

Review of the effectiveness of the Combined Code – call for evidence – May 2009

Response from Hermes

By way of background, Hermes is a leading pension fund manager in the City of London and is the principal manager of the BT Pension Scheme, the UK's largest. We also respond to consultations such as this one on behalf of many other clients.

Hermes takes a close interest in matters of corporate governance because the environment in which companies operate sets the context for how we are able to engage with companies. We seek to safeguard our clients' current rights and also to enhance the transparency and accountability of companies and their directors to their long-term owners. To minimise risk to our clients we believe that the governance regime of the markets in which they invest should be transparent and efficient and that the corporate governance framework encourages those aims.

Introduction

We believe that the Combined Code has rightly been viewed as a landmark for corporate governance, not just in the UK but also globally. Famous landmarks change over time as does the landscape in which they sit. We therefore welcome the opportunity to think about and comment on how the Code is working. The comply or explain principle continues, in our view, to have significant merit. Nevertheless, we believe that for it to work properly boards need to demonstrate better that their behaviour is in tune with the spirit of the Code. To achieve this, more boards must make decent disclosures that reveal how they actually operate. Better disclosure is one factor that will make it easier for investors to engage properly with companies and enable them to call them to account when necessary. We also believe that better behaviour, better disclosure and engagement by investors are inextricably linked and each will act as a catalyst for improvements.

Importance of the Preamble

One of the most significant changes to the Code has been its new Preamble that states that "Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term." This sentence is a very welcome addition to the Code. However, this central tenet of the Code and the whole tone of the renewed Preamble is somewhat lost in the main body of the Code itself. It would be useful to review the Code with the intention of emphasising that the effectiveness of the Code and how it is applied within companies should be judged against this measure. It may be that the Code's tone could be altered to highlight the importance to companies' health of good governance, thereby encouraging the link between good performance and good governance that is overlooked in the main body of the Code. This may be best effected by reducing the number of Provisions, leaving more space for individual companies to respond in their own way to the Principles.

Quality of companies' disclosure

Otherwise, we believe that much of the content of the Combined Code as far as it relates to companies is satisfactory and therefore does not need revision. However, how companies report on their compliance with or explanations for divergence from the Code is frequently boilerplate and illuminates little on the actual workings of the boards, their processes and the outcomes that they desire or achieve. The conclusions of 2007's review noted this finding, however, there has been little sign of improved reporting subsequently. We believe that the FRC should consider how best it can encourage companies to improve their disclosure. In this context we would

note that this year's report from Bae Systems is an excellent example of how a company has decided to use its governance reporting to explain to its members and other stakeholders how the board works and the context in which it works. If the Code can include a provision that encourages companies to put their governance arrangements in a strategic context (that is its efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term) this could be a very significant development. Disclosures should illuminate the behaviours and approach of the board rather than simply describe their structures.

Disclosures on risk management are particularly poor at the moment. Typically, the disclosure of key risks – most usually contained in the Business Review – is no more than a laundry list of all possible risks such as might appear in a prospectus document. We find this particularly disappointing given the fact that investors agreed to a reduction in the liability attaching to the Business Review in order to encourage better disclosure. We would welcome boards being encouraged to disclose the four or five genuinely key risks facing the business. This would add much more value for investors than a laundry list and also would be a positive discipline for the board and for companies as a whole.

Independence and behaviour

As far as the detailed provisions of the Code are concerned, we believe that it may be appropriate for the FRC to co-ordinate a debate about what constitutes independence and the weight of independent directors on boards.

We believe that independence is difficult to define and that bland application of those circumstances that may constitute independence described in the Code and a box ticking mentality by both boards and investors is causing certain problems, not least the premature retirement of decent independent directors at nine years' service or before so as not to jeopardise the calculation of independence. Independence is a state of mind more than a list of criteria to be met and well run boards and their nomination committees should be prepared to explain better their assessment of independence where directors do not meet all the relationships or circumstances that are highlighted in the Code. Moreover, they should also be able to identify those directors who are not playing a sufficient role notwithstanding their notional independence. We therefore also believe that it is not necessarily essential that half the board is independent according to the criteria set out in the Code – quality is a more important feature than quantity. We note for example that bank boards frequently contain a majority of independent non-executive directors but those individuals were unable to prevent the problems that beset those companies.

Whilst it is difficult for codes by themselves to improve behaviour, we believe that many of the problems associated with the Code stem from reporting formal compliance to the letter of the Code rather than reporting on the actual behaviour of boards and how they operate. We suggest that the FRC think about how to overcome this problem and to consult on how best to achieve this. An insight into what happens in the boardroom is extremely valuable and the best companies acknowledge this. The Code should encourage the reporting of how the principles of the Code are applied, not just that there is compliance. The FRC should therefore consider the merits of encouraging apply or explain as the latest King report in South Africa suggests. We would also commend the formulation of the approach to this area being consulted on by the ICGN. Inclusion of this approach in the Code might assist companies in improving the value to investors of their corporate governance disclosures.

Non-executives' resources

We believe that the Code has rightly granted more flexibility over time to smaller quoted companies. We believe that it may be appropriate that in particular for the largest, most complex companies there be additional requirements. In particular, the resources of non-executives should be considered. These include both the time that they might be expected to devote to the companies on whose boards they serve and also the other resources at their disposal. It might be appropriate that they have an independent secretariat reporting directly to it which is able to gather information, resolve enquiries and engage with management as appropriate. Clearly this is not appropriate for smaller companies where the costs may be prohibitive and the benefits less easy to justify. However, even within smaller companies there is an argument for the non-executives to be able to spend more time on the business of the companies than they currently do, potentially with the associated effects on both their fees and on the number of companies on whose boards they serve.

Institutional investors

The concept of comply or explain relies on the disciplining power of the market and on institutional investors actively holding companies to account in relation to Code Principles. We therefore welcome the current debate on how institutional investors can be encouraged to fulfil their full role. The intention of Section E's main and supporting principles is unambiguous and unequivocally supportable. However, there is no mechanism with which to ensure inclusion of the Institutional Shareholders' Committee's Statement of Principles into fund managers' contracts. Where the Statement it is included within such contracts there is no mechanism to ensure that its provisions are enforced by the fund manager nor, frequently, any desire to do so by either party to the contract.

We would welcome the FRC giving consideration to whether it or another party needs to act as a catalyst to encourage institutional investors fully to carry out the role envisaged for them under the Code. Without the discipline of institutional investors calling boards to account the comply or explain mechanism is in danger of decay with the concomitant danger of increasing slackness in companies' governance arrangements. If this cycle is allowed to continue there is a danger that the comply or explain principle might increasingly come under question.

Conclusion

We believe that improving the Code and its application by both companies and investors is an exercise of enormous value. The Code's intent has been blunted by boilerplate and insufficient attention to its spirit by the parties to it. Above all, it is a behavioural question that needs an answer – how can we encourage boards and investors apply the Code's principles in a way that adds value to both parties? Our suggestions, we believe, will help achieve this goal.