**Review of the effectiveness of the Combined Code on Corporate Governance**

**Response 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. I should explain that the Railways Pension Trustee Company Limited is a major institutional investor on behalf of its 350,000 beneficiaries and is a long standing supporter of better corporate governance and investor protection. Railpen Investments oversees the investment of assets worth around £15 billion and has been active on corporate governance since our UK voting policy was introduced in 1992.

We welcome the opportunity to offer our views on the utility and effectiveness of the Combined Code on Corporate Governance. We consider that in the light of the current financial crisis now is the correct time to consider the applicability of the main provisions of the Code, the efficacy with which it is being applied and the effectiveness of the main provisions which seek to set out the best practice principles of good governance. We hope that the review will help enhance the Code's effectiveness, encourage transparent and meaningful disclosures and facilitate effective dialogue and engagement between listed companies and their institutional shareholders.

Fundamentally, we believe 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.

It is probably fair to say that the current economic crisis is a collective problem with many and varied causes. There seems to be an increasing consensus that corporate governance failings were not the only cause of the crisis but they were highly significant, not least because boards (of banks and other businesses) failed to understand and manage risk and tolerated perverse incentives. In turn, shareholders lacked information and at times, motivation, to address the gathering problems. Whilst it is clear that there were regulatory failures, it is also evident that enhanced governance practices should be integral to an overall solution aimed at restoring confidence to markets and helping to mitigate the effect of any future crises. Better corporate governance can and should play a part in restoring trust in global capital markets. With this in mind, we offer the following suggestions as ways in which we consider that the Code could be improved, in order that the UK remains a leader in terms of corporate governance structures and application:

**1) Comply or Explain**

We consider that the basis upon which it is applied, that of 'Comply or Explain', remains the most appropriate way in which to achieve good governance structures within UK Plc. However, we do consider that too much emphasis has been put on 'Explain' 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 principle such as separation of the roles of Chair and CEO, investors should be entitled to a credible and robust engagement process.

There have been many examples in recent times of a fundamental lack of credibility in terms of the explanations provided, and poor practices by companies in entering into dialogue with shareholders prior to announcing a major contravention of the Code's key principles. We recommend that the Code specifically states that the emphasis of 'Comply or Explain' is very much on the former and not the latter.

**2) The responsibilities of institutional shareholders**

We recommend 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. We consider that the Combined Code currently focuses too much attention and provides minutiae of detail on the responsibilities of companies and there needs to be a re-balance towards a more equal weighting; expanding and strengthening the section on the role and responsibilities of investors would achieve this. After all, investment is a two way process, and companies and investors play an equally important role in that process; a criticism of the Combined Code in its current form is that it may have served to focus too much attention on companies, and as a consequence, the spotlight has not been shining on shareholders, their duties and their responsibilities.

Guidance on, and requirements for, engagement, would be particularly welcome, and on the importance of an active dialogue between companies and investors, where the onus should also be on shareholders to start that dialogue. Whilst we note that the Institutional Shareholders Committee's (ISC) Principles for Engagement cover this aspect, and are referenced in Combined Code, we consider a more detailed section on engagement is now necessary.

**3) Risk management**

Although there is some risk management content in the Turnbull guidance and the Smith Report, we recommend that the Code more specifically references a provision on risk management in that boards of companies are required to consider actively, and report on, risk aspects of their businesses and how these are managed. We believe it is important to indicate the board's risk appetite and how this is monitored. We consider this would increase the significance and relevance of this aspect of business management from the perspective of shareholders. As an extension of this, we consider that the section on remuneration should include a provision or principle that all performance criteria for incentive plans are risk-adjusted in order that executives are not encouraged to pursue activities which would ensure they meet the performance hurdles of their pay incentive schemes to the detriment of the business overall.

**4) Board performance evaluation**

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.

**5) Competent non-executive directors**

We consider that the discussion around independent non-executive directors has distracted attention from the fundamental question of the competence of directors. We have no comment to make on the nine-year rule in terms of this length of tenure compromising an individual's independence, as we do think it has been helpful from the perspective of both companies and investors in having an established point of reference on tenure providing that this does not become a form of passive box ticking. We readily recognise that longer serving directors with experience of several business cycles in the sector may have a valuable role to play in ensuring that the board retains sight of the longer term perspective in setting corporate strategy and so on.

However, we do consider that the non-executive director element of a board as a whole needs to be balanced between those directors who have served on the board for a length of time such that their knowledge of the business is invaluable in terms of providing challenge and oversight to the executive directors, balanced against fresh blood which will serve to challenge deep-rooted norms of boardroom, and company, behaviour.

We consider that a more fundamental area to consider is the competence of directors who are appointed to boards, and the information on that competence should be provided to shareholders. Equally shareholders need to use the election/re-election vote of directors in a more progressive manner. For reference, we include a questionnaire that Railpen Investments and other shareholders have constructed to request better information on director candidates of US corporations, in order that shareholders may make more informed voting decisions on the re-election of directors to the boards of companies. We consider that there should be some requirement within the Combined Code for better information on this important aspect of governance.

**Railpen Investments**
**1st June 2009**