

***FairPensions' Submission to the Financial Reporting Council's Consultation
on the Revised UK Corporate Governance Code
March 2010***

1. Introduction and General Comments

We are pleased to have this opportunity to comment on the consultation paper ("*the Consultation Paper*") containing the draft of The UK Corporate Governance Code ("*the Code*"), which has been issued by the Financial Reporting Council ("*the FRC*") and which is designed to give effect to the conclusions of the FRC's Final Report of December 2009 ("*the FRC Final Report*").

As a general preliminary comment, we must express our disappointment that the FRC has not, in our view, come up with sufficiently far-reaching changes to redress the defects in corporate governance that were highlighted by the financial crisis. We do welcome some of the changes which the FRC has proposed. Overall, however, we do not think that the FRC's incremental approach will materially reduce the risk of future catastrophic outcomes.

In our submissions to the FRC's two previous consultations and to the Walker Review, we set out some of the reforms which we believed were needed. We shall not return to those arguments here - that is for another day - and we shall generally keep our comparatively few comments on the Code within the confines of the policy decisions contained in the FRC Final Report.

We have one other general observation, which will be reflected in some of our specific comments on the Code. This relates to the relationship between the Code and the proposed Stewardship Code for institutional investors on which the FRC is also currently consulting ("*the Stewardship Code*"). We fully support the idea of a separate code for investors to promote more effective and responsible ownership. At the same time, it is essential that there be an integrated approach to governance at both corporate and shareholder level.

To take one example of the need for such integration, fiduciary long-term investors such as pension funds, being "*universal owners*" with widely diversified portfolios, have a particular interest in ensuring that their investee companies do not have business models that rely for their profitability on the externalisation of costs. That is because this could have adverse effects on other sectors in which they are also invested or on the wider economy and environment, on which the welfare of their beneficiaries ultimately depends.

Consequently, such investors may wish to encourage the boards of all their investee companies to pursue enlightened shareholder value and, in particular, to show that they are paying due regard to the various "*stakeholder*" interests specified in section 172 of the Companies Act 2006, including the company's social and environmental impacts. Shareholders seeking to exercise their influence to this end would be helped if the Code gave explicit guidance to company boards to embrace fully the stakeholder concept of

governance, so that where necessary they could cite such Code provisions to corporate management.

It is therefore important that the two codes be not only consistent with each other but also mutually reinforcing. In this connection, we note from the introduction to the Consultation Paper that the FRC intends to publish the Code in April or May 2010. As the consultation on the Stewardship Code does not close until 15th April, it appears that this will not allow the Code to be compared with the Stewardship Code before being published. We think that this is unfortunate. Even if it is not possible to change the timetable on this occasion, we would suggest that all future reviews of the two codes be synchronised, so that a coordinated and holistic process can take place.

2. Specific Comments on the Consultation Paper

In what follows we adopt the headings in the Consultation Paper, including the Code. Section, page and paragraph references are also to those in the Consultation Paper, unless otherwise stated.

Section A: Proposed Changes to the Code

Proposed changes to the structure of the Code (pages 3 & 4)

We agree that the proposed changes outlined in paragraphs 2 to 6 are an improvement overall.

Proposed changes to the content of the Code

Changes to the Main Principles

We agree with the general intention behind these changes, that is, to emphasise the spirit rather than the letter of the Code. We do, however, have concerns about the effect on some of the specific provisions of the Code, as mentioned below.

Section B: The Draft Revised Code

Governance and the Code (page 11)

First paragraph: We agree that corporate governance should facilitate “*efficient, effective and entrepreneurial management*” (although we are not sure that there is much difference in meaning between “*efficient*” and “*effective*” here) but we believe that equal emphasis should be laid on responsible and prudent management, particularly in view of the irresponsible practices which brought about the financial crisis. We would therefore suggest amended wording such as “*effective, entrepreneurial and responsible management*” or “*effective, entrepreneurial and prudent management*”. We think that either form of words would sit well with the remainder of the sentence: “*that can deliver growth in shareholder value over the longer term*”

(our emphasis). (We should add that we welcome this express reference to long-termism.)

Second paragraph: The statement that the description of corporate governance in the original 1992 version of the Code that is quoted here *“is still the classic definition in the context of the Code”* could be read as implying that that description is still adequate, whereas it is clearly not, at least in its narrow view of the role of shareholders:

“The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.”

As stated in paragraph 2 of the Chairman's Preface (page 12), one of the two principal conclusions drawn by the FRC from its review is that *“the impact of shareholders on monitoring the Code could and should be enhanced”*. We suggest that that conclusion should also be reflected in this introductory page.

Chairman's Preface (pages 12 & 13)

Paragraph 1 describes how the financial crisis triggered reappraisal of the governance systems *“which might have alleviated it”*. We suggest that this should instead read *“which might have prevented or alleviated it”*. We think that there is a significant danger in underestimating the extent to which governance failures contributed - or at least *“might have”* contributed - to bringing about the crisis: the more the causative role of such failures is downplayed, the less may be the willingness to take any measures that could help to prevent another disaster.

Many of the factors which are widely held to have played a part in the crisis fall within the sphere of corporate governance. These include board group-think and lack of challenge by non-executive directors, inadequate risk controls, perverse or excessive remuneration structures, conflicts of interest and failures of shareholder oversight.

It may be true that *“Nearly two decades of constructive usage have enhanced the prestige of the Code”* (paragraph 3) and also that the Code's *“comply or explain”* mechanism *“is strongly supported by companies and shareholders and has been widely admired and imitated internationally”* (page 14, paragraph 1). In view, however, of how the two decades in question have ended, both here and abroad, it seems at least arguable that there is less cause for satisfaction than the Consultation Paper seems to suggest.

Paragraph 2 states that the first main conclusion which the FRC drew from its review was that *“much more attention needed to be paid to following the spirit of the Code as well as its letter”*.

Naturally, we agree that it is important to follow the spirit as well as the letter of the Code. As we said in our previous submissions, however, we do not believe that it follows from this that the Code should be less specific. On the contrary, an advantage of the

“*comply or explain*” system is that more explicit guidelines give something more definite to report against, whilst still allowing the flexibility to depart from the recommendations and to explain the reasons for such departures. Indeed, in this sense, there is no obligation to “*follow the letter*” of the Code.

The FRC Final Report (paragraph 2.4) expresses concern that more attention is sometimes paid to the Code’s detailed provisions than to its “*high-level principles*”. That may be so but there is the opposite danger that without reasonably clear supporting guidance the high-level principles can be so high-level as to be effectively out of sight and thus have little effect on behaviour. We refer below to what we think are some potential instances of this in the Code.

As to the FRC’s second principal conclusion, the need to enhance the role of shareholders in monitoring the Code, we very much welcome this. We appreciate that this aspect of governance will mainly fall to be dealt with under the Stewardship Code. We would, however, refer to the point made above regarding the need for the two codes to be mutually supportive.

Section A: Leadership

A.1: The role of the board (page 18)

“*Main Principle*

Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.”

Here again, we welcome the amendment confirming long-termism.

“*Supporting Principles*

.....

All directors are fiduciaries who must act objectively in the best interests of the company and in accordance with their statutory duties.

Footnote: For directors of UK companies, these duties are set out in the (sic) Sections 170 to 179 of the Companies Act 2006”

We also welcome this revised provision, with its references to both fiduciary and statutory duties. We would suggest, however, that this should be taken further by having the Code set out in full the six factors listed in section 172 of the Companies Act to which directors are to have regard (among other matters), i.e.:

“(a) *the likely consequences of any decision in the long term,*

(b) the interests of the company’s employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company”.

We think that there are at least two good reasons for doing this:

Firstly, as already mentioned, it is in the interests of long-only institutional investors that their investee companies (and, indeed, companies in which they are not currently invested) observe the above stakeholder principles, not only to promote the companies' own long-term success but also to avoid harm to other investee companies or to the wider economy.

Secondly, although, as the footnote to this provision makes clear, the statutory duties under the Companies Act apply only to UK companies, there seems to be no reason why the Code should not recommend that non-UK companies also adopt an equivalent stakeholder approach, provided this is not inconsistent with any applicable foreign statutory duties. Here again, the flexibility of the “*comply or explain*” regime should prevent any conflict of duties arising. In this way, just as the Companies Act put the UK in the van of statutory stakeholder reforms, so the Code could claim a similar leading position in principles-based regulation.

B.2 Appointments to the Board (pages 24 & 25)

“Main Principles (sic)

There should be a formal rigorous and transparent procedure for the appointment of new directors to the board.

Supporting Principles

Appointments to the board should be made on merit and against objective criteria that do not inappropriately restrict the talent pool from which candidates will be identified.”

Given the widespread recognition, not least by the Treasury Committee, of the need to promote greater diversity in the boardroom in order to improve the quality of decision-making, we think that the proposed new wording in the Supporting Principle is surprisingly weak. We cannot see how such an oblique and anodyne provision is likely to encourage the cultural change that has to be achieved. Presumably, no boards consider that they are currently being inappropriately restrictive or they would have already

altered their appointment practices. In the absence of any more specific guidance from the Code, it is hard to discern any dynamic for improvement.

We believe that the most practicable and measurable way to make progress in this field is to concentrate on the under-representation of women in UK boardrooms. We mentioned in our submission to the Walker Review that research carried out by The Co-operative Asset Management (as reported in *The Observer* on 23 August 2009) showed that women occupied only 242 out of 2,742 seats on the boards of FTSE 350 companies. We also pointed out that non-executive directorships, being part-time posts, should be especially suited for business and professional women with family commitments, yet the absence of this most frequent justification for the poor representation of women in senior positions has made no apparent difference to this boardroom disparity.

In our first submission to the FRC, we supported the idea (originally floated in a *Financial Times* editorial on 18 May 2009) that the review of the Code offered an opportunity to increase the proportion of women directors and that, in the *FT*'s words,

“there is a strong case for a voluntary time-limited quota. A declaration that at least 30 per cent of board members should be female, applied for the next 10 years would attest to serious intent. Using the “comply or explain” principle, companies with a lower proportion would have to explain if they proposed to fill a vacancy with a man. Chairmen of companies with all-male boards - a fifth of the FTSE 100 - should explain in the annual report why they think this is acceptable”

As we have already said, we do not propose to reopen in this submission ideas which have not been adopted in the FRC Final Report. Even at this late stage, however, we would urge that the Code might at least recommend that the Chairman report on what view he (or even she) takes of the degree of diversity on the board, including the gender balance (if there is one) and what steps (if any) are envisaged in order to improve matters.

We would add that if there is a continued failure on the part of UK public companies to address this problem on a voluntary basis, pressure is likely to grow for a statutory solution, perhaps on the Norwegian model.

B.7 Re-election (page 30)

As we have stated in our previous submissions, we support the annual re-election of all directors, in the interests of maximum accountability to shareholders. We therefore favour the first of the alternative versions of paragraphs B.7.1 and B.7.2.

Paragraph 3.26 of the FRC Final Report observes that anecdotal evidence from companies that already have annual re-elections does not seem to support concerns that these *“might have a destabilising effect or encourage short-termism on the part of the board and shareholders”*.

In any case, even if there were any evidence for such fears, we think that the

fundamental solution to this should lie in a general shift towards a culture of long-termism, perhaps strengthened by legislative changes giving some additional rights and protection to long-only shareholders to help them discharge their ownership role.

Section D; Remuneration (pages 35 - 38)

As will be apparent from the various points concerning remuneration which we made in our earlier submissions, there are many respects in which we find this section disappointing. Here again, we shall not revisit those points in this response. In the light of research recently published, however, we do wish to comment on one matter which we think has serious implications for the general credibility of the Code in relation to remuneration.

The FRC Final Report refers to Sir David Walker's recommendation that *“the terms of reference of the remuneration committee should include responsibility for setting the principles and parameters of remuneration policy on a firm-wide basis”* and notes that the FSA is responsible for addressing this recommendation in respect of banks and other financial institutions (paragraph 3.60). The report goes on to say

“The Code currently states that the committee should recommend and monitor the level and structure of remuneration for senior management and should be sensitive to pay and conditions elsewhere in the group. The FRC shares the view of many respondents that this should be sufficient for non-financial companies. Sir David's recommendation is intended to be applied to organisations where there are a large number of high earners below board level whose activities could have a material impact on the company's risk exposure, and this is not typically the case below senior management level for most companies outside the financial sector” (paragraph 3.61) (our emphasis).

We are not immediately concerned here with whether the FRC is right to draw this distinction between the financial sector and other companies in relation to high earners' pay: our focus is on the wider provision of the Code highlighted above, which is reproduced unchanged as a Supporting Principle under Section D.1 (page 35):

“[The remuneration committee] should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases”.

There is compelling evidence that this provision of the Code is largely a dead letter. The latest such evidence was in a press release dated 1st March 2010 issued on behalf of Incomes Data Services (www.incomesdata.co.uk) which referred to findings in their Executive Compensation Review, February 2010.

These findings show that the average basic fee for non-executive directors in the FTSE 100 has risen by 5.1% over the last year (covering financial year ends from March 2008 to September 2009). This is more than double the going rate of inflation during the period and comes in a year when many workers have had their pay frozen.

There was also a significant growth in fees for chairing committees. In particular, remuneration committee chairmen received an average fee increase of 14.6%. This is not perhaps what is usually understood to be leading by example.

These figures are part of a secular trend which has seen boardroom pay increase far more than either average pay or shareholder value. We think that, as a first small gesture towards restoring credibility, the Code should at least recommend that the remuneration committee should report on quite how it has taken into account employment conditions elsewhere in the group and should publish comparative median figures.