To:

Chris Hodge
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Dear Chris

Review of the effectiveness of the Combined Code call for evidence

We are responding on behalf of Aviva Investors. Aviva Investors is a global asset management company wholly owned by Aviva plc, the world's fifth largest insurance group, with assets under management in excess of £236 billion across a range of funds. The creation of Aviva Investors was announced in February 2008, to leverage the combined resources of several long-established asset management businesses owned by Aviva plc, bringing them together in a unified, global management structure. Aviva Investors was previously known as Morley Fund Management.

This is our response to the review of the effectiveness of the Combined Code. Firstly we deal with the Code in respect to companies and then we comment on Part 2 which relates to shareholders.

We would like to start by saying that the comply or explain regime has worked well and we would strongly support its continuation. We believe the Combined Code has contributed significantly to the understanding of good board practices and where these are applied meaningfully by companies, has given shareholders greater reassurance on the stewardship of those companies.

Having said this, taken from our own experience, some improvements can be made, as follows:

Succession planning: We have long advocated proactive succession planning for boards and senior management. We say this because we have found, on a number of occasions, that lack of succession planning has led to boards being put under extreme pressure on e.g. awarding greater level of pay to executives who threaten to leave if they don't receive what they are asking for. On other occasions, share prices plummet on the announcement of the CEO leaving because he "was the company". This is not in long term shareholders' interests. These situations can be avoided by having a well thought out process on succession. This should be disclosed in the Report & Accounts and boards, particularly the Chairman, should be held accountable for a lack of succession arrangements.

Board evaluation: Shareholders are unable to determine how effective boards are because they are not able to see boards in action. The next best thing for shareholders is to have an independent evaluation of how boards work from a respected source. Without such verification, shareholders are more likely to insist on best practice structures e.g. removal of non executive directors that have exceeded 9 years, vote against Chairmen who were CEOs etc. We do not believe it is necessary to carry out an external evaluation every year but certainly every 2 or 3 years. When boards complain that shareholders "tick boxes" and vote against non independent directors, this is because they are unable to ascertain from other sources how well the board works in practice. It may be that with external verifications and with more helpful disclosures in the Report & Accounts, shareholders will be more inclined to evaluate boards more holistically and flexibly.

Board competence: On the majority of occasions, directors are voted against because they lack independence. More focus should be put on individual directors' experience and skills. Annual Report and Accounts should describe each director's contribution. Where a director's particular contribution is not easily ascertained, investors could consider this as a reason for withholding support. In view of the importance of the Chairman, it may be appropriate to ensure that Chairmen get proper training and guidance, especially if they are new to the role.

Board output: Whilst the Combined Code has extensive guidance on what a good board looks like, it has very little guidance on how the board should provide stewardship over the whole business, in that it deals with each aspect of board practice and processes separately, and each part of the board's processes are dealt with and reported separately to shareholders e.g. remuneration is separate from governance which is separate from strategy, etc. As shareholders, we would very much like to see how the board approaches their stewardship of the company as a whole so we would like to see more use made of the Business Review in describing this to us. So, for example, the Business Review would describe the company's strategy, how it is linked into the experience and skills on the board to take the objectives forward and how management is incentivised to achieve those objectives. Intertwined into this information would be the usual risks and opportunities the company faces and how the board is dealing with them. The objective of such reporting would be to give shareholders an overview of how well the company is being managed and how focused the board is on its stewardship role. This report should not be too long or detailed (further information is available in the rest of the Annual Accounts) but should be a "summary of stewardship". There has been talk of a "vote on stewardship" similar to European "Discharge of Directors" votes. This would be an overall approval rating on how well shareholders consider the board has led the company and would help boards think "in the round" rather than in silos. We believe there is some merit to this as it brings all governance arrangements together and describes the overall effectiveness of the various structures and processes. However, we are aware that there have been calls for lots of new resolutions and are wary about a vote on practically everything.

Risk management: It is very difficult if not impossible for shareholders to assess what are effective risk management practices. However, having to describe such practices to shareholders and having to give a view on how effective the arrangements are is likely to focus boards' attention to this important area. Shareholders would be much more reassured if reporting was more bespoke with examples of how known and "known unknown" risks are captured and dealt with. This would include reporting lines, incentivisation, and status of risk and audit personnel. We believe risk should be a regular topic for discussion and action for boards but that the responsibility for risk should be for the whole board rather than an individual board director. Risk committees may be helpful for larger and more complicated businesses. Scenario and stress testing activity should be disclosed and commented on. There may be merit in considering a review and update of guidance for Audit Committees (i.e. update of the Smith Guidance) which could cover disclosures around audit, risk and the effectiveness of internal controls.

Remuneration: Certainly this is an area where risk and audit committees should interact with remuneration committees. Whilst the remuneration committee is ultimately responsible for its recommendations on executive pay, they should test these with risk and audit teams to ensure that the arrangements do not pose a risk to inappropriate behaviour or incentivise the wrong decision making. Remuneration itself remains a problem too large to be dealt with in this response. Basically, our view is that many boards have not approached remuneration policy in a respectful way and have not shown much integrity or consideration for shareholders or employees. This is reflected in the way many boards have, it appears to us, maximised what they can take out of our companies irrespective of whether they deserved those payments or not – simply because they can. There are concerns that remuneration committees are not operating well and are conflicted because many of them are executives themselves and have no concept of what “fair” pay is. Our main concern is pay for failure and it needs to be said that if companies perform we are very willing and happy that they are paid extremely well.

Integrity: Other than the first supporting principle in A.1 which states that “the board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met”, the Combined Code does not refer again to what these should be. We believe that many companies are not led with clearly defined principles on integrity and ethics and that greater focus on “doing the right thing” and developing such a culture would help resolve some fundamental problems at companies.

Environmental and social disclosure: We believe that ESG issues can have a material impact on companies’ long term sustainability and also on its corporate reputation. General Motors is a case in point. In order for companies to address all risks that might affect their long term performance they should also disclose their approach to the growing environmental and social focus of regulators and society in general. A good starting point would be for companies to comply with the Association of British Insurers guidelines on Responsible Investment Disclosure as these are well established guidelines and already being used by many UK plcs.

AGMs: AGMs are an essential mechanism for holding management to account. Whilst it is not possible for investors/fund managers to attend most of them, it is a useful forum to make views known if necessary and for boards to face their shareholders. It would be very helpful if AGMs were spread out more evenly throughout the year so that it allows more time for investors to consider the issues and turn up at the AGM if necessary. Chairmen should always demand a poll if they are aware that the outcomes could be different from that on a show of hands and the result of polls should always be made available on the company’s website.

Voting on directors: In order to enhance accountability of the board, the chairs of the Board committees, (remuneration, audit, nomination and risk) should stand for re-election each year. This is a compromise solution whilst the debate on whether all directors should stand for re-election every year continues. Where re-appointments are approved by less than 75% of the votes then the company should be expected to put the same directors up for re-election again the following year.

PART 2 Institutional shareholders

The review has asked specifically for views on Part 2 of the Combined Code. We do believe that for comply-or-explain to work effectively there needs to be a sufficiently representative number of investors that respond to companies and engage effectively. Whilst there are a number of investors that do this in a diligent and considered manner, our view is that not enough investors consider voting and engagement as sufficiently important to be a core part of their investment activity. Therefore, in principle, there should be some pressure on investors to honour their part of the arrangements.

However, we do not believe that a solely voluntary approach will make much difference. This is because there is no incentive for investing organisations to take a more active approach if there is no demand for it, or if it might upset their commercial clients and add to fund management costs. This is why most fund managers have not taken much notice of Part 2 of the Combined Code. We would like the section on Institutional investors to reinforce the need for investors/fund managers to act in all circumstances in the interest of their clients and not in their own interests.

Such a lack of interest in governance is surprising to us (who put time and resource into engagement) as we view engagement and voting as appropriate “due diligence” on behalf of our clients if we are to put several hundred million pounds of their money into a particular company. It seems to us that not doing so could amount to a dereliction of duty by those responsible for investing clients’ money.

There needs to be “teeth” if Part 2 is to be effective. As the Combined Code has no authority over unlisted fund managers or pension funds and other investment funds, there is very little incentive to comply.

Because of a lack of an obvious appropriate alternative place to house a code for investors, we would recommend that more emphasis should be made of the ISC Principles within the Code with a recommendation that investors should disclose their application with the principles as follows:

- Publish a policy statement on engagement;
- Monitor and maintain a dialogue with companies;
- Intervene where necessary;
- Evaluate the impact of their policies; and
- Report to clients.

This approach has the benefit of avoiding heavy handed regulation on how fund managers should carry out its voting and engagement activities. We believe regulation would be counter productive and not achieve the benefits of effective engagement, leading to less risky companies, that the regulators are looking for. The advantage of this approach would be that fund managers maintain their control over how they meet the ISC principles.

Disclosure of compliance with the principles could be made on fund managers' websites. Pension funds should regularly report their approach and resulting activities to the members of their funds.

However, it should be acknowledged that even the best intentioned shareholders have their limits. They own too many companies to be actively involved in all of them and therefore need to prioritise attention to those companies most important to them. Companies that are therefore not on the priority list may feel aggrieved. Also, as a group, shareholders often hold very different views on individual companies (which is what makes a market!) and one investor's concern is another investor's opportunity. This results in a lack of clarity for companies as to their shareholders views.

That being said, it does not mean that investors should not bother. This would clearly let companies off the hook as there will be no accountability. Instead, we believe fund managers ought to manage their own engagement activities in the most effective way they can. This would mean being properly prepared for meetings, for governance and investment views to be integrated and aligned, and to be willing to have an honest and open conversation with boards. Ultimately, fund managers need to be prepared to take a strong line and vote against management if it is in their clients' interests to do so.

In conclusion:

We believe that the UK has one of the best governance regimes in the world. The comply-or-explain approach is effective and flexible. It is up to companies and shareholders to fulfil their roles conscientiously in order to make the process work more effectively. The Combined Code has contributed to improving governance at UK companies although, like most things, more can be done. The areas highlighted above are some areas which merit further attention. In particular, it would be helpful to find an equally effective code for shareholders.