



5 March 2010

Email: codereview@frc.org.uk

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
5th floor, 71-91 Aldwych
London WC2B 4HN

Dear Chris

Financial Reporting Council – Consultation on the Revised UK Corporate Governance Code

IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey showed that at the end of 2008 IMA members managed holdings amounting to 44% of the domestic equity market.

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the Combined Code from the perspective of our members as institutional investors.

IMA supports good governance and the flexibility afforded by the “comply or explain” framework in the UK Corporate Governance Code, as it is to be renamed, and the FRC's conclusion that the Code “remains broadly fit for purpose” and that neither the FRC or the FSA should take on a formal role in monitoring and enforcing it. The consultation proposes a number of helpful amendments and, as per our response to the Second Consultation¹, we welcome Sir David Walker's recommendations for banks and financial

¹ http://www.investmentuk.org/news/research/2009/topic/corporate_governance/imaresponsetofrcpnoneffectivecode191009.pdf

institutions only being implemented in the Code where they are suitable for the listed company sector generally.

We also welcome the focus on behaviour and practical issues. The UK operates high standards of governance but it is now apparent that in the run up to the crisis there were failings in banks' governance and in certain instances investors' scrutiny and challenge. These did not cause the crisis, nor would changes to governance have prevented it, but the experience prompts an examination of the framework to make it more effective. In this context, the Institutional Shareholders' Committee (ISC²), whose members, including IMA, represent virtually all UK institutional investors, published the Code on the Responsibilities of Institutional Investors in November 2009³. We support the FRC's remit being extended to cover this and will be responding to its consultation on the "Stewardship Code" in due course. We are also participating in the review of the ISC's constitution to see if this should be changed to make it more effective.

One of the more controversial aspects on which the consultation specifically invites views is whether to improve board accountability the Code should provide for the annual election of the chairman or of all directors. Our members' views on this vary and to determine where the balance lies, 24 of our members that actively engage on these issues were invited to indicate their preference out of four scenarios. The results are summarised below.

Scenario	Number of members
1. Status quo - one third every year	8
2. Chair and a third of all directors (Walker's Rec for BOFIs)	1
3. One third every year and if the rem. report receives less than 75% then the chair of remuneration committee stands for re-election in the following year (Walker's Rec.)	1
4. All directors	11
Other proposals or undecided	3

There was little support for the chairman standing for re-election annually (scenario 2). This was considered a somewhat "nuclear option" that may only destabilize boards and undermine the chairman's standing. It was also considered inconsistent with the concept of the unitary board in that the board as a whole should be accountable.

Similarly, there was little support for Sir David Walker's recommendation that the chair of the remuneration committee should stand for re-election in the following year if the remuneration report received less than 75% support (scenario 3). One respondent felt this could have perverse implications in that the board may not address remuneration

² The members of the ISC are: the Association of British Insurers; the Association of Investment Companies; the National Association of Pension Funds; and the Investment Management Association.
³

<http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCCode161109.pdf>

issues pending the vote on the committee chair. A number felt it unfair to single out one director and the issue of remuneration.

The majority of our members were divided between all directors standing for re-election annually (scenario 4) and, although not specifically raised in the consultation, retaining the status quo (scenario 1). Those that supported all directors standing for re-election considered that:

- it is more equitable than singling out individual directors;
- it has not caused a problem in those companies that have adopted it;
- it enforces shareholder support for directors, and improves the opportunity for constructive dialogue when concerns arise;
- shareholders would not have to propose resolutions to remove directors, which can be costly and expensive; and
- singling out individual directors may exacerbate existing difficulties in finding chairmen for the audit and remuneration committees.

Those against considered:

- it works against stable and consistent governance, and risks destabilising the board;
- it exacerbates the trend for short termism and that directors should be given a chance to run the company;
- it opens the board to attack from activists and predators;
- it makes it easier for boards to oust NEDs who are doing their job properly and are perceived as awkward;
- it makes it easier to hide unexpected departures;
- operational risks would increase - up to 3,000 resolutions would have to be voted in the UK;
- it is already possible for shareholders to get together and table a resolution to remove a director;
- it is a US solution to a US problem; and
- there is no evidence that it is needed or that the power would be used. Investors can currently vote down one third of all directors and yet have not tended to.

In summary, there is no clear consensus among our members between all directors standing for re-election and retaining the status quo. There are valid arguments both for and against the former and we question whether the FRC has made a case for change. If change is necessary then the original ISC position⁴ of the annual re-election of the chairs of the main committees has widespread support in the industry, although a number consider it runs the risk of dividing the unitary Board.

The consultation also invites views on whether companies should be able to take advantage of the flexibility under the Disclosure and Transparency Rules and make full

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http://www.investmentuk.org/news/research/2009/topic/corporate_governance/ISCpaperonimprovinginstitutionalinvestorsroleingovernance.pdf

corporate governance statements available on their website and include an abbreviated version in the annual report. IMA does not support this as:

- auditors report on particular parts of the accounts and the corporate governance statement and clarify this in their report, if disclosures are made on the web then it may not be clear which aspects have been reviewed/audited and which not;
- investors currently know where to locate the statement; and
- matters may not be reported on the web in the same time frame as in the statutory accounts. Investors need certainty of these disclosures to enable them to exercise their stewardship role.

We set out in the attached annex our observations on the changes proposed to the individual sections and summarise our main concerns below.


- Support the Code clarifying the role of the SID and reflecting Walker's recommendation but the SID should not act as an intermediary for the other directors as this questions the unitary board structure. Code Provision A.4.1. should be amended to address this.
- The independence criteria in Code Provision B.1.1 can sometimes be too strictly applied and the Code should emphasise that these are guidelines. What is important is that the independent non-executives have independence of mind and this cannot necessarily be ensured through the rigid application of criteria.
- The Code should emphasise succession planning more clearly under B.2., through a provision that encourages chairmen to report annually on the process followed and progress made.
- Existing provision B.3.3 is too prescriptive in stating that a full time executive director should not take on more than one non-executive directorship or the chairmanship of a FTSE 100 company, and potentially restricts the supply of skilled people to act as NEDs or chairs of large listed companies. It also ignores the impact of commitments outside the FTSE 100 and that certain individuals may be able to take on a number of sizeable obligations. The main principle should be enough to ensure that board members have sufficient time.
- New provision B.4.2 expects the chairman to agree a personalised approach to training with each director and does not distinguish between executive and non-executive directors. The chairman should not necessarily be responsible for all aspects of an executive director's training in that much of it will relate to his/her executive responsibilities as opposed to their role on the board. We would prefer the Code to offer more flexibility and state "the chairman should agree and regularly review an *appropriate* approach to training and development with each director".
- The provision whereby "the company should offer to major shareholders the opportunity to meet a new non-executive director" should be retained. Although not necessarily always taken up, investors value the opportunity particularly

when there are concerns about board balance and effectiveness. In addition, directors should be offered the opportunity to meet any shareholder and just *major* shareholders

- Investors value external evaluations and consider them beneficial in that they give them some independent assurance as to the operation of a board as a whole. However, whilst the approach proposed is welcome, the fact that the market in external evaluation services is still evolving and the quality variable needs to be recognised. Thus until these are more developed, the Code should not go further than requiring companies to disclose how frequently they undertake external evaluations and the name of the service provider. Moreover, where there is external facilitation, there should not be any other business relationship that could give rise to a conflict of interest.
- For the Code to require disclosure of the basis on which the company generates revenue and makes profit, and its overall financial strategy (new provision C.1.2), muddles the requirements for reporting and governance disclosure. These matters are normally included within the business review required by the Companies Act 2006 and apply to UK incorporated companies that are *quoted* and do not fit with a comply or explain regime.
- Provision C.1.3 on the going concern statement now refers to the obligation to report half-yearly as well as in the annual financial statements. The corporate governance statement is an annual requirement and the Code does not need to refer to the half-yearly financial statement.
- The Turnbull Guidance should be reviewed and whilst many risk reporting requirements are outside the FRC's remit, few companies provide adequate disclosures in paragraph 36 of the Guidance: "the board should summarise the process it has applied in reviewing the effectiveness of the system of internal control. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts". This should be made more explicit.
- In envisaging that the chairman will have a separate dialogue with major shareholders Code provision E.1.1 could bring to question the unitary board structure. To address this, we consider the text should be revised to state: chairman should discuss governance and strategy with major shareholders. *In this context, the chairman and* non-executive directors should be offered the opportunity to attend existing meetings with major shareholders....."

We trust that the above and the attached are self-explanatory but please do contact me if you require any clarification or if you would like to discuss any issues further.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Liz Murrall', with a long horizontal flourish extending to the right.

Liz Murrall, Director – Corporate Governance and Reporting

IMA'S COMMENTS ON PROPOSED CHANGES

IMA sets out below its detailed comments on the proposed changes to the "UK Corporate Governance Code".

SECTION A: LEADERSHIP

FRC proposals:

- New principles on the roles of the chairman and the NEDs.
- The provision on the role of the senior independent director amended to reflect Sir David Walker's recommendation.
- ICSA commissioned to work with others to update the good practice guidance from the 2003 Higgs Report.

IMA supports the proposed restructuring and new sections on Leadership and Effectiveness. Upgrading existing supporting principles which define the responsibilities of NEDs and chairmen to main principles will emphasise the importance of board behaviour and mean that companies with a Premium Listing will be expected to report on how they have been applied. We also support the addition of the text "long-term" to be consistent with the new statutory duties of directors contained in the Companies Act 2006.

We broadly supported Walker's Recommendation on the role of the SID and welcome this being incorporated into the Code but the SID should not act as an intermediary for the other directors - to do so questions the unitary board structure. Also the SID should be more proactive and not only be accessible to shareholders if communication becomes difficult but, if warranted by the concerns, should take soundings from investors and ensure an appropriate response from the whole board. Code Provision A.4.1. should be amended to address this.

Sometimes matters investors raise are not reported to, or discussed with, the full board. We suggested in our response to the Second Consultation⁵, that the Code should clarify that chairmen are responsible for overseeing communications with investors on governance matters and they should be encouraged to inform the whole board of investors' concerns (Section A.3).

SECTION B: EFFECTIVENESS

Board Composition

The FRC proposes revising the principles to stress the need for an appropriate balance of skills, experience and independence and for candidates for board appointments to be drawn from a broad talent pool.

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http://www.investmentuk.org/news/research/2009/topic/corporate_governance/imaresponsetofrcpnoneffectivecode191009.pdf

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For a board to fulfil its role effectively, its members need to have both relevant experience and a broad range of skills and we support this being made a new main principle B.1. Research shows that the independence criteria have not necessarily resulted in a loss of relevant experience or a decline in the number of NEDs. However, we believe the independence criteria in Code Provision B.1.1 can sometimes be applied too strictly. It is important that the non-executives have independence of mind which cannot necessarily be ensured through the rigid application of criteria and the Code should emphasise that these are guidelines.

Lastly, the new supporting principle states that “the board should include a *strong presence* of executive and non-executive directors....”. The phrase “strong presence” should be replaced with “appropriate balance” in that other than the company secretary, a board only comprises the executive and non-executive directors.

Appointments

The FRC proposes amending the Supporting Principles so that appointments do not “inappropriately restrict the talent pool from which candidates will be identified” and “ensure progressive refreshing of the board”.

Presently, investors are not routinely involved in the selection of directors and are rarely consulted by the Nominations Committee – unlike remuneration issues where, since investors were given an advisory vote on the remuneration report, they have been regularly consulted. A number of investors would like to be able to be more proactive in the selection of non-executives and we consider the Code should emphasise succession planning more clearly, through a provision that encourages the chairman to report annually on the process followed and progress made.

Commitment

The FRC proposes a new main principle, previously a supporting principle, on the need for all directors to have sufficient time to perform their responsibilities effectively.

The quality of NEDs' oversight would be enhanced if they devoted more time to their role and we welcome the Code adopting a principles based approach to this and making it a main principle in A.4.4. However, in stating that a full time executive director should not “take on more than one non-executive directorship or the chairmanship of a FTSE 100 company”, the Code is too prescriptive and potentially restricts the supply of skilled people to act as NEDs or chairs of large listed companies. It also ignores the impact of commitments outside the FTSE 100 and that certain individuals may be able to take on a number of sizeable obligations. The main principle should be enough to ensure that boards decide how best they are structured and whether the members have sufficient time and B.3.3. should be deleted.

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Development, information and support

The FRC proposes:

- Former Principle A.5 on development, information and support divided into two principles.
- A new supporting principle on the need for all directors to have knowledge of the company and access to its operations and staff.
- A new provision that the chairman agrees and reviews development requirements with each director.

Currently, induction and training for directors is variable and we support proposals to address this. However, new provision B.4.2 expects the chairman to agree a personalised approach to training with each director and does not distinguish between executive and non-executive directors. A chairman should not necessarily be responsible for all aspects of an executive director's training in that much of it will relate to his/her executive responsibilities as opposed to their role on the board. B.4.2 should offer more flexibility and state "the chairman should agree and regularly review an *appropriate* approach to training and development with each director".

The provision should be retained whereby "the company should offer to major shareholders the opportunity to meet a new non-executive director". Although not necessarily always taken up, investors value the opportunity particularly when there are concerns about board balance and effectiveness. In addition, directors should be offered the opportunity to meet any shareholder and not just *major* shareholders.

Evaluation

The FRC proposes:

- A new provision that board evaluation reviews are externally facilitated at least every three years, and any other connections with the reviewer disclosed (as is the case with remuneration consultants).
- Discussing with providers of board evaluation services and other interested parties what actions might be taken to address the quality of such services and concerns about conflicts of interest.
- Encouraging Chairmen to report personally in their annual statements how the principles in Sections A and B of the new Code relating to the role and effectiveness of the board have been applied.

IMA supports the board undertaking a formal and rigorous evaluation and that there should be external facilitation to introduce greater objectivity and help raise the tone. External evaluations give investors some independent assurance as to the operation of a board as a whole. Thus whilst the approach proposed is welcome, the fact that the market in external evaluation services is still evolving and the quality variable needs to be recognised. External evaluation every three years would be reasonable if there was

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an adequate supply of such services, but until the market and the standards operated are more developed, we do not consider that the Code should go further than requiring companies to disclose how frequently they undertake external evaluations and the name of the service provider. Moreover, where there is external facilitation, there should not be any other business relationship that could give rise to a conflict of interest.

Frequency of director re-election

The FRC is inviting views on two versions of a provision recommending either the annual election of the chairman or of all directors. If the latter option were chosen, the separate provision stating that non-executive directors should be re-elected annually when they served more than nine years would also need to be amended.

The consultation invites views on annual re-election either of the chairman or of all directors. Our observations are set out in the covering letter.

SECTION C: ACCOUNTABILITY

Corporate Reporting

The FRC proposes a new provision stating that companies should disclose their business model and overall financial strategy.

Financial reports and accounts have become increasingly complex and it would be helpful if disclosures were rationalised in that they can be difficult to analyse being spread throughout the report and accounts. We consider the proposal to include a requirement in the Code for directors to state in the annual report "an explanation of the basis on which the company generates revenue and makes profit from its operations (the business model) and its overall financial strategy" following a suggestion from the Treasury Select Committee⁶ could further impair clarity.

These matters are normally included within the business review required by the Companies Act 2006 and apply to UK incorporated companies that are quoted⁷. Including them in the Code muddles the requirements for corporate reporting and governance disclosures. Nor do we consider such disclosure fits with a comply or explain regime. As such, this provision should be deleted.

⁶ The Treasury Select Committee commented that "at the moment, financial reports can be used for finding specific bits of information, so are useful for reference, but they do not tell the reader much of a story...A useful approach would be to insist on all listed firms setting out their business model in a short business review, in clear jargon-free English, to detail how the firm has made (or lost) its money and what the main future risks are judged to be".

⁷ In accordance with the Act, a quoted company is one whose equity share capital:

- is included in the Official List in accordance with FSMA;
- is officially listed in an EEA Member State; or
- is admitted to dealing on either the New York Stock Exchange or Nasdaq.

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In addition, the provision on the going concern statement now refers to the obligation to report half-yearly as well as the annual financial statements. The corporate governance statement is an annual requirement and the Code should not refer to the half-yearly financial statement.

Risk management and internal control

The FRC proposes:

- The principle on internal control is amended to state the board's responsibility for defining the company's risk appetite and tolerance and maintaining a sound risk management system.
- A new provision stating that the board should satisfy itself that appropriate systems are in place to enable it to identify, assess and manage key risks.
- A limited review of the Turnbull Guidance during 2010, on which there will be separate consultation.

IMA agrees that the Code should apply to all UK listed companies and should not contain special provisions for financial institutions and that as regards risk management, the same systemic issues do not apply to the listed sector generally. Nevertheless we support the unitary board and its responsibility for overseeing risk management and for setting the company's risk appetite being made more explicit, and a new provision that the board "should satisfy itself that appropriate systems are in place to identify, evaluate and manage the significant risks faced by the company".

The Turnbull Guidance was last amended in 2005 and, whilst we believe it remains sound, it is appropriate that it should now be reviewed in that this likely to prompt companies to examine the effectiveness of their internal controls to see if they need to be modified and updated. We concur with the view in the Final Report that the current risk reporting by many companies is largely unsatisfactory. Whilst many of these reporting requirements are outside the FRC's remit, few companies provide adequate disclosure in relation to paragraph 36 of the Turnbull Guidance: "the board should summarise the process it has applied in reviewing the effectiveness of the system of internal control. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts". We believe this should be made more explicit in the Code.

SECTION D: REMUNERATION

The FRC's proposes:

- A new supporting principle on the need to align performance-related remuneration to the long-term success of the company, with a similar reference to be added in Schedule A.

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- References to the Schedule added on: the link between remuneration and risk policy; the use of non financial metrics when measuring performance; and arrangements for reclaiming variable components in certain circumstances.
- The provisions on remuneration of NEDs to clarify that all forms of performance-related remuneration are discouraged, not just share options.
- To keep under review whether future changes to the UK Corporate Governance Code or its associated guidance would be appropriate in respect of the code of practice for remuneration.

There is widespread agreement on the need to reform remuneration structures in financial institutions and there are a number of initiatives afoot to address them. We agree that the Code should not seek to become more prescriptive in this area in that the same systemic issues do not apply to the listed sector generally. The Code's provisions as regards directors, when independence is an issue, work well but we support the changes to align the performance related elements with the interests of shareholders and the long term success of the company and that this should only relate to the executive directors.

Furthermore, currently in the UK investors can only engage with remuneration issues at board level and even then only have a non-binding advisory vote on the remuneration report. Although the board should not necessarily be responsible for the remuneration of individual employees, as stated in our response to the Second Consultation, we believe it should discuss remuneration policies as a whole and take responsibility for them and that there should be more transparency to investors.

SECTION E: COMMUNICATION

The FRC proposes:

- To take responsibility for a Stewardship Code for institutional investors, subject to consultation designed to ensure it can be operated effectively.
- Section E of the Combined Code is deleted, subject to satisfactory progress on the Stewardship Code.
- Considering options for producing practical guidance on good practice engagement between companies and investors.
- Clarifying the wording in the previous Section D of the Code where necessary.

IMA welcomes the FRC's proposals to delete Section E in that we did not consider a Code for listed companies was the right place for requirements that seek to encourage institutional investors to enter into a dialogue with companies. Nor was it clear how it could be ensured such obligations were effected in practice in that few fund managers are listed in their own right in that they tend to be subsidiaries of banks or insurance companies, independent entities, or even partnerships. We also had concerns that certain of the provisions in Section E were not always practical.

Code provision E.1.1 envisages that the chairman will have a separate dialogue with major shareholders on governance and strategy and we are concerned that this

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questions the unitary board structure. To address this, we consider the text should be revised to state: chairman should discuss governance and strategy with major shareholders. *In this context, the chairman and the non-executive directors should be offered the opportunity to attend existing meetings with major shareholders....."*

In addition, the supporting principle to E.1 states that "the chairman should ensure that all directors understand their major shareholders. Chairmen cannot necessarily ensure they do and we consider this should read "the chairman should *seek to ensure*".

If the FRC decides to produce practical guidance and support on engagement, we would welcome the opportunity of working with it to ensure that any publication that results is practical from the perspective of the investor community.