

5 March 2010

Mr Chris Hodge
Corporate Governance Unit
Financial Reporting Council
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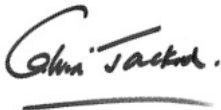
Dear Mr Hodge,

**Consultation on the Revised UK
Corporate Governance Code**

I enclose Towers Watson's comments on the proposed revisions to the Code.

Please contact me (020 7227 2329 / calvin.jackson@towerswatson.com) if you wish to discuss our comments. Alternatively, my colleagues Katharine Turner (020 7170 2823 / katharine.turner@towerswatson.com), Vicky Wright (020 7598 2898 / vicky.wright@towerswatson.com) and Tamsin Sridhara (020 7170 2914 / tamsin.sridhara@towerswatson.com) would be happy to assist.

Yours sincerely



C L R Jackson

Financial Reporting Council**Towers Watson's Consultation Comments on the Revised UK Corporate Governance Code*****Introduction***

- 1 This paper contains Towers Watson's response to the FRC's call for consultation comments on its proposed revisions to the Code. Given our role as advisers to companies and to remuneration committees on executive remuneration, our comments are solely on the proposed changes regarding remuneration aspects. We welcome the fact that the FRC has continued to avoid a more prescriptive approach to remuneration.

Summary of aspects in respect of which we comment

- 2 We comment below on each of the following in turn:
 - Proposed Revision 1: Performance-related remuneration should promote the long-term success of the company (Section D: Remuneration – Supporting Principle and Schedule A)
 - Proposed Revision 2: For long-term incentives there should be challenging performance criteria, including non-financial metrics. Remuneration incentives should be compatible with risk policies and systems, and criteria for paying bonuses should be risk adjusted (Schedule A)
 - Proposed Revision 3: Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement and misconduct (Schedule A)
 - Proposed Revision 4: Remuneration for non-executive directors should not include share options or other performance-related elements (Section D: Remuneration. D.1.3).

Our comments

- 3 Proposed Revision 1 (Performance-related remuneration should promote long-term success). The emphasis on 'long-term success' seems entirely uncontroversial in our view. We take the view though that there are various ways of achieving this. For some companies, longer-term incentive plans which seek to measure longer-term performance may be appropriate. For others, it may be in shareholders' interests to place greater emphasis on performance over a year on the basis that remuneration is then deferred and perhaps also subject to claw-back. All the more reason, therefore, for the FRC to avoid prescription.
- 4 Proposed Revision 2 (Inclusion of non-financial metrics in long-term incentives, compatibility of incentives with risk policies and systems, and criteria for paying bonuses should be risk adjusted). The proposed revisions also include the removal of wording to the effect that consideration should be given to the use of relative performance measures such as Total Shareholder Return.

We endorse the inclusion of the provision that 'remuneration incentives should be compatible with risk policies and systems'. We see this as a valuable prompt to Remuneration Committees (working with the Audit or Risk Committee) to consider how incentive arrangements interact with risks within the organisation and how any risks inherent in the incentive arrangements themselves ought to be managed.

However companies have multiple risks (for example, operational, financial, compliance and people) and the risk profile of each company and its incentive arrangements can vary significantly. For this reason, we do not think it is appropriate for the Code to prescribe *how* the Remuneration Committee should manage any risks associated with its incentive arrangements.

The proposed revision to the Code that 'criteria for paying bonuses should be risk adjusted' appears to us to combine vagueness with prescription. This is particularly unhelpful given that the wording also says 'should be', rather than 'consideration should be given to'.

In our view, there is a strong argument that in some instances (including, but not necessarily exclusively, financial services) companies should give consideration to using risk adjusted financial measures perhaps in respect of both annual bonuses and long-term incentive arrangements, but we consider the case not proven in respect of all UK companies generally in the context of executive directors' remuneration.

We believe therefore that it would be more helpful for the specific reference to risk adjusted bonuses to be removed from the Code but for the provision that 'remuneration incentives should be compatible with the company's risk policies and systems' to remain, supported by the proposed revision under Section C: Accountability that 'the board is responsible for defining the company's risk appetite and tolerance and should maintain a sound system of internal management and controls'.

We endorse the FRC's inclusion of non-financial metrics in the revised Code – our view is that these can be very quantitative/demanding and can appropriately set the scene for 'good corporate citizenship'. However, we believe that the wording 'should' is again too prescriptive - particularly as it is proposed to be applicable to both short and long-term incentive schemes. Our view is that the wording 'consideration should be given to' would be more appropriate for the revised Code.

We welcome the proposed removal of the wording from the Code on relative performance measures and TSR. Many UK-listed companies continue to use relative TSR but market practice has changed in recent years. Relative TSR, where it is used, is often used as one of two separately applied measures. Some companies have dropped relative TSR completely, in favour of internal business performance measures. Our 2006 research 'Relative Total Shareholder Return – The Best Measure of Executive Performance?' showed that the way the relative TSR measure is used in the UK, including the vesting schedules arising from it use, results in a flawed performance metric – with a strong tendency to produce 'unfair outcomes' for participants and/or shareholders.

For these reasons, we endorse the proposed deletion. As an aside, UK institutional shareholders currently have mixed views on the types of measures that are appropriate for long-term incentive plans. Some institutional shareholders are strong advocates of the use of relative TSR and vote against new long-term incentive plans unless TSR is incorporated; others favour the use of business performance measures.

- 5 Proposed Revision 3 (Claw-back provisions). We believe that provisions within rules of incentive arrangements to reclaim remuneration in the case of the misstatement of financial information could provide reassurance to shareholders.

Our experience to date is that UK publicly-listed companies are taking differing stances on the approach to 'claw-back' in terms of the coverage i.e. the seniority/reporting level at which claw-back provisions will apply, the elements of pay and the circumstances in which claw-back will be invoked. Our view is that it is not possible for the FRC to be more specific on its proposed revision and it would probably be a mistake for it to do so – because of the differing types of company/business.

We note that the FRC has gone further than the European Commission's recommendation in this area by adding 'misconduct' to 'misstatement'. However because the draft Code refers to 'misstatement and misconduct', this is leading some to argue that there has to be a causal link for a reclaim to occur (i.e. amounts can only be reclaimed from an executive where there has been personal misconduct leading to the misstatement). If this is not the intention, we suggest that it might be clearer to refer to 'misstatement and/ or misconduct'.

Alternatively on the 'least prescription' principle, the Code could be drafted to invite consideration of reclaiming variable elements of remuneration 'in exceptional circumstances' (with no mention of misstatement and misconduct) and leave boards to decide what these might be.

- 6 Proposed Revision 4 (Remuneration for non-executive directors). We endorse the FRC's approach in this regard. This accord with the UK norm that non-executive directors should not participate in any form of incentive compensation. We suggest that for reasons of clarity the current references to 'share option schemes' should be broadened to 'share option and other long-term incentive schemes'.
- 7 Please do contact us if you would like to discuss any aspects of our submission.

Towers Watson
5 March 2010