paper below.

Yours sincerely,

Tim Goodman
Hermes Equity Ownership Services

PROPOSED CHANGES TO THE STRUCTURE OF THE CODE
We believe that the change in nomenclature to "The UK Corporate Governance Code" ("Code") is a sensible one. The reason for naming the existing code "the Combined Code" is now a merely historical curio.

It is appropriate to review the structure of the existing Combined Code and we believe that the changes make sense. However, we think that it is critical that the linkage between the UK Corporate Governance Code and the likely Stewardship Code for Institutional Investors is made clear and that the governance framework of companies with listings in the United Kingdom is based around the symbiotic relationship of company owners and boards exemplified in the respective codes. We therefore think that there should be either a paragraph in the Chairman's preface or in the comply or explain section that links the UK Corporate Governance Code to the proposed Stewardship Code. Whilst there may be technical issues arising from the Stewardship Code not yet existing we believe that these can be overcome by, perhaps, inserting a paragraph that only comes into effect once the Stewardship Code is extant.

Notwithstanding our previous support for the preamble we are pleased that the context to the Code has been developed. Application of the Code should involve the board's consideration of the particular circumstances of the company as well as the Code's principles. Many boards, and indeed investors and their advisers, have been overly formulaic in their desire to adhere to the various provisions of the previous code. The introduction is a good attempt to remind all parties that they should apply the code flexibly and pragmatically taking into account the particularities of the company. The board's explanations of these issues will help to inform investors' views of the company.

We are particularly pleased that the role of the chair has been made more prominent in the Code, not least in the preface. With this in mind, we wonder whether Sir Christopher Hogg's hope that chairs will choose to report personally in their annual statements on how the principles in Sections A and B of the Code have been applied should also be developed into a provision whilst leaving the preface to the Code unchanged? We would suggest that the provision should be that the chair should explain in the annual report how his or her responsibilities for the leadership of the board and the principles of the Code have been carried out in a manner conducive to ensuring the long term success of the company.

PROPOSED CHANGES TO THE CONTENT OF THE CODE
We are supportive of most of the changes to the content of the Code but highlight, below, a few places where we believe the Code could be further refined.

Changes to the Main Principles
We welcome the changes to the main principles of the code. However, we make two suggestions on possible additions to the main principles.

Much of the debate on the Code has centred on the "fungus of boilerplate". We wonder whether there should be a further main principle in Section E - Communication. Disclosure in annual reports is the main vehicle for initial communication on governance between companies and their owners. However, the current section on communication does not refer at all to the annual report. Should there therefore be a main principle that requires companies to report on their compliance or otherwise with the Code in terms of how their arrangements attempt to apply the spirit of the Code, if not the letter, and explain how their arrangements are designed to deliver long-term success for the company?

We also suggest that the main principle on remuneration takes account of risk by adding a final clause “whilst taking appropriate account of risk” to the end of the principle.

Election of directors
We feel like a sailor navigating between Scylla and Charybdis in our thoughts concerning the options proposed. We remain strongly opposed to either the annual election of the chair or the annual election of all directors. Our objections centre on our view that whilst voting rights are important, most productive change normally happens through sustained dialogue between companies and their owners, not just in the, sometimes febrile, period immediately preceding the annual general meeting. We are concerned that the implementation of either proposal will result in more debate on how to cast votes rather than mutually beneficial discussion over time on improving long-term company performance. Encouraging a shift towards shorter timescales between individual director elections at the current time, when so much damage has been done by short-termism, seems to us to be wholly inappropriate.

We are concerned that some institutional investors may think that they have fulfilled their engagement obligations merely by casting their votes with the briefest of dialogues. This will not improve corporate, board or individual performance. The intention of the FRC behind the review of the code is to improve behaviour; we do not see how having, what will increasingly become, show piece elections will achieve this result. In fact, often the best results are achieved in private, outside the glare of media speculation. We believe that board refreshment is better served by the current regime and that the options presented may have the unintended consequence of bolstering unjustifiably entrenched boards that need refreshment through annual votes, or, perhaps more worrisome, destabilising boards through large, even majority votes against either the chair or large swathes of the board.

We note that the recent events at Mitchells & Butlers where a large shareholder was able, it would appear, to take control of, or at least significantly increase his influence over a company without paying a control premium might become far more common under the proposal to elect all directors annually. We also note the Minerva AGM last year when, due to a low turn-out the incumbent chair was not re-elected because the largest shareholder voted against his re-election. The removal of the chair may unnecessarily destabilise a company under the former proposal. It is clear that good chairs are a fairly rare breed and their succession is something that is much better approached in discreet, painstaking fashion rather than as a result of the consequence of the latter proposal which may lead to hurried and inopportune replacements.

The clarification of the role of the chair and senior independent director and the increased emphasis on behaviour and evaluation will have a greater influence in improving board behaviour than the voting proposals. Together with the Stewardship Code which should encourage all investors to extend their ownership responsibilities to include engagement, we believe that investors should have sufficient tools to exert their influence, including removal of directors, without an extension of voting rights as proposed.

Communication
We are satisfied that the proposals regarding shareholders, except where we have indicated, are appropriate and believe that, whilst it can inevitably be improved, the proposed Stewardship Code for institutional investors is also a very significant step to improve the working of corporate governance in the UK.

Disclosure
We are in favour of suitably flexible reporting of the Code's requirements, including providing information on-line. However, as well as the practical considerations made in the consultation about requirements to change the Listing Rules and so on, we would add that it is essential that companies make it very clear where to find governance statements and similar. The current reporting regime means that it is very easy to find governance reports as they are in the annual report. Some company websites are hard to navigate and when resources are pressed, particularly during the AGM season, finding information quickly is imperative.

Separately, we have made a suggestion on how reporting against the Code's provisions might be improved by adding a new Communication Main Principle.

A number of the current requirements seek the disclosure that the board operates certain processes. We believe that there would be substantial benefit to governance reports if they focused on disclosing the outcomes of those processes rather than just the existence of the process. We firmly believe that this would lead to reporting which more fully reflects the intent of the revised Code – a focus on substantive behaviours and not just on procedural guidelines and niceties. Such reporting would also provide a much more substantive basis for shareholder engagement and dialogue. It would also provide something of substance for the auditors to report on. The patchy requirements of the auditors at present are not useful; a removal of the formal specific requirements and their replacement with the general audit requirement to identify any areas of the report which do not accord with what has been learned through the audit would add much more value – when it applied to disclosures of substance rather than the existence of processes. We discuss some specific ways of encouraging disclosure of substance below. There will be many others.

Detailed comments regarding changes to the other provisions
We welcome the improved definition of the role of the senior independent director in A.4.1. However, we do not believe that it goes far enough. The senior independent director can act as an intermediary not only for the other directors but also for shareholders, particularly when they perceive that the chairman is not performing as well as they expect. We therefore suggest inserting "or for shareholders" into the first sentence of the provision after "for the other directors" so that it reads: "… and to serve as an intermediary for the other directors or for shareholders when necessary."

We welcome the changes to section B of the new Code. However, we would propose the insertion of one word to B.2.4 which we believe may make a significant change to the quality of nominations committees' reporting. We suggest inserting "criteria and" before "process" in the first sentence so that it reads: "…including the criteria and process it has used in relation to board appointments." We hope that this change will encourage reporting on the specific skills and experience identified in new appointees in the context of the progressive refreshing of the board. We trust that it will move the report away from empty reporting of process without context on which much boilerplate is based.

Furthermore, we would suggest adding at the end of B.6.1 "to apply Section B of the Code." Again, we believe that this minor change will encourage more meaningful reporting on board evaluation to put it into the context of improving board and individual effectiveness rather than a bland report on the process followed.

In B.6.2 and D.2.1 we propose inserting at the end of the last sentence "and how any perceived conflicts are managed." Whilst identifying connections is important, it is more important to describe how possible conflicts are managed.

We have already expressed our general view concerning election of directors in this response. Notwithstanding these remarks, it is important that the information concerning directors standing for election includes a description of their skills and experience that the board believes will enable shareholders to take an informed decision as to their election or re-election. We propose that the second sentence of B.7.1 should therefore read "The names of directors submitted for election or re-election should be accompanied by sufficient biographical details*, information on their relevant skills and experience* and any other relevant information…"

Regarding C.1.1, we do not believe that the provision has been amended properly to reflect the latest developments in the requirements for auditor reports, of which we and other shareholders have been very supportive. To reflect these changes, we believe that it would be appropriate that the auditors' statement of their responsibilities concerning reporting could be fulfilled by a cross reference to the relevant page of the Auditing Practices Board website.

We are not convinced that C.1.2 or C.2.1 add anything, as drafted, to the reporting obligations of UK registered companies but are useful requirements for non-UK listed companies. We believe that the footnote to C.1.2 could clarify that the provisions are particularly apposite for non-UK listed companies and that the obligation could be met by cross-referring to the business review.

Nevertheless, we would like to propose an important but simple strengthening to the new provision C.2.1 by inserting "as they evolve" at the end of the provision to ensure that there is a sense of risk management being dynamic.

We believe that it would be very helpful to move reporting away from boilerplate to more meaningful disclosure if C.2.2 was developed to require a more meaningful disclosure from the board, that the best reports in this area provide. We therefore suggest the following amended provision:

"The board should, at least annually, conduct a review of the effectiveness of the company's system of internal control. The review should cover all material controls, including financial, operational and compliance controls and risk management systems. The report to shareholders should disclose whether the review found any material weaknesses and if so explain the action taken to improve the specific internal control and, if applicable, the risk management systems or, alternatively, that there were no such issues to disclose."

We also believe that it would be extremely useful to include an additional provision in section C.3 – Audit Committee and Auditors. We have long been concerned that the audit committee report has comprised little other than boilerplate in most annual reports. We suggest an additional provision, C.3.8 to read:

"The audit committee should include in its report the up to five key areas of accounting judgement which they asked the external auditors to focus on and which proved the largest areas of discussion with the auditors; a description of how the audit committee reached its view on key concerns identified in the audit and how these were addressed; how

recommendations from past audits were followed up and how the committee gains effective confidence regarding risk oversight and the effectiveness of mitigation.

We believe that such a provision would encourage the audit committee to provide more useful disclosure to investors which in turn will inform better discussions between the board, including members of the audit committee and investors. Most current audit reports do not provide much useful material on which to determine the extent to which shareholder interest has been served by the audit.

Having taken the opportunity presented by the consultation to reflect on the remuneration provisions, we are not at all convinced that the supporting principle requiring the remuneration committee to judge where to position their company [in relation to remuneration] is appropriate in all cases. We are not convinced that the process does not act as a catalyst to the ratchet effect on pay. We suggest that the principle should be reworded to state: "If in its view it is appropriate the remuneration committee should judge where to position its company. It should use such comparisons with caution…"

We agree with the proposed amendment to D.1.3 but believe that the penultimate and last sentences in the provision should also be amended to reflect the change. We propose the following:

"If, exceptionally, options or other rights to shares are to be granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options or other performance-related mechanism should be held until at least one year after the non-executive director leaves the board. Holding of share options or other rights to shares could be relevant to the determination of a non-executive director's independence."

E.2.2 We believe that it would be a useful amendment to the provision for all votes taken on a poll to be similarly recorded on the website. Such a provision would help transparency and enable investors to understand better the opinions of other investors. This has long been an anomaly which should be rectified.

We welcome the principles, clarified in section D schedule A concerning remuneration. However, we propose deleting "traditional" from the second sentence of the second paragraph so that it reads "Share option schemes should be weighed…" We also propose amending the penultimate paragraph, adding "or where the performance on which payment was made was otherwise less good than was believed at the time payment was made.

Whilst the first point is minor, to reflect the substantial move away from share option schemes, the second point attempts to address our concern that payments have been made, for example in the banking industry, on non-realised profits that ultimately will never be realised. We believe that companies should consider whether long term periods for performance measurement, additional deferral periods and claw back provisions in service contracts might be needed to reduce this risk.

Costs and benefits
Whilst we understand the need to attempt the cost and benefit analysis, measurement of the effect of the proposed changes is far from straightforward. However, we do not see the costs associated with the changes as particularly significant.

The benefits are far more difficult to measure; any improvement in a company's governance arrangements that leads to either the protection of longer term value or its enhancement is of benefit both to the company and its owners. How to calculate this value is difficult. Moreover, the extent that such changes can be attributed directly to the provisions of the revised code is even more difficult to calculate. We also believe that investor engagement is an important part of the algebraic equation that provides some of this symbiotic benefit. Arguably these benefits should be attributed to the mooted stewardship code. However, the sum of the two benefits, of fruitful engagement between informed investors and boards on the basis of mutual understanding, enhanced by improved governance and disclosure thereof, is greater than the two parts. If the effects of the next downturn on UK listed companies are reduced by a tiny fraction and if they take any slightly greater advantage of any upturn as a result of thinking more closely about how they are directed and acting in more clearly in the interests of all shareholders then the cost of the changes will be vastly outweighed by the benefits.