

Response to Corporations & Markets Advisory Committee on
Corporate Social Responsibility

Introduction

Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme and the Royal Mail Pension Plan. We also respond to consultations such as this on behalf of the British Coal Staff Superannuation Scheme and some 200 other clients. Hermes has approximately £61 billion under management* and it advises with respect to a further £10 billion. Of the total, around £19 billion is invested in overseas equities in markets including Australia. The beneficiaries of our clients are over 12 million people worldwide who depend on us for at least a part of their financial security in retirement.

Hermes takes a close interest in matters of company law and regulation because they set the context for the exercise of our clients' rights as part owners of the companies in which they invest. 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.

By enhancing accountability, we hope to improve efficiency by addressing what economists call the "agency problem". It is our fundamental belief that companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without. By helping make company directors accountable to company owners for the decisions they make and the actions that they take, we believe that over time we will encourage better decision-making and greater value-creation. We believe that this will benefit our clients, which need long-term real growth to meet their obligations to pension beneficiaries, and it will also make companies and economies as a whole more efficient.

In pursuit of these aims Hermes supports a flexible regime which will:

- encourage company accountability;
- encourage responsible ownership by shareholders and fiduciaries;
- ensure independence of those who audit and monitor company performance;
- and
- ensure the measures used in reporting performance are relevant for owners.

We welcome the opportunity to respond to this important consultation by the Advisory Committee. Our answers draw on our experience of the development of corporate social responsibility in other markets, primarily the UK. As an investor in public equities, we restrict our comments to companies in that sector.

* As at January 2006

SECTION 1

- **How might corporate social responsibility usefully be described for working purposes**
- **Which approach or combination of approaches to responsible corporate behaviour is most appropriate**
- **What are the incentives or disincentives for a company to conduct its business in a socially responsible manner**

It is Hermes' view that it is for the board of each company to define what corporate social responsibility signifies for them. This decision should be taken within the context of the company's strategic objectives and its overriding obligation to shareholders to create value over the long term. Hermes position is therefore closest to what the advisory committee describes as a commercial approach. We believe it is in the interests of all companies to conduct their business in a socially responsible manner because this is the best way to ensure that business survives and thrives over the long term. The incentive to adopt responsible practices is therefore one of "enlightened self interest". This is *Principle 9* of the *Hermes Principles* which can be found on our website (www.hermes.co.uk).

Adopting such an approach is for many companies an essential part of maintaining a "licence to operate" in a particular area that is, the ability to maintain the goodwill of the community in which it is located so that future development plans are not frustrated. It is also a key part of good risk management. A sound system of internal control will take into account all potential risks, including social, ethical and environmental risks.

We support the approach embodied by the ASX in its *Principles of Good Corporate Governance and Best Practice Recommendations* and believe that Principle 10 together with Principles 3 and 7 ought to serve as useful guidelines to listed companies.

A company is a legal entity which should only act in the interests of its shareholders. The role of the directors is to ensure that this occurs. Therefore, we believe a purely philanthropic approach is unlikely to be appropriate, as it is difficult to see how this could lead to increased shareholder value. Likewise, an ethics-based approach – where directors decide to adopt particular ethical standards without consideration of the impact on shareholder value – does not seem sensible to us. Quite apart from the difficulties of determining which ethical standards are appropriate, it is again difficult to make a link between this position and the ability to increase shareholder value.

- **Do different or additional implications arise depending on the nature or size of the enterprise, for instance:**
 - **the sector or industry in which an organisation operates**
 - **whether a company has international operations**

Clearly, the sector in which a company operates is likely to have a significant bearing on the nature and the size of the risks it faces. An extractives company will face very different challenges to an information technology company, for example. Likewise,

the presence and location of any international operations has a major bearing on a company's risk profile particularly if, for example, these operations are in emerging markets located far from the company's headquarters or held via a joint venture. It is for these reasons – among others - that Hermes does not favour mandatory reporting of particular areas but rather an individual approach to each company depending on its particular circumstances. Each company is unique and faces unique challenges.

- **In practice:**
 - **to what extent is corporate decision-making driven by stakeholder concerns**
 - **how do companies differentiate between various categories of stakeholders**
 - **in what ways do companies balance or prioritise competing stakeholder interests, and**
 - **How do companies engage with stakeholders?**

Hermes believes that those responsible for managing a company are in best placed to define the key issues it faces and the most appropriate reaction to these. Whether or not companies approach investors proactively via a 'stakeholder consultation' or responsibility roadshow, Hermes contacts firms where it has concerns about any aspect of their performance. We would expect to be able to discuss such concerns with board level representatives where required.

- **In practice, to what extent do stakeholders consider a company's social responsibility performance when making assessments or decisions about a company**

From our own perspective as a shareholder, the vast majority of Hermes' assets are passively managed. Where we believe that companies in which we invest are not managing the risks that they face appropriately, we will engage with board members at these companies with the aim of encouraging better risk management. We also have a number of smaller, actively managed portfolios and social responsibility performance is one of the factors that our active fund managers take into account when making investments in these portfolios.

- **Are there any changes that could enhance triple bottom line, sustainability or like reporting; including:**
 - **Increasing the level of clarity and comparability of these reports**
 - **Any suggested changes to external verification of those reports**
 - **Whether any aspect of this reporting should be mandated and, if so, for what companies and in what respect(s)**

While Hermes would welcome increased levels of clarity in sustainability reporting, we do not believe that mandatory reporting of particular facts or figures is the right way to achieve this. Our concern around mandatory reporting is that companies would tend to view such reporting as a compliance process rather than an opportunity for communication. There is a danger that excessive rule-making might encourage a proscribed, a 'boilerplate' reporting style. Too many of companies'

communications with shareholders are already of this nature, and they provide very little in the way of genuinely useful information to investors or to other stakeholders.

In this light we would encourage a loose framework rather than a rule-based approach, which should give rise to an environment where investors could suggest improvements or further disclosures by individual companies. Best practice would therefore develop through a process of dialogue between companies and their shareholders.

Hermes does not have a particular view on external verification. However, where companies choose to adopt this approach, we would hope that the process of gaining verification has helped them in their reporting and management processes.

- **Are there particular issues for small to medium enterprises?**

Were the current requirements for sustainability reporting to be significantly expanded it is likely that this burden would weigh more heavily on SMEs than their larger counterparts. This is a further argument for the loose framework approach so that companies can respond appropriately to the regime in the way which is most suitable to their particular circumstances and financial means..

SECTION 2

- **Whether, or in what circumstances, companies feel constrained by their understanding of the current law on directors' duties in taking into account the interests of particular groups who may be affected, or broader community consideration, when making corporate decisions**
- **If so, is there any useful scope for clarifying the current law in this respect**
- **Does the current law give directors sufficient flexibility to balance long-term and shorter-term considerations in their decision-making**

As indicated above, we believe that the directors' duty always to act in the best interests of the shareholders means that they need to take into account the interests of other stakeholders. The bulk of shareholders – pension schemes and the like – invest for the long term and their interests are not served if the company takes short term advantage of customers, suppliers, employees or its environment. Thus the current articulation of directors' duties captures these issues already and so clarification is necessary. If a change were to be made, we would recommend following the restatement in the UK Company Law Bill.

- **Are any changes needed to the current law regarding the right of shareholders to express their view by resolution at general meetings on matters of environmental or social concern?**

Hermes does not believe that changes to the law are required in this respect

SECTION 3

- **Does the Corporations Act need to be amended to adopt a pluralist, an elaborated shareholder benefit, or some other, approach to directors' duties**

Hermes supports the approach that has been adopted in the UK to incorporate "enlightened shareholder benefit" into company law. We believe that a director's primary duty is to the shareholders of the company on whose board he or she sits. A director has the obligation to take other interests into account where these have a bearing on a company's ability to create shareholder value, but not to the detriment of shareholder interests.

- **Would any suggested change be intended to go beyond the current law or would it be intended as a clarification only.**

As in the UK, this change would be only a clarification not a change in the law.

- **If a pluralist approach were to be adopted**
 - **Should directors be permitted to take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions, or alternatively**
 - **Should directors be required to take into account their interests of specific classes of stakeholders or the broader community when making corporate decisions**
 - **In either case, what broader interests should be identified**
 - **How might any proposed amendment be implemented and enforced.**

Hermes does not believe that a pluralist approach ought to be adopted.

- **If an elaborated shareholder value benefit approach were to be adopted:**
 - **What form should it take**
 - **Would the UK Company Law Reform Bill clause be an appropriate precedent, either as drafted or with amendments**
 - **How might any proposed amendment be implemented and enforced?**

Hermes would favour the introduction of an enlightened shareholder value benefit approach. We support the model adopted in the UK Company Law Reform Bill and believe that this would be appropriate within the Australian regulatory regime.

SECTION 4

- **Are any changes to current statutory requirements needed to ensure better disclosure of the environmental and social impact of corporate activities.**

- **Are any changes desirable to any other reporting requirements, such as the ASX Listing Rule requirements, the ASX Corporate Governance Principles or relevant accounting standards, to provide more relevant non-financial information to the market.**
- **Is it possible to specify criteria to assist in comparing narrative disclosures, including by valuing or quantifying intangibles**

Hermes believes that the *ASX Principles of Good Corporate Governance and Best Practice Recommendations* if properly interpreted are sufficient to ensure that the environmental and social impact of a company's activities is properly disclosed. In particular Principles 3, 7 and 10 appear to provide for all the key disclosures in these areas to be made. We would therefore discourage the Advisory Committee from recommending additional regulation.

Hermes does not believe it would be helpful to specify criteria to assist in comparing narrative disclosures. Aside from the fact that it is difficult for us to imagine what these could usefully be, each company faces a unique set of challenges and has a unique set of issues on which is it appropriate to report. It is preferable in our view for shareholders to engage with companies where they believe their narrative reporting is inadequate to develop a best practice approach.

- **Would an additional environmental or social 'impact' reporting obligation be appropriate and feasible and, if so, how might it be stated?**

We believe that the current principles do already place an obligation on companies to disclose in these areas where these represent material business risks.

SECTION 5

- **To what extent are voluntary initiatives leading to improvements in corporate social and environmental performance.**
- **What lessons might be derived from any experience with voluntary initiatives.**

Hermes believes that shareholders have a key role to play in encouraging companies to adopt responsible business practices but that the most effective encouragement is peer pressure. Market initiatives, such as that adopted by the ASX, are also from our experience extremely successful in bring about changes in corporate behaviour.

Voluntary initiatives may be important where there is a clear void in terms of guidance or where competitive issues make such initiatives appropriate. Companies may also choose to take advantage of voluntary guidelines, such as the Global Reporting Initiative, in preparing their reports. These are available to companies on a global basis.

In our experience market indices have not led to an improvement in standards of behaviour of disclosure as the requirements for inclusion in such indices tend to be extremely broad. Being excluded from such indices, by contrast, can have a substantial reputational impact.

While we have seen a marked increase in corporate interest in social and environmental performance in recent years, we do not have any compelling evidence that the variety of governance and joint government industry initiatives has had a substantial impact on standards of corporate behaviour.