Review of the effectiveness of the Combined Code on Corporate Governance

Response to the Progress Report & Second Consultation 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 which together 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.

Response to the First Consultation

We provided a detailed response to the first consultation on the effectiveness of the Combined Code earlier this year, which we attach again for reference. We would reiterate our fundamental belief that the Combined Code, as a whole, is working well and that there is no need for a major overhaul of the main tenets of the current version. We strongly support the principles-based approach and would be concerned if a legislative approach to the application of the Combined Code was introduced, as we consider that a consequence would be a lowest-common denominator approach to corporate governance, which would be damaging to both companies and their investors.

Other supporting evidence and articles

We also attach our response to the review of corporate governance in UK banks and other financial industry entities undertaken by Sir David Walker (the 'Walker Review'), which is referred to heavily within the Progress Report and Second Consultation document.

As well as these responses, we also attach a research report published by Railpen Investments and PIRC Limited in September 2009, entitled "Say on Pay; Six Years On – Lessons from the UK experience" which looks at the UK's experience of having an advisory vote on remuneration since the introduction of the Directors' Remuneration Report Regulations in 2002.

We would also note that we have been working with the FRC staff in the face to face meetings being held with investors to discuss the workings of the current iteration of the Combined Code and the impact it is having on boards and investors, and will continue to do so.

Second Consultation

On the specific areas for further consideration and response identified in the Second Consultation, we would make the following comments and observations:

SECTION 1: THE CONTENT OF THE COMBINED CODE

Guiding Principles

We support the three guiding principles as set out on page 6 of the Progress Report. Limited revision to the current version of the Code will be sufficient and excessive prescription needs to be avoided. Rationalised disclosure is desirable and we support the removal of standing data (which by definition rarely changes from year to year) from the Annual Report and Accounts provided it is relocated to an easy-to-find section of the company's website.

Walker Review

We set out in our response to the Walker Review the areas that we consider should extend to all companies, not just banks and other financial institutions, and, as referenced above, attach a copy of our response to that review in order that those areas can be identified.

The responsibilities of the chairman and the non-executive directors

We agree with the NAPF's view that further codification would not be helpful but that shareholders do need to be provided with sufficient and relevant information in order to assess the effectiveness of the board in carrying out its role. The chairman should be expected to report to shareholders on the way in which directors have discharged their responsibilities. We would also add to this that the chairman should report on this information in the annual report & accounts, in non-boilerplate form.

Board balance and composition

We think that a focus on competence, rather than independence, is a key area that would serve to improve the quality of boards. We use the 'nine year' rule of independence pragmatically but would observe that this has been somewhat of a gift to passive box tickers and some companies take the line of least resistance, rather than making the case to retain longer serving directors. On the other hand, many so-called justifications of independence are no more than an assertion of fact rather than a reasoned case. This is another example of how boilerplate reporting can undermine the spirit of Code. We would also refer you to the fuller comments we made on the area of competency of directors in our response to the First Consultation.

Frequency of director re-election

Annual elections are desirable in markets like the USA where the directors are far more insulated from shareholders and cannot be removed by them. This is a less obvious problem in the UK and it may be wise to avoid imposing what might be suitable for the USA in what is a very different context. On balance, we favour retaining the three year cycle which encourages longer time frames for chairmen and shareholders alike.

However, 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 see some merit in the Walker Review suggestion that, where the Remuneration Report attracts less than 75 per cent of the total votes cast, the chairman of the remuneration committee should stand for re-election in the following year, as it reinforces accountability on an important issue where there is a clear indication of concern on the part of a significant proportion of shareholders. However, as we noted in our response to Walker on this point, whilst this would increase accountability, it is counterbalanced by the lapse of time to the next AGM. Companies need to deal with remuneration concerns in a more timely fashion than waiting until the next year's AGM and we would not wish to see the imposition of this recommendation as encouraging a habitual approach to dealing with remuneration concerns, instead of addressing them in a more pro-active fashion.

Board information, development and support

We think that it would be helpful for the Code to provide more guidance on the information provided to boards, and board development. In our response to Walker, we noted that the role of the Company Secretary is important here, to provide support not just for non-executives but for all board directors. The concern often cited is that non-executives are too reliant on information provided by the executive directors / executive management so a dedicated support service for the non-executives is vital, especially if they are to carry out effective independent oversight. We also note that whilst we would not expect it to happen frequently, we consider that non-executive directors should be able to seek advice, at the company's expense, from independent external advisers where they consider it necessary.

In terms of development, ongoing training is a vital part of any board director's role and we would expect companies to provide sufficient support networks to ensure that directors are able to carry out their duties effectively and in an informed manner.

Board evaluation

We agree with the NAPF's opinion that board evaluation was one of the most important innovations of the 2003 Higgs' Review but agree that its application varies considerably in quality. We emphasised the importance of effective board evaluation procedures, and the disclosure to investors thereof, in our response to the First Consultation which we reiterate here for emphasis:

"We recommend that there is a specific provision introduced into the Combined Code that requires companies to disclose in more detail the nature of their board performance evaluation process, and that more information is reported in the annual report and accounts about the key areas that were evaluated and where improvements can be made. We are not convinced by the argument many companies use that they cannot disclose more information in this area because of the commercial sensitivity. In this respect we would commend as a tangible example of good practice the detailed disclosure on board evaluation made by BAE Systems in their 2008 Annual report.

We also recommend that the FRC looks at introducing a requirement for an independent, external evaluation process to be undertaken periodically, say, at least once every three years in order that shareholders can have confidence in the validity and stringency of the process."

Risk management and internal control

We strongly believe that the Turnbull Guidance on risk management, given that it was last reviewed in 2005, should now be reviewed as a matter of urgency. It might also be helpful for this to be made more explicit in the Code, where appropriate.

It is also important that as part of the ongoing dialogue with companies, risk management features prominently on the agenda and investors are assured that there are sufficient procedures in place to meet the requirements of the board's risk appetite.

In terms of risk committees, it may be appropriate to establish a separate board risk committee depending on the size of a Company and / or the sector that it operates in. As we state in our Walker Review, the key point is that there should be a robust executive function in risk management which is answerable to the board. Ultimately the board should determine its risk appetite from a properly informed position. It may be helpful for the Chief Risk Officer to be in attendance at board meetings as well as at the relevant committee.

Remuneration

Some of the key findings of our recent research report, referenced above, into remuneration practices since the introduction of the advisory vote on the remuneration report are insightful in understanding remuneration practices and trends in engagement on remuneration in recent times:

- Both investors and companies report that since the introduction of the vote there has been an increase in engagement over remuneration. Whilst this has led to some friction, it has also created an improved dialogue between companies and their owners over this important governance issue.

- There has been a sharp reduction in directors' typical notice periods since the introduction of the shareholder vote. 75% of directors were on one year in 2001, compared to over 95% now. This has reduced the risk of payment for failure.

- Performance-related elements of remuneration now account for a much larger percentage of the total, with long-term incentive plans (LTIPs) becoming a more significant element.

- Between 2000 and 2008 there was a clear movement away from the use of option schemes towards LTIP share awards. From 2003 onwards there was a small increase in the number of share matching (or bonus deferral schemes) being introduced, suggesting that following the introduction of the vote in 2003 companies were more innovative in considering their remuneration structure.

- Total remuneration has continued to grow even when markets have fallen, suggesting shareholders need to do more to achieve true performance linkage.

- Some shareholders do not appear to have used their voting rights effectively, with the average vote against a company's remuneration report falling from a peak in the 2004 season. Therefore the report argues that shareholders need to use their ownership rights actively if it is to have a meaningful effect.

We do not consider that shareholders should have a more direct role in setting remuneration; after all, this would essentially be micro-managing companies. The vote on remuneration has allowed shareholders to be more involved in the process in terms of engagement and consultation processes. We do consider that more collective engagement needs to be undertaken on remuneration to ensure that common concerns are fed back to the company in a constructive way, and can be dealt with. Defeat of the remuneration report vote at the annual general meeting is in interests of neither shareholders nor companies as it may signify that the engagement process has failed.

Setting limits or levels of different aspects of remuneration (eg. share ownership levels, bonus limits, caps on long term incentive plan awards) is not advisable as it assumes a one size fits all approach, whereas effective remuneration systems tend to consider the company, its size, the sector and other aspects.

SECTION 2: THE IMPLEMENTATION OF THE COMBINED CODE

Introduction

In terms of the Code being applied on a "comply or explain" basis , we noted in our response to the First Consultation that this remains the most appropriate way in which to achieve good governance structures within UK Plc. The "comply or explain" approach is a win-win for investors but also for companies as it provides them with some room for flexibility. However, we did note that we considered there was too much emphasis on the 'Explain' option and often the very existence of that option has generated very weak explanations for divergences from the main aspects of the Code. Investors are entitled to expect *credible* explanations from companies, and where companies are planning to contravene a key governance principle, such as separation of the roles of Chair and CEO, investors should be entitled to a credible and robust engagement process.

We agree with the main comments that the NAPF make in this area, with respect to the main focus being to encourage 'integrity of reporting' by both boards and investors to demonstrate that they have fulfilled their fiduciary responsibilities.

Engagement between boards and shareholders

We would direct you to our observations in our response to the First Consultation, where we recommended that Section 2 of the Combined Code, entitled 'Institutional Shareholders', be enhanced and significantly strengthened in order that the responsibilities of institutional investors (pension funds and insurance companies), *and* their intermediaries (fund managers) are laid out clearly and succinctly, providing clarity on their responsibilities that are attached to having voting rights and providing capital to companies.

As a member of the NAPF, we agree with the general view expressed that effective engagement and collaboration is best conducted based on a commonality of views on a case by case basis rather than an institutionalised structure. We think that Walker's suggestion of a Memorandum of Understanding in engagement issues may well be unworkable in practice. We do think that there is a role for the FRC in asking for evidence about the mechanisms in place to facilitate such engagement and for the FRC to report publicly its views on those mechanisms. This goes to a broader comment that we see a role for the FRC in overseeing the implementation and review of the Code's content – see below.

We agree with the NAPF's view that Sections D&E of the Code represent best practice, that compliance standards vary and that failure to vote at a company meeting is a control weakness which should be disclosed and explained to clients of the investment manager. It is important that votes not in support of management are supported by a letter of explanation or, at the very least, the reason for voting is communicated to the company, in such circumstances. This is a clear responsibility of the fund manager/beneficial owner (ie. whoever takes responsibility for voting). However, we do not think the publication by the company of such correspondence/communication is sensible. This would challenge the trust that is built up between long term investors and the companies in which they invest, where engagement is a two way process of communication. Obviously there are times when engagement should be made public, but this is necessary only in extremis and when all other lines of communication have failed.

In terms of the observations by companies that there is a divide between the governance/compliance team and the investment managers who make the stock selection decisions; this is an observation on the fund management industry generally and, we would agree that this disconnect needs to be addressed within investment houses. As a pension fund where all of our funds are externally managed but where, for the most part, we direct the voting of our own shares, we try to ensure that this disconnect is limited, to the extent possible.

Other comments/observations

Role of the FRC

We think it would be appropriate for the FRC to have some sort of generic role in reviewing comply or explain disclosures, especially in light of the admirable work it has done in overseeing the implementation and reviewing the Code's content to ensure it remains current and relevant.

However, we would point out that the FRC's Financial Reporting Review Panel (FRRP) already has a significant role in reviewing narrative disclosure and the Business Review, as well as reviewing financial accounts. Therefore, it would seem entirely logical to extend the FRRP's role to look at "comply or explain" & other governance disclosures and perhaps to publish an annual report on the general quality of disclosures which would identify areas of strength and weaknesses, in a generic format – we would not advise naming and shaming individual companies. This oversight role would also be helpful in respect of smaller companies that lack the oversight of major institutional shareholders. The greatest gain is potentially through the annual report which, if it works properly, could have a virtuous circle type of effect in encouraging collective improvement which is very much part of the FRC's public interest remit.

How can the Code encourage changes in behaviour?

This was a major theme of the discussion at the FRC that Railpen participated in during September 2009. Behavioural and disclosure shortcomings are perceived to be the most significant problems with the Combined Code. It was readily acknowledged that process can only do so much and too much emphasis on process may in fact be counter productive. The challenge is to change behaviour and this is admittedly much harder to do. We consider that the Combined Code should help to encourage this by trying to articulate expectations more effectively. Boilerplate reporting has definitely undermined confidence in the

Combined Code so perhaps there should be an exhortation or even a requirement to report meaningfully.

Railpen Investments
9th October 2009