Governance for Owners

29 May 2009

Sir Christopher Hogg
Chairman
Financial Reporting Council
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By email: codereview@frc.org.uk

Dear Sir Christopher,

Thank you for the opportunity to submit comments in relation to the latest review of Combined Code. By way of background, and to put our comments in context, Governance for Owners (GO) is an independent partnership dedicated to adding long-term value to clients' equity holdings through relational investing and active share ownership.

As we have commented in response to previous reviews, we are strong supporters of the Combined Code as a market standard of sound corporate governance practice in the UK context. We see the "comply or explain" approach as imperative to the effectiveness of the Code as it enables companies and shareholders to reach mutually acceptable comprises when necessary. A "soft law" approach is both more cost effective and more readily adapted as market conditions change. We are particularly concerned that the high level of political interest in this area at present, coupled with the need to be seen to be doing something, will result in unnecessary additional regulation and possibly even legislation.

In our opinion, there is only one area in which the Code is weak and that is in relation to the responsibilities of institutional investors. The rights that investors in UK companies have in relation to protecting their interests are the envy of many an international shareholder rights advocate. In addition, over a decade of debate on governance and subsequent fine-tuning seems to have produced a corporate governance framework that most are comfortable operating within. Yet the focus has predominantly been on companies, that is, on only one half of the equation. Investors have fiercely resisted the imposition of any formal framework of governance in relation to themselves and the fulfilment of their fiduciary duties either to clients, in the case of asset managers, or to beneficiaries, in the case of asset owners. This has meant that while a handful of long-term share owners have actively played a role in the governance of investee companies a significant majority have not, opting either to free-ride or to be ambiguous about their approach.

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Much has been written on the responsibilities of share owners and there are a number of well thought through statements from investor bodies and international organisations such as the UNPRI and the ICGN so we do not propose that the FRC attempt to amplify the existing principles in section 2 of the Code. However, we do believe they need to be revisited as they are incomplete and too ambiguous to be put into practice, particularly in terms of investors being held to account. We await with interest the forthcoming statement from the Institutional Shareholders' Committee. Our concern is, however, that many investors seem willing to wait and see what the government will do rather than to propose solutions that might meet it half way. We hope we are wrong. Assuming that the revised ISC principles are robust, set out clearly the responsibilities of institutional investors and propose practical ways investors might fulfil those responsibilities we would suggest that the principles be embedded in the Combined Code and thus be subject to the same comply or explain regime.

We expect that another consultation would be necessary to ensure that the Combined Code so amended was workable. As part of that consultation, we suggest it might be valuable to investigate mechanisms by which institutional investors could be incentivised and/or sanctioned to fulfil their ownership responsibilities. Ideas that have already been discussed publicly to a limited extent include tax benefits or sanctions, a loyalty dividend to long-term shareholders, and an enhanced dividend for shareholders who vote at general meetings. Regulation, say by the Financial Services Authority, is clearly another means to an end. Ultimately, client demand is likely to be the most compelling argument for institutional investors to develop governance capabilities but debating other mechanisms could also be productive.

On a slightly different note, the current debate around engagement and the need for investors to be seen to be doing more of it is concerning. We believe constructive engagement (by which we mean, basically, communication) with companies by shareholders can protect and enhance long-term value. However, in our experience, the approach to take varies considerably between companies and depends on the issue under consideration and any number of company-specific factors. We are not supportive of engagement in the public eye of the media yet we are not sure how else there is going to be sufficient 'evidence' of activity to address concerns of shareholder apathy. We believe the focus should be on effective action and thus outcomes, which is something best assessed by the clients of asset managers and the beneficiaries of asset owners. In our experience, coordinated engagement by a number of shareholders can be effective, particularly when time is short or the issues are highly contentious. But the vast majority of engagement is relatively low key, in which case building a consensus around the issue is unlikely, even if other investors recognise there is an issue. In addition, cross-border cooperation is generally more important now than working collaboratively with fellow UK shareholders, which brings a different set of challenges.

We do have some suggestions for minor enhancements of section 1 of the Combined Code. Our focus in our work is very much on the board and its ability to, and track record of, serving the interests of long-term shareholders. Overall, we believe that the Code provides a sound benchmark for making such assessments. As ever, more information (rather than just disclosure) would be beneficial.

We believe it would be helpful if companies provided more detailed biographical notes on board directors, setting out clearly their relevant skills and experience rather than just listing their career history. When a director is standing for election we believe it would be helpful, in addition, to have a brief statement from the nominating committee on the particular contribution the candidate is expected to make to the work of the board (from the board's perspective). This helps to give a clear picture of the skills and experience the board deems necessary for it to discharge its responsibilities and it helps shareholders assess the diversity of skills and perspectives around the board table. We are also keen proponents of meaningful and thorough board performance evaluation with the emphasis on the performance and potential for continuing contribution of the directors, rather than on the more comfortable terrain of board process. We believe that external facilitation can enhance the evaluation and would suggest consideration be given to recommending that internally conducted annual evaluations are alternated with those led by specialist external consultants.

We have followed closely the debate on how frequently directors should stand for re-elections. Given the rights shareholders have to propose resolutions to and to call extraordinary general meetings we believe a rolling three-year period is generally acceptable. However, we recognise that there are matters for which the chairman of the board and the chairmen of the board sub-committees take particularly responsibility and thus for which shareholders deem them particularly accountable. Rather than annual election of all directors, we suggest that the chairmen of the board and the sub-committees could usefully stand for annual election. We expect that this may well give them more impetus in difficult discussions, particularly in relation to remuneration where the levels of mistrust between boards and shareholders recently witnessed need to be reduced.

As we have mentioned in previous consultation responses, we believe that the audit committee could usefully provide more detailed explanation of its activities over the year and the scope of the audit. It would also be useful if the report of the audit committee were put to a vote, which we expect would open a channel of communication between shareholders, and the audit committee chairman and audit partner. It would be helpful if each year the report stated the date that the auditor was first appointed and the last time the audit was put out to tender. The report should also set out the committee's contingency plans should the audit firm be unable to continue to provide audit services.

We hope you find these comments helpful.

Yours sincerely,

M Edkins
Managing Director