<u>**FRC Consultation on the Revised UK Corporate Governance Code**</u>

Response from Railpen Investments

Railpen Investments is a subsidiary of rpmi, a UK pensions administration firm which runs the Railways Pension Scheme and other railway pension schemes on behalf of the Railways Pension Trustee Company Limited. Together these schemes make up one of the largest UK occupational pension funds. The Railways Pension Trustee Company Limited is a major institutional investor on behalf of its 350,000 beneficiaries and a long standing supporter of better corporate governance and investor protection. Railpen Investments oversees the investment of assets worth around £18 billion and has been active on corporate governance since our UK voting policy was introduced in 1992.

We welcome this opportunity to respond to the proposed new framework of the Code. In addition to the specific points we make in this response, we would also refer to our responses to (i) the two consultations on the Combined Code undertaken by the FRC in 2009 and (ii) the Walker Review into the governance of banks and other financial entities. As a general point, in our responses to the Combined Code consultations, we stated our fundamental belief that the Combined Code, as a whole, was working well and that there was no need for a major overhaul of the main tenets of the current version and we are very supportive of the principles-based approach. We are pleased that the changes suggested do not present a major overhaul and aim only to bring the Code into a more focused and effective framework for best governance practice, which continues to evolve. Nevertheless we have some reservations about the proposals that (i) all directors be subject to annual election by shareholders or the Chairman be subject to annual election, and (ii) that Section E on Institutional Shareholders be removed in its entirety. These are set out below in more detail.

CHANGES TO OVERALL STRUCTURE OF THE CODE

1) Change of name to UK Corp Gov Code to make status clear to foreign investors and foreign companies with a UK listing. As a result of changes to FSA's Listing Regime, such companies will need to report against the Code if they have a premium listing.

We agree with this name change as it clarifies the UK Code for all users. It is not contentious, in our view, and is reflective of the changing nature of ownership of UK companies and that many more foreign companies are seeking a listing on the UK market. The name change reinforces that the quid pro quo of the privilege of UK listing is the high standard expected of corporate governance.

2) Significant changes to Section A to give real prominence to components of an Effective Board as well as incorporating the recommendations from the Walker Review. The existing principles split into 2 sections - Leadership and Effectiveness and creation of some new main principles on roles of Chairman and the non-executives and the time commitment expected of all directors.

This gets to the crux of the revision of the new Code going forward and is in line with the new era of board accountability and effectiveness. This is entirely appropriate, in our view, and should be the focus going forward. There was a lack of accountability within some boardrooms and the revision of the Code emphasises board accountability. The Walker Review identified the need to bring about change in behaviour in the boardroom. We welcome the introduction of a specific section on board effectiveness under the new Section B as this should be given more prominence. The section on the accountability of the Board will further enforce this, especially given the specific reference to risk management within internal controls in this area of the Board's responsibility. This should encourage even more of a risk discipline within the organisation that is apparent from the actions of the Board to the day to day operations of the Company. However, we would encourage boards to have a separate risk committee if they deem it appropriate but we recognise in some companies outside the financial sector that this role may be performed adequately by the Audit Committee.

Although beyond the scope of the consultation, we consider that the FRC should refresh the Turnbull Guidance on risk as an urgent priority, given that it was last reviewed by Douglas Flint's Committee in 2005. We therefore welcome the commitment to conduct a limited review in 2010 but hope this does not rule out a fuller review should that be considered necessary.

3) New Introductory section to reinforce important message about way Code is viewed and applied. Does this work?

Yes, we consider this new section is clear and effective in setting out how the Code should be applied and the nature of the 'comply or explain' framework. We are pleased to see that there is an extensive paragraph explaining the responsibilities of companies when they do not comply and the importance of credible explanations for investors to understand how departures from best practice are backed up with practices that are consistent with good governance principles. Previously, the explanation per se was the focus, and not enough emphasis was put on the *credibility* of explanations. Note in Australia that the reporting system of comply or explain is termed 'if not, why not?'[1] which clearly requires a credible explanation. We agree that the strength of the "Comply or Explain" approach is that it avoids passive box-ticking which has sometimes been perceived to undermine the effectiveness of the Code in the past. Such a box-ticking mentality has been applied by both companies and investors in their interpretation of a company's position – a reinforcement of the message away from such application and clarification of the true purpose of the "Comply or Explain" approach is very welcome and will also serve to discourage vague or boilerplate explanations in PR-speak.

4) Removal of Section E on Institutional Investors - subject to sufficient progress being made on the Stewardship Code for institutional investors (further to Walker's recommendation). If sufficient progress not made, Section E will be reinstated.

We have some concerns about the *entire* removal of Section E on "Institutional Shareholders" given that the consultation is still ongoing on the proposed new Stewardship Code for investors. It is obvious that there is still some way to go on the format and structure of the Code, which is very much out for debate and we are contributing to ongoing discussions through our membership of the NAPF and other corporate governance forums.

Should it be considered appropriate to remove Section E in its entirety, which we would oppose, it is absolutely vital that the Stewardship Code is fit for purpose. In

[1] "Principles of Good Corporate Governance and Best Practice Recommendations", published by the Australian Stock Exchange's Corporate Governance Council in March 2003 (pg. 2) and the revised edition published in August 2007 (pg. 2).

any event, we would suggest a cross reference to it in the new Corporate Governance Code in order that the responsibilities on shareholders remain part of the Listing Rules reporting requirements going forward.

A further consideration is that the overall benefit of a “combined” Code was that the obligations on companies and shareholders were mutual. It does concern us that the previous section of the Code relating to the obligations on companies with respect to dialogue with their shareholder, entitled “Relations with Shareholders”, has been renamed “Communication” as such a title does not engender reciprocity and does not reinforce the importance of developing a *two-way* dialogue. The title “Communication” indicates information flowing in one direction, from a company to its shareholders, and does not reflect the current culture of dialogue and engagement between shareholders and companies. However, we do accept that the individual provisions within the “Communication” section do reinforce the overall message about a *two-way* dialogue.

5) Deletion of previous Schedule B on liability of non-executive directors - ICSA has been commissioned to develop updated guidance on FRC’s behalf.

We agree that this is appropriate and look forward to the outcome of ICSA’s work in this area.

CHANGES TO CONTENT

Main Principles

<u>Section A content:</u>

1) 3 Supporting Principles to be upgraded to Main Principles:

- the role of the Chairman in terms of being ‘responsible for leadership of the board and ensuring the effectiveness of all aspects of its role’;
- the role of non-executive directors to ‘constructively challenge and help develop proposals on strategy’; and
- the time commitment expected of all directors

We agree with the promotion of these Supporting Principles to Main Principles as it supports the overall focus of the new draft Code in terms of the importance of the role of effective boards collectively and the competence and effectiveness of the individuals who sit on the board.

We agree strongly with the point made in the preamble to the Code that “To run a corporate board successfully is extremely demanding – far more so than is generally realised by those who have never participated in one”. We consider this pinpoints how boards may have been dysfunctional in the past. The importance of the pivotal role of the Chairman, and the responsibility involved in running the board effectively, should not be underestimated. The focus on the responsibility and the role of the Chairman is the right one, as we very much see the Chairman as the driver of the board’s functioning and decision-making.

The commitment and responsibility required of being an effective board director, either executive or non-executive, should not be undertaken unless the individual is ready to commit to the time, effort and skills required. We agree that many shareholders may not be in a position to realise the demands of running, or indeed, participating in a board – nor should we do as this is not the role of external shareholders. We further welcome the additional wording to strengthen the role of the non-executive director and we agree that there is now no requirement for an extra appendix on their role and liabilities.

2) Information and Development (previously a Main Principle) has been divided into two separate principles.

We agree that this is appropriate and strengthens the importance of each in the role of an effective board and the effectiveness of the individuals on that board.

3) Two new Main Principles on:

- the appropriate balance of skills, experience, independence and knowledge needed on the Board
- the Board's responsibility for overseeing risk management and setting the Company's risk appetite and tolerance.

As in our answer to 2): we agree that this is appropriate and strengthens the importance of each in the role of an effective board and the effectiveness of the individuals on that board. This will reinforce the pressure for behavioural change. In addition, we consider the implicit reference to the Board's role in overseeing risk management will ensure the elevation of risk and related matters to discussion in the boardroom, where it is not already, and should ensure that the risk appetite of the Company is fully understood, endorsed and cascaded throughout the organisation so that most, if not all, employees understand how to gauge the impacts of their activities and contributions.

4) Drafting changes to Main and Supporting Principles to indicate:

- the Board's responsibility for the long term success of Company
- Remuneration – addition of an explicit reference to the long term success of the Company
- Appointments to the Board - to encourage Boards to consider candidates from broad talent pool and progressive refreshing of board.

We agree with these drafting changes. The first should, we hope, engender at least to some extent a culture away from short-term decision making to a longer term approach to management and strategy, which is in keeping with our interests as long term shareholders. This will be reinforced by the inclusion of such references into the overall remuneration framework, the absence of which has been noted as a driver in the excessive risk-taking that contributed to the banking, and ensuing financial, crisis. We consider that one of the most effective ways to influence behaviours is to reflect those preferred actions in the performance criteria of remuneration policies. We still have reservations, however. about the short-term bias in financial reporting to period of twelve months or less, and also the pro-cyclical bases of many accounting standards. While these are beyond the scope of the Code, these issues are related to perceptions of short-term decision-making predominating over longer-term sustainable success.

On the final point, we agree that it is important that the Nominations Committee consider candidates that will truly add value to the board, be it from their unique skill set or talent pool that they have been chosen from.

Provisions

4 new provisions:

- Chairman to agree and review regularly a personalised approach to induction training and development with each director: we agree this is appropriate.
- Evaluation of the board should be externally facilitated at least every three years, and any other connections between external consultants and the company disclosed: this was one of our recommendations in our previous responses to the FRC on the Combined Code consultations last year. Board performance evaluation is a key indicator to shareholders of the effectiveness of the Board as a whole and we welcome the increased emphasis on this within the new Code provisions. We do appreciate that there is a cost to external evaluation which may be very significant for smaller companies and it is for the board to decide if this is a cost they are willing to bear. However, we do consider that the benefits of an external evaluation process, and the assurance it gives to shareholders, can outweigh the costs incurred.
- The board should satisfy itself that appropriate systems are in place to identify, evaluate and manage significant risks faced by the company: we agree that this is appropriate, and will support the re-focus of the Code on the role of the Board in the management of risk.
- The annual report should include an explanation of the company's business model and overall financial strategy: we agree this is appropriate and note the ASB's recent review of narrative reporting has identified a link between better reporting and clearer disclosure of business strategy.

Additional changes

- Clarification on the role of the Senior Independent Director: we welcome this further clarification which is in line with the recommendations from Walker. We consider that the SID is an important and crucial element to the boards of companies.

- Re-election of directors: there are two options:

  1) Annual re-election of Chairman; or
  2) Annual re-election of all directors.

This has polarised opinion and we anticipate that there will no agreed consensus. In our view, we do not consider that the annual election of either the Chairman, or all directors, is necessary. We think such annual elections may engender a short term attitude by both directors and some of the shareholders who appoint them. It is not a direct analogy but UK local government councillors are generally elected for three year terms and there is no suggestion that this undermines accountability, although within some council committees, including pensions committees, annual appointment procedures may undermine such desirable accountability. A further concern is that annual elections could undermine the tenure of independent directors. We have seen this happen, where challenging non-executives have their position weakened and are not proposed for re-election at the next annual general meeting. This is not in the interests of shareholders, whom such non-executives seek to protect.

The strengthening of the provisions in the new draft Code in terms of the explicit responsibility of the Board for the long term success of the Company, for risk management oversight and for the Board to provide an overall statement on how the

Company generates revenues and makes a profit from its operations and its overall financial strategy should be allowed to bed down and Boards should be allowed to react to these new challenges and requirements.

A further consideration is that annual election debases the currency of the election process – the value in requiring the entire board to stand for election is in its exceptional use, eg. following a major capital raising, and if it becomes routine, it will be less effective with the added threat of a rubber-stamping approach to election decisions, which is tantamount to box-ticking. We strongly support the ABI guidance on recommending that the entire board stand for re-election after a major capital raising issue at the next AGM. Capital raising and dilution are of vital interest to investors and boards need to understand that they have to be fully accountable on these issues.

We favour retaining the current system of retirement by rotation such that at least one third of the board is elected every year, and each individual director is elected every three years. Such three year cycles, which encourage longer time frames for chairmen and shareholders alike, have not led to entrenched boards. We consider that annual elections of the entire board would be a challenge to the continuity and consistency of the board, and would also be detrimental to effective long term succession planning. Given that a board is a group of human individuals, it usually takes some time for them to get to know one another and work at optimum levels. Such annual elections may de-rail this process. Furthermore, a proper functioning Board is a collegiate body with collective responsibility. We would also note that a limited tenure of 3 years does not represent excessive entrenchment and can actually support independence.

Furthermore, there is a reserve power to remove directors *in extremis* through requisitioning a general meeting and proposing a resolution to remove a director. This contrasts with the position in the USA, where directors are far more insulated from shareholders and generally cannot be removed by them. Furthermore, it is not easy for shareholders to convene company meetings in order to do so, and in those circumstances there is a stronger need for the annual re-election of all directors. However this is not the case here and it may be wise to avoid imposing what might be suitable for the USA in what is a very different context. A further comparison indicates that shareholders in US companies that use the plurality voting system effectively cannot vote against a director, and whilst a majority voting system is becoming common place, it is by no means prevalent across all companies; these two further strengths of the UK system ensures the proper level of accountability.

In addition, shareholders must have faith in the strong corporate governance culture here in the UK and annual elections, together with the other rights that shareholders have, could foster a micro-management culture which would not appear to be in the long term interests of either party.

If it is decided that annual elections are appropriate, we feel that the annual re-election of **all** directors is preferable to the annual re-election of the Chairman, the latter having the potential to be divisive for the Board. It is a major step to oppose the re-election of the Chairman and one that shareholders do not take lightly. Furthermore, a proper functioning Board is a collegiate body with collective responsibility.

We agree that, if annual election is considered appropriate, the current Code requirement that all non-executives who have served for nine years be subject to annual re-election should be removed as it will be redundant unless such directors should then be singled out separately from an otherwise composite board re-election procedures.

CHANGES TO PROVISIONS

1) Remuneration

We welcome the additional narrative within the provisions on best practice in remuneration to indicate a link between pay and risk policies and systems; that performance related pay should create alignment with shareholders' interests and to promote the long term success of the Company; the use of non-financial metrics within remuneration systems, which we strongly support; and arrangements for reclaiming variable components (ie. clawback) – although it is important that appropriate and effective remuneration mechanisms are in place in the first instance.

We also support the change to the provision on variable pay for non-executives such that all performance-related pay for non-executives be discouraged, not just share options. This is entirely in keeping with the nature of the non-executive's role and they should not be compromised by participation in variable, performance related pay, especially when their role is to oversee it. We would however, continue to encourage non-executives to hold some shares in the Company to provide some notional alignment with shareholders.

2) Communication

On the suggested change to the wording such that non-executives can attend **existing** meetings with shareholders instead of setting up separate meetings of non-executives in order that companies can comply the provision to dialogue with their shareholders effectively: we are happy with this change as it is a more pragmatic approach than having separate meetings although we would hope that there is no reduction in the established engagement systems that are in place between non-executives and shareholders. Certainly, if a shareholder requires a separate meeting with the non-executives, this should be honoured.

We would also reiterate our concern about the title of this section being changed from 'Relations with shareholders' to 'Communication' which we set out above.

Disclosure requirements:

We note that no disclosure requirements are to be removed under the new Code, which we welcome, and that the current requirements will appear as the new Schedule B.

On the question of whether companies should be allowed to choose to put their corporate governance reporting on their websites **or** in the annual report: we consider that the main corporate governance reporting should continue to be required in the report and accounts document, as this is the annual set-piece of accountability of a company to its members. We would not want to see the corporate governance statements detached from this. We do agree that information on corporate governance (for example, on the terms of reference of each board committee) should be placed on the website for ease of reference, and indeed many companies do now provide supporting documents in this format. There are a variety of ways in which this information is provided on websites, and some website disclosure is far superior than others, in terms of ease of reference and website navigation. This may raise further issues for APB about auditors' responsibilities and shareholders' reasonable expectations regarding website-only disclosures.

OTHER MATTERS

Section E.2: Constructive Use of the AGM

Poll voting

We consider all poll voting to be best practice. The re-wording of Provision E.2.2 -

"For each resolution, after a vote has been taken on a show of hands, the company should….."

- with the addition of the words underlined above - appears to imply that the show of hands should be the *norm* rather than the *exception*.

We note that most FTSE 100 companies have adopted all poll voting and many have had it in place for some time. We have recently participated in an initiative with other major investors to encourage the remaining FTSE 100 companies to adopt all poll voting. In engaging with companies on this, we were concerned to note that some considered that Section E.2 actually encourages the show of hands. We accept that the existing wording of the provision E.2.2 was not entirely clear but we feel that the proposed new wording would exacerbate the problem. We believe that this suggests that the wording needs to be clarified to make it clear that a poll vote is an acceptable alternative to a show of hands.

Railpen Investments
5th March 2010