<u>Response to the consultation on the Combined Code, October 2009</u>

Background

Hermes is one of the largest pension fund managers in the United Kingdom and is wholly owned by the BT Pension Scheme. As part of our Equity Ownership Services, we also respond to consultations on behalf of many other clients from around the world, including the Lothian Pension Fund, the BBC Pension Trust, Ireland's National Pension Reserve Fund, PNO Media of the Netherlands, Australia's VicSuper and Canada's Public Sector Pension Investment Board (Only those clients which have expressly given their support to this response are listed here). Hermes EOS has assets under advice of approximately £40 billion.

Hermes welcomes the opportunity again to comment on the development of the Combined Code. We strongly believe that the Code has made a significant improvement to the governance arrangements of companies during its existence. However, we believe that the Code now needs to strengthen the link between governance and both board and company performance at this stage in its evolution. Through encouraging better board performance we believe that the Code can assist in the creation of sustained shareholder value as well as reducing the risk of value destruction.

Introduction

"Good governance should facilitate efficient, effective, and entrepreneurial management that can deliver shareholder value over the longer term." This critical sentence from the preamble of the current Combined Code (Code) should be the test for what follows in the Code itself.

Reporting on the company's governance should be predicated on explaining to the company's members how its governance arrangements are intended to deliver efficient, effective and entrepreneurial management to deliver shareholder value over the longer term.

Thinking about the Code itself has until now concentrated on identifying the structural features of boards that are more likely to have good governance. Whilst these structures are of enormous importance the terms of this debate have meant that the questions of how they link to appropriate and effective board behaviours, and through them to the delivery of board and company performance to deliver long-term shareholder value has been lacking.

How to bridge the gap between the purpose of the Code, articulated in the preamble and the detailed principles and provisions which have become the focus of reporting for most companies should be the focus of this consultation and the work arising out of it. One way in which the transition between eh preamble and the structural focus of the provisions of the Code might be eased is by a fuller discussion of appropriate board behaviours – highlighting what the structures are intended to engender. In this respect we would commend to you the forthcoming ICGN Principles, which consider behaviour directly.

Without losing sight of this fundamental point, we have responded to the consultation in the order that the points were raised, using the same headings.

The responsibilities of the chairman and the non-executive directors

We are not convinced that the Walker proposals concerning the amount of time that chairs and non-executives should devote to the affairs of the company should be directly translated into the Code. We believe that it is up to individuals (when they are considering directorships and on an ongoing basis) nomination committees and boards to establish whether or not the time commitments required can be met. This should be considered in the context of particularly busy periods and intense work at one or more of the companies at which an individual is a director. It would also be helpful for investors that annual reports contain cogent explanations of how apparently very busy non-executive directors and their boards are satisfied that the directors have sufficient time to fulfil their obligations.

We welcome the clarification of the role of the senior independent director in Walker's recommendation 11. We believe that the introduction of the senior independent director has been an important initiative during the history of the Code. We believe that such clarification is useful and do not believe that it will reduce the pool of available candidates. Instead it will highlight the importance of the role to investors and encourage both investors and those with the position to ensure that they use the it to the fullest extent appropriate. We believe that such clarification should be in the form of guidance in an effort to reduce the length of the Code and to avoid boilerplate reporting on it.

The comment that some analysts felt that there was insufficient attention to executive directors is an interesting one. We believe that this is symptomatic of the failure of the Code to address within its principles and provisions how the board works collectively to deliver shareholder value over the longer term. We recommend that in order to link delivery of shareholder value over time in the preamble and the principles and provisions in the main body of the Code, companies should report on the following:

- How the board collectively, and also through its committees, works to deliver shareholder value over the longer term;
- How the governance arrangements in place aid this work and how the board reviews them and if necessary changes them to ensure that they are the most appropriate arrangements for the company at its current stage of development.

The report should be sufficiently detailed to enable a reasonable shareowner to be able to assess the governance arrangements and decide whether the board has successfully met this central objective of the Combined Code. A good report would be likely to include information on how the board spends its time, what its particular areas of focus are and why, and similar disclosures to provide an understanding of how the board actually operates.

Board balance and composition

Our response to the previous consultation, attached, provides our views on independence and board balance.

There seems to be a growing call for the removal of the test of independence after nine years' service by a non-executive director. We have not applied a box-ticking mentality to this criterion of independence as we do not believe that anything miraculous happens to a director on the ninth anniversary of appointment. However, we believe that board refreshment is an important process to ensure that boards remain vigorous and effective and to prevent any decline into clubbable cosiness. The nine year provision is useful inasmuch as it helps to keep refreshment and succession in the forefront of the board's mind. We would note that overlong tenure, particularly by more than one director, would indicate a lack of refreshment and would provoke enquiries from us to establish the board's plans and their reassurance on the how the balance of the board is being examined and addressed.

We frequently engage with companies who are anxious to let us know that they will shortly reach 50% independence on the board following the appointment of a new director. Reporting on similar lines in annual reports is not an uncommon occurrence. We ask how does this formal compliance drive shareholder value in the long term? The answer is generally that we do not know as we are not told. The requirement for 50% of the board, excluding the chair, to be independent is driving somewhat perverse behaviour. We wish to be satisfied that the board balance carries sufficient weight of independent directors *and* that it also has the necessary skills, experience and other attributes amongst both the executives and non-executives to optimise the company's ability to increase sustained shareholder value. If it does not have this correct balance we would like some explanation as to what attributes are missing and how they will be brought to the board and over approximately what period.

We therefore think that the obligations on composition and balance should include a criterion concerning tenure to encourage periodic refreshment but should require better disclosure on the attributes the board has and may be looking for. Within this context the provision requiring 50% independence could be relaxed in favour of the company explaining how it ensures that there is sufficient weight of independent thought and other attributes on the board to deliver long-term value. We have sad to individual companies and on public platforms that the 50% guideline is the one we would favour seeing more explanations against than compliance with. We believe that more flexibility in respect of this guideline would drive less mechanistic behaviour in relation to the nine year guideline.

We suggest that the disclosure obligation might therefore be widened to provide for reporting on:

- How the structure of the board acts to engender the appropriate board behaviours;
- Independence and the balance therein on the board;
- What skills and experience are necessary and useful to the board and how these criteria are met by the directors;
- What attributes are being looked for if the board is recruiting and what attributes were found in the event that the board has recruited in the year under review;
- How the directors keep their skills updated;
- How the foregoing is managed to ensure that long term value is delivered to shareholders;
- How evaluation helps this process.

Frequency of director re-election

We are not convinced by the call for annual elections of particular directors or the whole board. We believe that such voting could, in practice, act as an unfortunate substitute for longer term engagement by the company's owners. Annual elections could therefore actually act as a distraction for both directors and their owners in their mutual task to maximise value over the longer term.

We believe that there are appropriate avenues and remedies available to shareholders to agitate for change successfully at most companies despite most directors being up for election every three years. Such change may only come about through sustained engagement, including collective action and the call from the Code should be to encourage this work. More voting does not necessarily lead to sustained increases in shareholder value. However, we believe that intervention by active and engaged owners is more likely to achieve such a result.

There is a danger of increasing the number of resolutions at AGMs as regulation increases and we do not believe that this tendency should be encouraged without good reason. Again, there is a danger that the role of long term investors as the critical long term friend of the company that assists it to deliver sustained shareholder value might be undermined by substituting this role for brief engagement around voting once a year.

Board information, development and support

This is an important element of the Code but one that has been neglected. Timely information that is sufficient but not too detailed for its purpose is essential to enable the board to debate properly as part of its decision making function. Such regular information will vary over time as the business evolves and what was important becomes less so and vice versa. The board should regularly review the information it receives and update its requirements in accordance with its needs. Such review should also take account of the information asymmetry between executives and non-executives to ensure that the non-executives obtain sufficient information to enable them to fulfil their roles. The non-executive directors must also have systems in place to enable them to supplement their information or be able to test it as required. This may best be achieved via an independent secretariat but this may not be appropriate for all companies, particularly smaller ones. The chair should therefore not only ensure that board information is timely and fit for purpose but must ensure that the non-executives have sufficient resource, contacts and ability to obtain other further information that they require.

Board development is an important factor in ensuring the continued success of the company. The board must collectively ensure that it has the necessary up to date skills and aptitudes. Where necessary it should also arrange collective and individual training to ensure that it can fulfil not only its regulatory and compliance requirements but also its individual directors' duty to promote the success of the company. Performance management should not, therefore, stop at the boardroom door. Evaluation should be designed to ensure that board, committee and director development is sufficient to achieve such success. How the evaluation is carried out is for the boards to decide. However, they should demonstrate not only whether evaluation has taken place but how it has been designed and carried out with the success of the company in mind, with a particular focus on outcomes.

The support given to the board via the company secretary and elsewhere should also be reviewed by boards and reported with the success of the company in mind and whether the way in which such support is given optimises the chances of delivering such ongoing success.

We note for example that very few company reports provide details of how the board or its committees spent their time and how their work is linked to the continued success of the company. Instead most governance statements describe how the board and its committees complied with each provision of the Code. Such statements do not inspire confidence in the board's oversight of the company to achieve its continued success which is the point of the Code; instead the disclosures tend to suggest that such governance is a compliance chore to be fulfilled.

The best reports highlight a thoughtful application of intelligence rather than a checklist approach to the Code. It is such reports which give invstors much greater confidence in the quality and effectiveness of their board. It is to encourage better reporting that Hermes EOS is taking a lead role in the ICSA Hermes Awards.

We believe that recommendations 1, 2, 9, 12 and 13 of the Walker review could be included in the Code but we would add that the evaluation reporting should provide some outcomes and all of them should be geared to the continued success of the company and the preamble of the Combined Code. Recommendation 13 should also include details of any communication between the non-executives and shareholders, if applicable.

We remain of the view that annual board evaluation continues to be helpful as it sets the tone from the top and without it performance management elsewhere in the company is likely to be less effective. However, we would also note that it is likely that the rigour and use of evaluation of boards, committees and individual directors is likely to vary over time. For instance the appointment of a new chair of the company or of a committee is likely to lead to a particularly rigorous evaluation. Similarly, a significant event in the company, such as a strategic failure, poor performance of the company or a division, a compliance failing, concerns about remuneration or an accounting policy or similar would lead to work to resolve the issue and there should therefore be a focus on it in any evaluation. Evaluation reports should make clear what has happened as a result of such failings to improve the situation. Conversely successes at the company should also be the focus of evaluation to understand why such success was achieved and how such successes can be replicated. The correlation between evaluation and remuneration should also be considered.

We are not sure that “assurance statement” is necessarily the correct terminology for reporting how the board works and how its composition addresses succession and the company’s needs but the foregoing shows that we are in agreement with the suggestion that the governance report should provide answers to such questions.

Risk management and internal control

We would agree with the summary conclusions of the consultation. Risk management is one of the worst reported elements of the narrative report. Common failings include:

- Lack of linkage to strategy – what are the particular risks of the strategy and how are they managed?
- Failure to disclose the company’s risk appetite and how the strategy reflects this appetite;
- Failure to link and cross reference the risk reporting requirements of the business review to the internal control statement found in the governance report;
- A shopping list of possible risks rather than the real risks to the company that the board is focused on;
- A lack of quantification of both likelihood and mitigated impact;
- A lack of dynamism in the risk reporting. As the company evolves, presumably so do the risks. Some risks become more important, some less so. Mitigation of risk also evolves so that some risks reduce in net effect whereas others may increase for a period whilst improved mitigation is put in place.

The better reports take account of such factors and provide a better insight for investors and other stakeholders and we would urge companies to address their poor reporting. Presenting a fair assessment of results and prospects by necessity should include an honest and open assessment of the company’s risks and how they are managed.

We are not convinced that the Walker recommendations on risk should be translated into the Code. Particularly for smaller companies the creation of a risk committee may not be the effective way to manage risk effectively. Similarly, the smallest companies may not be able to justify the resource requirements implicit in the recommendations. Instead the Code should mandate the board to explain better how it manages risk, including how it factors risk into its strategic development. As part of this revision to the Code we believe that it could encourage boards to improve reporting on risk. Conceivably the Walker recommendations could form guidance applicable in particular to the biggest companies.

We believe that approaching risk less from a process perspective and more from a behaviour viewpoint and mandating the resulting reporting to demonstrate how risk is effectively managed is the appropriate way of tackling this issue. The Turnbull guidance should be reviewed in this light by the FRC and if necessary put out to further consultation.

Remuneration
Our chief concern is that remuneration reporting does not, in the majority of cases, explore and justify fully the following:

- How remuneration is designed to encourage delivery of the strategy (for instance many, probably the majority of, companies use a combination of relative TSR and an EPS target as the basis for their long term incentives but very few of them explain cogently why the remuneration committee believes that these measures best align the directors with delivery of the strategy);
- Remuneration reports normally do not report how risk is factored into remuneration to reduce the likelihood of unexpected consequences, to encourage the right behaviour and culture and so on;
- Remuneration reports do not often look at how other factors can influence performance; implicit within them is often no real thought on how best to motivate performance other than through remuneration arrangements. We would argue that some of the best performing executive teams and companies deliver above average performance with less than average gearing of the pay towards such performance. We would expect companies to consider these other factors and better explain how they motivate and retain their teams.

Additionally, we broadly welcome most of the proposals in the Walker report and believe that they can be translated into the non-financial sector. We are less convinced by clawback provisions as by bonus periods better reflecting the performance periods to which the bonus relates. Bonuses should, for example, not be paid for winning of contracts but for the profitable performance of contracts and should not be paid for acquisitions but for realising the value in the acquisition plan.

We also believe that personal and group objectives should be better reported in the remuneration report. We understand the need for confidentiality and not forecasting, but as a minimum, the areas in which an executive is to be incentivised should be disclosed in advance and then the results of such incentives should also be disclosed retrospectively, together with an explanation of any discretion used by the remuneration committee. It is frequently not clear to outside shareholders how remuneration committees justify certain decisions and we would encourage the review of the Code to assist them to improve such disclosures.

We have particular concerns with the Walker proposals concerning remuneration consultants. We think that the FRC, in the absence of any other suitable body, should take ownership of any consultants' code and do not believe that remuneration committees should be obliged to use a consultant who has signed up to the code provided that it is happy that it manages the risks associated with using such consultants appropriately. Most importantly we believe that to manage the conflicts of interests of remuneration consultants appropriately the remuneration committee or committee chair should be aware of and be satisfied that all appointments of remuneration consultants by the company are appropriate.

Implementation of the Combined Code

We think that the format of the Combined Code should be examined with the intention of considering whether the existing format achieves its intention to deliver shareholder value over the longer term. The Code should be redrafted to provide a linkage between this overriding objective and the principles and provisions which ultimately are the distilled experience, suggestions and recommendations of how this may best be achieved. What has been missing from the Code is that stakeholders to it (notably boards and institutional investors) have focused on the principles and provisions and not on the intended outcomes and how these should be articulated. There should therefore be a revision of the code, possibly involving a transitional section between the preamble and the structural section of the current Code, which encourages both boards and shareholders to ensure that the overriding objective of shareholder value over the longer term is being considered and addressed by the company's governance arrangements, the reporting of them by the company. This will enable engagement between companies and their owners to be at a much higher level than is frequently the case.

This new section might include some of our suggestions on reporting but will be likely to include an examination of how the board is composed with this in mind, how succession is considered, how the board monitors and improves its collective and its members' performance, how remuneration and culture is designed and developed to achieve this objective and how shareholder engagement is carried out to do so. Above all, the board should explain how the board sets, develops, challenges and revises its strategy over time, identifying, taking account of and managing the risks inherent within it and how behaviours within the boardroom deliver these intents.

We believe that "apply or explain" better describes this missing link in the code and might also encourage the mindset of both boards in their reporting and behaviour and some constituents in the investor community and voting agencies to move from thinking too much about compliance with the Code and too little about how best the company can deliver shareholder value over the longer term. However, the bigger change will be achieved by moving the discussion of the Code from the individual principles and provisions and towards how governance supports the strategy of the company.

We acknowledge that both boards and investors will need to rethink how they work and engage more closely as a result but we also believe that a significant part of such engagement can be achieved through better reporting of how boards are working to meet this objective and through investors engaging on governance with this at the forefront of their minds rather than compliance with individual provisions of the Code. This, in turn, should influence how their representatives and voting services conduct their work.

We note that any monitoring by the FRC will be limited to "checking whether an explanation had been provided, not whether the explanation was appropriate". We understand why the FRC would find it difficult to provide a qualitative assessment of reporting under the Code but unless qualitative factors are taken into account such monitoring may have the consequence of perpetuating sterile compliance without illuminating the behaviour of boards via better reporting and otherwise. It may therefore be counterproductive.

Qualitative assessment of reporting is better approached via initiatives such as ICSA/Hermes's transparency in governance awards which we are both delighted to sponsor and to play a significant role in the assessment of companies' reports. This initiative will encourage better reporting thereby improving board behaviour and ultimately assist the development of shareholder value over the longer term.

We believe that investors should play a more active role in engaging with companies in which they invest and not only once a year at the time of the AGM. We also believe that investors should explain how they engage and use their votes so that the ultimate beneficiaries of their investments can assess whether the institution is representing their interests in the ways in which they can reasonably expect.

We further believe that collective engagement should be considered where appropriate. However, there are a number of barriers to its effectiveness. These include:

- The current poor nature of much company reporting making engagement more time consuming and difficult than it otherwise would be;
- The different perspectives of investors on which issues to address and in what way;
- Concerns about inadvertent formation of concert parties, because of the lack of clarity on the issue from the FSA and the Takeover Panel and the strictures of European law.

Finally, we believe that investors should be encouraged to report more expansively on the work that they are obliged by the Code to perform. This reporting should encompass non-voting related engagement as a counterbalance to the current excessive emphasis on this single event in the year. We believe that investors should be encouraged to report on:

- how votes have been cast and the reasons for opposing management;
- details of the number of engagements, how they have been conducted (telephone conversations, correspondence, face to face meetings) and high level details of subject matter (to ensure confidentiality such details should be aggregated so that individual companies cannot be identified unless the engagement is in the public domain);
- details of the skills and resources in place for engagement work to include the number of staff, what skills, experience and other relevant attributes these staff possess to carry out successful engagement;
- how engagement work fulfils the institutional investor's policy on stewardship and how it is integrated into its wider investment strategy.

Conclusion

We should not forget how far we have travelled under the Code. Concepts such as independent chairs, significant weight of independent directors, senior independent directors, board evaluation and others were alien in the UK not so long ago. As the Code develops it is important to review it afresh and improve it further.

It is clear that the next stage of its evolution should take boards and investors away to an extent from endless discussion of particular provisions and principles and towards a more holistic approach to governance. Good governance practice at a company is to improve the likelihood of good performance over time and to reduce the risk of significant damage to it. Debate around the Code, activity around how boards work and reporting thereof as well as engagement between companies and their owners should focus on how governance practice enables better performance to "facilitate efficient, effective, and entrepreneurial management that can deliver shareholder value over the longer term".

Changes to the Code should be made if they encourage this behaviour. Our suggestions on reporting and activity by boards and investors fulfil this criterion and we trust that they will be considered positively by the FRC together with other suggestions that achieve this objective.

How best to incorporate our suggestions on improving reporting may be best addressed by a new section of the Code between the preamble and the principles and provisions that articulates better how boards and their members should behave to deliver the objective of the Code.