

Hermes response to the FRC Review of the Impact of the Combined Code

Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme and the Royal Mail Pension Plan. We are also responding to this consultation on behalf of the BBC Pension Trust and some 200 other clients. Hermes has approximately £65 billion under management and it advises with respect to a further £23 billion.*

Some years ago the CEO of the FRC wondered out loud at a public meeting how many staff he might need were the FRC to have the duty to enforce the Combined Code. A member of Hermes' staff at the meeting responded to the rhetorical question with the answer: "More than any fund manager currently has". Since then, there has been some increase in the average staffing levels devoted by fund management houses to their governance responsibilities: generally the work is now done by two rather than one member of staff. But is this enough and what are the implications of the low staffing levels?

Smaller companies often complain that the fund managers they meet are overstretched and out of touch with their company, largely because they are covering a universe of dozens of companies. The situation in relation to governance issues is much worse than this, with the (generally) two staff needing to cover hundreds of companies in the UK, and often also others abroad. In this context, it is no wonder that their knowledge of individual companies is sometimes superficial. It is no wonder that companies find themselves faced with broad-brush judgements which tend to apply a one-size-fits-all approach even when a company needs bespoke and specific understanding. The largest companies may enjoy some degree of specific attention and concern; smaller ones rarely so. We believe that this is the origin of the concerns reflected to the FRC that there is a tendency towards box-ticking and that there are potentially high compliance costs for smaller companies.

In this context, Hermes has a very real concern that companies will take the line of least resistance and seek to comply with the Combined Code rather than explain, even when the board's judgement is that an explanation might be the better route for their business. An explanation requires there to be another party to form the other half of a dialogue. Too often, companies do not believe that they have an intelligent conversation partner and so feel that they cannot take the risk of explaining but must simply comply. We also believe that companies' concerns that investors are not flexible enough to respond to bespoke disclosures may be driving the tendency towards boilerplate and less useful discussions in governance reporting.

The danger of this is that the UK's much-vaunted principles-based approach is tending towards a rigid rules-based approach as companies decide it is simply easier to comply with what appear to be rules than to take the less certain route of an explanation. We refer to this below as the 'simply comply' approach.

We would welcome urgent attention being paid to this issue so that the principles basis of our system is effectively reasserted.

If our analysis is correct, there is a very real danger that the mechanical way the Code is applied will impede UK listed companies from being led in a way which facilitates entrepreneurial success and the management of risk, which is the FRC's strategic aim.

**Figures as at July 1st 2007*

Answers to specific questions

Question 1. Does the Code support better board performance over time?

We strongly believe that the terms of the Code do promote better performance by boards and should thereby add value at companies over time. We do not believe that there is a need for any substantive change to the terms of the Code itself. However, the addition of a brief preamble highlighting the purpose of the Code to promote value-enhancement through higher board skill levels and better board processes might provide a better context for the drafting of governance disclosures, and also for the assessment of them.

Question 2. Is the 'comply or explain' approach working effectively?

As discussed in some detail above, we are not convinced that fund managers are properly performing their role in the comply or explain structure. In particular, we are concerned that fund managers do not have sufficient senior staff considering – and able to discuss – the explanations provided by companies. We fear that this undermines the effectiveness of the comply or explain approach and may drive companies towards compliance even where the directors do not believe that compliance is the most appropriate route for their company. We strongly support the comply or explain approach and regard it as the touchstone of the UK's principles-based approach to governance. If comply or explain becomes simply comply then we have moved to a rules-based system and the flexibility inherent in the framework has been lost.

We believe that this eventuality needs to be guarded against with vigour. We are concerned that this situation may not accord with the investment industry's commitments under the Institutional Shareholders' Committee Code, the statement of principles on The Responsibilities of Institutional Shareholders and Agents. The FRC may therefore need to encourage all parties to live up to the commitments which they themselves have made. We note that the ISC Code is explicitly endorsed in the Combined Code.

Question 3. What impact has the Code had on smaller companies?

As discussed above, we are concerned that the burden of the simply comply culture falls disproportionately on the shoulders of smaller companies, many of which would benefit most from the explain alternative. However, we do not believe that there is any need to adjust the expectations which the Code makes of smaller companies. Rather, their owners, the institutional investors, need to expend effort to understand their investee companies and their individual needs such that comply or explain works more effectively. This, we believe, would have a much lower cost to the UK economy than a shift to the simply comply approach.

Question 4. Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?

As discussed above, we are concerned that the simply comply approach is driving company governance disclosure towards boilerplate and away from disclosure which generates understanding and so adds value to the relationship between the company and its investors. However, much company reporting remains valuable and useful to owners, and this is particularly the case where companies are explaining some non-compliance with a term of the Combined Code. We welcome such thoughtful and helpful disclosures.