

IBE Roundtable, 25th February 2010

Governance, Ethics and Engaging with Shareholders *Paul Lee, Hermes Equity Ownership Services*

Paul began the discussion with an overview of his role at Hermes. He then led a lively discussion on governance and engaging with stakeholders on ethical issues.

- Governance isn't just about structure or policy – it's about how people behave in the board room. Do board members have the chance to challenge the fundamentals of the business? Can this discussion take place in the board room? Often this is not the case. Instrumental to shaping the behaviour of the boardroom is the quality of the Chair and the agenda that the Chair sets. It is about interactive behaviour.
- It was felt that investors hadn't been particularly helpful in encouraging good governance and shaping behaviour in the boardroom. Their dialogue with companies has been focused on the structure and not the behaviour of boards. It was suggested that this needs to change
- The potential impact of the forthcoming Stewardship Code for Institutional Investors was discussed. The Code will set out good practice for institutional investors when engaging with the UK listed companies in which they invest. It was felt that there is a danger that the Code will not have a significant impact as it has been drawn up by the industry and therefore is likely to be protective of the industry. There is the risk that it will simply turn into a 'box ticking' exercise.
- Issues surrounding the use of agents were raised. They are hired and remunerated to outperform a stock. How do you set financial management mandates so as there is an alignment of interest with the pension fund with the interest of underlying clients? A similar issue exists with investment bankers – they are incentivised by success measured on a very short-term time horizon.
- People on boards tend not to raise issues that are outside the 'norm'. Channels for directors to challenge the company were discussed and felt to be limited.
- One delegate suggested that we need more, not less risk, in the market. In the UK there is an implicit guarantee that large companies/investment institutions won't fail. If there was more hazard in the market, greater attention would be given to many issues currently ignored.

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- What makes a 'quality' board? It was suggested that the following characteristics would be present:
 - People with deep knowledge of the industry
 - People from 'left field' asking what seems like obvious questions to those in the industry
 - People who are fresh and new
 - People who have been on the board for some time and know about some of the company's 'buried bodies'
 - Key to 'gelling' them together – a good chairperson who can get the conversation going
- The ideal size for a board was discussed. Longer agendas mean less time for items and increased reliance on sub committees.
- The issue of board diversity and performance was also discussed and it was concluded that although diversity is important, it is not a panacea (HBOS board failed and it was one of the most diverse). The impact of mandatory quotas of female board members (positive discrimination) was also discussed.
- The process of recruiting non-executive directors was criticised as being 'opaque and frustrating'. The influence of institutional investors in this process is limited. Some suggestions were put forward for ways to improve this e.g. independent nomination committees.
- External board evaluations are useful. However it depends who the results go to. They need to go to someone who will act upon them.
- The issue of shareholder responsibility was addressed. Questions raised were:
 - should someone who owns shares for a very short period of time have a responsibility to engage with the company?
 - should a distinction in law be made between an investor and an owner? Owners might be defined as those holding an equity investment for more than one year.