



**FINANCIAL REPORTING COUNCIL**

**DEVELOPMENTS IN CORPORATE GOVERNANCE 2011**

**THE IMPACT AND IMPLEMENTATION OF THE UK CORPORATE  
GOVERNANCE AND STEWARDSHIP CODES**

**DECEMBER 2011**

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## Introduction

The UK has a long tradition of pioneering developments in corporate governance and a strong track record of driving up standards. Our approach allows for both innovation and the spreading of best practice through the market. The Financial Reporting Council now has responsibility for two 'comply or explain' codes: the UK Corporate Governance Code for listed companies, last revised in 2010, and the new Stewardship Code for investors, launched in the same year. This is the first in what is intended to be an annual series of reports on their effect.

This assessment draws on new and publicly available research, a study of annual reports and Stewardship Code statements, and many conversations with companies, investors and other interested parties, including a 'One Year On' event for signatories to the Stewardship Code. The FRC would like to thank everyone who has directly or indirectly contributed to this report.

Previous experience suggests that the full impact of the changes made in 2010 will only be felt in a few years but, overall, the response of companies and investors to the challenge laid down in the two codes has been positive, and provides a platform for further progress.

Although compliance should not be the only test of their effectiveness, the strong take up by companies of the new governance provisions – with, for example, 80 per cent of FTSE 350 companies already adopting annual re-election of all directors - is encouraging. There has been an increase in the number of companies undergoing independent board evaluation.

Meanwhile, the sign-up to the Stewardship Code by over 230 asset managers, asset owners and service providers in its eighteen months of life was beyond our expectations. Signing up to the Code is only the first step: the objective is better engagement, and we are at too early a stage to declare victory on that. But the FRC believes that rapid sign-up indicates a real commitment to making the code-based approach work effectively, and the dynamic interaction between code-setting and response demonstrates the advantages this has over slower-changing law-based systems.

This interaction has, over the years, reinforced international recognition that standards of governance in the UK are high. But there are still, of course, plenty of risks to that reputation, and there will always be room for improvement.

The quality of explanations in annual reports varies, and we will be looking at this more closely over the coming year.

The quality of engagement between companies and shareholders remains variable. Investors have raised concerns that some companies do not respond appropriately to significant negative votes at AGMs, while companies complain that they are given too little notice of these.

Remuneration will be a highly sensitive issue over the coming year, with the onus on both boards and shareholders to demonstrate a responsible approach.

There are some big challenges here, not least what is called in the US the “pig in the python” problem – the fact that so much of engagement activity is concentrated into the few months between companies’ annual reports and annual general meetings, most of which take place at the same time of year. However, there are signs of a more proactive approach on both sides, and a determination to address this problem through on-going engagement at other times of year.

There is a continuing need for companies to demonstrate that they are acting in the interests of their shareholders and other stakeholders, and for investors to demonstrate that they are acting in the interests of their clients and beneficiaries. Some in Europe see boards and asset managers as part of the problem rather than part of the solution, and would therefore wish to restrict their freedom of action by replacing a ‘comply or explain’ regime with hard law. We believe that usurping the responsibilities of boards and the rights of shareholders, and transferring these to regulators, would only serve to slow the flow of equity capital to the region at a time when it is so clearly needed to support economic growth.

But the onus is on companies and shareholders to continue demonstrating that a code-based approach can change behaviour and drive up standards. At the FRC, we are proposing to make only a limited number of changes to the codes at their next revision, which subject to consultation will take effect from 1<sup>st</sup> October 2012. As we have already announced, these changes will include requirements for companies to articulate their policies for board diversity, and we have urged them to proceed with this as soon as possible.

These changes will be specifically targeted at strengthening the current framework rather than changing it, and our aim will be then to leave both codes unchanged for a further two years. Our energies, over this period, will be devoted to helping all participants understand where the weaknesses in execution lie, and helping to facilitate improvement.

**Baroness Hogg**  
**Chairman, Financial Reporting Council**

## Overview

The UK Corporate Governance Code (formerly the Combined Code) was updated in June 2010 following an extensive review carried out by the FRC in parallel with Sir David Walker's review of corporate governance in the financial sector. The following month the FRC published the first Stewardship Code for institutional investors.

Implementation of the UK Corporate Governance Code by listed companies has generally been good. Data shows high rates of compliance with most provisions of the Code by companies of all sizes. There has been an encouraging response to the changes made to the Code in 2010. Eighty per cent of FTSE 350 companies put all their directors up for re-election this year; more companies are bringing in external advisers to assist with evaluation of the board's effectiveness; and many company chairmen and committee chairs now make a personal statement in the annual report. And it was clear from a series of meetings with directors and others held earlier in the year that boards are now paying considerable attention to understanding and overseeing the main risks facing the business, as required by the Code.

Where companies do deviate from the Code, the majority only do so in respect of one or two of its 48 provisions. Most companies set out clearly their reasons for departing from the Code and the arrangements that they have put in place to provide any necessary safeguards, but unfortunately others continue to give only perfunctory explanations or occasionally no explanation at all. The FRC is currently holding discussions with companies and investors to identify the type of information that should be provided if explanations are to be useful to shareholders, and what steps are needed to ensure these standards are consistently applied. The FRC would also encourage investors to highlight examples of good and bad quality explanations.

Reporting on other aspects of governance is similarly variable. There has been some improvement in the overall standard of corporate reporting this year, with many reports providing real insights into how the company is run. In its annual report, published in September 2011, the Financial Reporting Review Panel found the general quality of corporate reporting to be good and was particularly pleased to note widespread improvement in the description of principal risks and uncertainties and of the actions taken by boards to mitigate their effects.

However some poor practice is still seen and the FRC believes there is need for continued improvement. In particular, reporting by audit committees is often unenlightening. The FRC will be consulting in early 2012 on proposals to amend the UK Corporate Governance Code and the related guidance on audit committees to stimulate more informative reporting.

In October 2011 the FRC announced that it would amend the Code to require companies to disclose and report annually on their policy on boardroom diversity, including gender, as recommended by Lord Davies. Although these amendments will not formally take effect until 1<sup>st</sup> October 2012 the FRC encourages all companies to disclose this information voluntarily in their next annual reports, and will report on the extent to which they have done so in its next monitoring report.

Turning to the Stewardship Code, it is of course early days - it has only been in operation for eighteen months, in contrast to the UK Corporate Governance Code, which will celebrate its twentieth anniversary in 2012 - and it will take time for its full impact to be felt.

The initial response from the investment community has been positive. The number of asset managers that committed to the Code voluntarily before being required to disclose their policy by the FSA in December 2010 exceeded the FRC's original expectations, and that momentum has been maintained since. As of December 2011 there were 234 signatories to the Code. The majority are asset managers but there are also a significant number of asset owners and service providers such as investment consultants and proxy voting agencies.

The FRC is pleased that so many asset owners and their advisers have given their support. In the long run, the Stewardship Code will only succeed in bringing about better stewardship of investee companies and greater value and accountability to the ultimate beneficiaries if owners demand it of their investment managers. Owners such as pension funds play a critical role in ensuring that money invested on behalf of their beneficiaries is properly looked after.

In feedback we have heard from a number of investors that the Stewardship Code is not as clear as it should be on the role of owners, and also that a better articulation of what is meant by stewardship will help in the task of promoting the Code with owners and with overseas investors, especially those with large stakes in the UK equity market.

The FRC intends to consult on proposals to amend the Code to clarify these issues. It may also consult on a limited number of other changes, primarily to clarify how aspects of the Code are intended to be applied. Consultation on these proposals will be carried out in parallel with consultation on proposed changes to the UK Corporate Governance Code, and both updated codes will come into effect from 1<sup>st</sup> October 2012.

The quality of reporting against the Stewardship Code, as with the UK Corporate Governance Code, is variable. There are many statements from signatories that set out clearly how they approach stewardship in practice, but there are others that are generic and uninformative. The FRC would encourage all investors to apply the same standards to their own reporting that they expect of companies.

Particularly in the case of asset managers, reporting needs to be sufficiently developed to help inform asset owners' decisions on awarding mandates. This requires a clear description of how each principle is being applied, with an explanation if not. Areas where the FRC considers there is room for improvement include reporting on how conflicts of interests are managed and the use made of proxy voting agencies.

As to whether the Stewardship Code has yet had an impact on the quality of engagement, there are mixed signals. Many companies the FRC spoke to said that they had not seen any notable increase in the number of investors wishing to engage with them - particularly outside the upper reaches of the FTSE Index - but others said that where engagement took place the quality had improved, with investors showing an interest in a wider range of governance, capital raising and strategic issues. This differing experience is perhaps to be expected when asset managers have holdings in an average of 450 companies in the UK alone, and asset owners almost as many.

Companies have as much responsibility as investors to make engagement work. Anecdotally some companies appear to be making more effort to engage, with more chairmen taking the initiative to meet major shareholders. Yet criticism has also been made of other companies that are perceived as being less responsive to shareholder concerns, including when there has been a significant minority vote against the remuneration report. The FRC considers such a reaction short-sighted. In the light of the growing concern about levels of executive pay, remuneration is an issue on which companies should take seriously any significant level of shareholder concern, and engage closely with them.

The recent influx of companies with concentrated ownership structures to the London market raises obvious challenges to a 'comply or explain' approach designed for a market where dispersed ownership is standard, and concerns have been expressed about the potential for damage to the reputation of the market. The FRC welcomes the FTSE Group's consultation on increasing the minimum free float required for UK incorporated companies to be indexed, but considers there is a need to look more broadly at the rights of minority shareholders in companies with dominant shareholders when listing on the market or applying for inclusion in the Index.

Looking ahead, there is the prospect of considerable further change to the regulatory framework in 2012 and beyond. The FRC has already signalled changes to the UK Corporate Governance Code in relation to diversity and audit committees, and changes to the "going concern" statement are being considered following the initial recommendations of the Sharman Panel of Inquiry. The FRC will also consult on limited changes to the Stewardship Code, and on updates to its guidance notes on audit committees and risk management and internal control.

The Department of Business, Innovation and Skills has recently consulted on proposals to overhaul reporting requirements on companies, and has sought views on whether the processes by which executive remuneration is set need to be changed. In addition, the Department has commissioned Professor John Kay to assess the effect of UK equity markets on the competitiveness of UK business. The next steps on all of these reviews are expected to be announced in the first half of 2012.

Similar discussions are also taking place at European level, where the European Commission has been very active. It remains to be seen what if any action will be taken as a result of its Green Paper on the corporate governance framework for listed companies, which looked at the rights and responsibilities of shareholders as well as corporate governance structures within companies. The outcomes of this review are expected in the second half of 2012.

There is some scepticism in Brussels about the effectiveness of the 'comply or explain' approach to corporate governance, and the willingness and ability of shareholders to hold boards to account. Some in the UK may feel that its track record should speak for itself, but in the current environment there is a need to demonstrate that 'comply or explain' continues to deliver strong and effective governance, and is taken seriously by companies and investors. Failure to do so could result in an approach which could be more prescriptive about the way companies organise themselves, and could give more power to regulators at the expense of shareholders.

## **The Operating Environment**

This section summarises the main changes in the regulatory framework for the corporate governance of UK listed companies since the UK Corporate Governance Code and Stewardship Code were published in mid-2010, and further developments that are anticipated in the next twelve months. It also comments briefly on some of the major developments in the operation and structure of the UK market.

### **The regulatory framework**

2011 has seen several regulatory reviews initiated, many of which are still underway. The cumulative impact on companies and investors and the extent to which they will result in a shift away from the UK's existing approach to corporate governance is as yet unclear.

The FRC continues to believe that the 'comply or explain' approach, backed up by reporting obligations on companies and effective rights for investors, is the right model for the UK. It has a strong track record which has resulted in governance standards and systems that are more advanced than in most other markets, and are often drawn on by other markets when developing their own governance standards.

The FRC therefore believes that the right approach is to build on the strengths of 'comply or explain' and to reinforce it where necessary. That is why the FRC has made, and is proposing, some targeted amendments to the two codes and the associated guidance.

In March 2011 the FRC published 'Guidance on Board Effectiveness', which replaced the 'Higgs Guidance' and provides guidance on the role of the board and directors, succession planning, decision making and board evaluation.

In the same month the FRC began consultation on whether to amend the UK Corporate Governance Code to require companies to disclose their policy on boardroom diversity and to report annually on how it was being implemented, as recommended by Lord Davies in his report on women on boards. The FRC announced in October 2011 that it will introduce such a requirement, but that it will not come into effect until 1<sup>st</sup> October 2012.

One reason for deferring the introduction of this new requirement was to allow time to consult on other proposed changes to the Code. In September 2011 the FRC announced that it intends to consult on proposals to extend the remit of, and reporting by, the audit committee, and to recommend that the external audit should be put out to tender at least every ten years. The FRC announced at the same time that it intends to review its guidance on audit committees and risk management and internal control during 2012.

It is also possible that the FRC will consult on changes to the "going concern" provision in the Code, depending on the outcome of the current inquiry being led by Lord Sharman. The final recommendations of this inquiry are expected in February 2012.

Consultation on these additional changes to the UK Corporate Governance Code is expected to begin in March or April 2012. Consultation on a limited number of changes to the Stewardship Code will be carried out in parallel, with the intention that both updated codes will take effect from 1<sup>st</sup> October 2012. The timing of the proposed revisions to the guidance on audit committees and risk management and internal control has not been finalised, but will be confirmed as soon as possible.

The other reason for deferring formal implementation of the new UK Corporate Governance Code provision on boardroom diversity was in order to bring it into effect at the same time as proposed Government regulations that would require companies to disclose the percentage of women on the board, at senior management level and throughout the company. These proposals are among a package of measures to reform corporate reporting on which the Department of Business, Innovation and Skills has consulted, and which it currently intends should be introduced on 1<sup>st</sup> October 2012.

The Department simultaneously sought views on a series of ideas for improving the process by which executive remuneration is set, and has commissioned Professor John Kay to assess the effect of UK equity markets on the competitiveness of UK business. The recommendations of both of these reviews are expected to be announced in the first half of 2012.

Similar discussions are also taking place at European level, where the European Commission has been very active. In July 2011 the Commission published a draft revised text of the Capital Requirements Directive which includes proposed mandatory corporate governance requirements for financial services companies and a role for the European Banking Authority in setting regulatory standards on different aspects of governance. In November the Commission published a draft Audit Regulation which sets out new requirements on the composition and functions of audit committees. Proposed revisions to other European legislation, including the Transparency and Market Abuse Directives, may also have an impact, as might the Commission's Communication on corporate social responsibility, published in September 2011.

Still awaited is the outcome of the Green Paper on the corporate governance framework for listed companies, which the Commission issued in the first half of 2010 and which sought views about the rights and responsibilities of shareholders as well as corporate governance structures within companies. Any actions to be taken as a result of this review are now expected to be announced in the second half of 2012, alongside the outcomes of a consultation on company law reform expected to begin in January 2012.

The FRC recognises that both companies and investors would benefit from operating within a stable regulatory framework. It is not clear at this stage whether these various reviews will lead to a need to consider further revisions to the UK Corporate Governance Code and/or the Stewardship Code, or changes to UK law. However it is the FRC's intention that after the codes are updated in October 2012, unless there are any unforeseen circumstances, no further changes to either code would be considered until 2014 at the earliest.

## **The structure and functioning of the market**

One of the points the FRC has been making in discussions with the European Commission and MEPs is that - while all regulatory frameworks need a combination of legal duties on companies and directors, shareholder rights and 'comply or explain' codes - the right combination will depend on a number of national considerations, including the structure and functioning of the market in each country. If the structure of the national market changes, that balance may need to be adjusted.

There have been significant changes in patterns of ownership in the UK market since the Cadbury Code was first published nearly twenty years ago. At that time UK pension funds and insurance companies - investors with a naturally long-term perspective - owned nearly half of the London market. For a variety of reasons, including as a consequence of regulatory requirements, they now own a much smaller, though still significant, share of the market. During the same period investment from outside the UK has increased significantly, with overseas investors now holding over 40 per cent of the market<sup>1</sup>.

Changes in ownership may have contributed to perceptions that equity investors overall take a more short-term approach to their investments. Whatever other steps may be needed to address short-termism, the FRC believes that it is necessary to rebuild a critical mass of long-term investors that are willing and able to exercise their stewardship responsibilities and hold company boards to account. That is one of the objectives of the Stewardship Code, although the Code itself cannot remove all the obstacles to achieving that objective.

In order to identify and encourage long-term investors, it is first necessary to have a much better understanding of who owns UK equities. For this reason the FRC is supporting research by Cass Business School aimed at identifying patterns of ownership in more detail than is currently available, and it is hoped that there will be more information available during the course of 2012.

The relative influence of different classes of investors is likely to continue to change in the future, so there will be an on-going need to track trends. For example, the shift from defined benefit to defined contribution pension schemes is likely to have a significant impact. NEST can be expected to emerge as a major player and the FRC welcomes its commitment to the Stewardship Code.

The changes in the types of investor holding equities in the UK have been happening over a prolonged period. A more recent development is the influx of companies with concentrated ownership structures to the London market. While there is no presumption that such companies do not act in the interest of all shareholders, closely controlled companies raise obvious challenges to a 'comply or explain' approach designed for a market where dispersed ownership is standard. As a result, concerns have been expressed about the potential for damage to the reputation of the UK market.

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<sup>1</sup> 'Share Ownership Survey 2008'; Office of National Statistics; January 2010

The FRC welcomes the FTSE Group's consultation on increasing its minimum free float requirement for UK incorporated companies, but considers there is a need to look more broadly at the rights of minority shareholders in companies with dominant shareholders when listing on the market or applying for inclusion in the Index. There is also a particular onus on all directors of such companies to ensure that they carry out their legal duty under the Companies Act 2006 to act in a way "most likely to promote the success of the company for the benefit of the members as a whole".

## The Governance of Listed Companies

This section of the report looks at how the 2010 UK Corporate Governance Code has been implemented, with a particular focus on the new principles and provisions introduced in 2010. Data shows that rates of compliance with the Code remain high among companies of all sizes, and the FRC has been encouraged by the way companies have responded to the revised Code. In the FRC's view it demonstrates a continuing commitment to improving standards of governance and to the code-based approach.

### Compliance with the UK Corporate Governance Code

The annual survey of compliance by FTSE 350 companies carried out by Grant Thornton<sup>2</sup> shows that 50 per cent of companies claim full compliance with the Code. Of the remainder, 80 per cent comply with all but one or two of the Code's 48 provisions.

Data compiled by Manifest<sup>3</sup> on behalf of the FRC shows that compliance levels among companies on the FTSE Small Cap and Fledgling indices are generally consistent with those of larger companies, as these examples show.

#### Compliance Rates

Code requirement	FTSE 350	Smaller companies
Separate Chairman and CEO	96%	98%
Minimum independent NEDs	80%	99%
Minimum audit committee composition	92%	89%
Recent and relevant financial experience on audit committee	93%	94%
Minimum remuneration committee composition	91%	82%
Minimum nomination committee composition	94%	95%

Sources: Grant Thornton and Manifest - The Proxy Voting Agency

*Note: There are different requirements for FTSE 350 and smaller companies regarding the minimum number of independent directors and the minimum requirements for board and committee composition (for example, for FTSE 350 companies independent directors must make up at least half the board, while smaller companies are only expected to have at least two independent directors).*

<sup>2</sup> 'Corporate Governance Review 2011'; Grant Thornton; November 2011.

<sup>3</sup> Manifest looked at a sample of 337 companies, 264 on the Small Cap Index and 73 on the Fledgling Index.

Where companies do deviate from the Code, it is of course necessary for them to give a clear explanation of why they have done so. The quality of explanations is considered in the 'Reporting' section of this report.

## **Board composition**

### *Diversity*

In 2010 the UK Corporate Governance Code was amended to encourage companies to have due regard for the benefits of diversity, including gender, on the board when considering new appointments. Since then Lord Davies' report, "Women on Boards", has increased the focus on diversity, and in October 2011 the FRC announced that further changes will be made to the Code next year to require all companies to explain their policy on boardroom diversity and to report on how it is being implemented. Current levels of reporting on diversity are covered in the 'Reporting' section of this report.

In the six months after the Davies report was published, 22 per cent of directors appointed to FTSE 100 companies and 18 per cent of directors appointed to FTSE 250 companies were women, many of whom had no previous experience on FTSE 350 boards. This means that women now hold 14 per cent of FTSE 100 directorships and nine per cent of FTSE 250 directorships<sup>4</sup>.

While the Davies report focused on FTSE 350 companies, the Code requirements will apply to all companies with a Premium listing. At present, just fewer than eight per cent of directors of FTSE Small Cap and Fledgling companies are women<sup>5</sup>.

Gender is only one aspect of diversity, and companies should not neglect other attributes and experience that can improve the board's ability to act effectively. For large companies operating in global markets, for example, international experience will be an important consideration. The number of directors of FTSE 350 companies that are not UK nationals has increased significantly in the last six years, from 15 per cent in 2005 to 22 per cent in 2011<sup>6</sup>.

Other research shows that the boards of the largest UK companies include a higher percentage of directors with current or previous CEO experience than most of their European counterparts<sup>7</sup>. This raises an interesting question about whether having so many directors with similar experience might increase the risk of "group think".

### *Independence*

As during previous reviews of the Code, concerns have been raised with the FRC by companies that the independence criteria in Section B.1.1 (and in particular the criterion on length of tenure) are applied too mechanistically by some investors, and that non-executive directors are being required to stand down as a result.

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<sup>4</sup> 'Women on Boards: Six Month Monitoring Report'; Cranfield University School of Management; October 2011.

<sup>5</sup> Manifest - The Proxy Voting Agency, on behalf of the FRC.

<sup>6</sup> 'Board Structure and Non-Executive Directors' Fees'; Deloitte; September 2011.

<sup>7</sup> 'Challenging Board Performance: European Corporate Governance Report 2011'; Heidrick & Struggles; 2011.

The available evidence suggests this appears not to be the case to any significant extent. 28 per cent of FTSE 350 companies have at least one non-executive director who is classified as independent despite not meeting the Code criteria, and eight per cent of non-executive directors in these companies have served more than nine years. This figure is largely unchanged in the last five years<sup>8</sup>. Among smaller companies, 51 per cent of companies have at least one non-executive director who has served more than nine years, although this falls to 41 per cent if investment trusts – whose boards are typically made up solely of non-executive directors – are excluded. Again, these figures have not changed significantly since 2006<sup>9</sup>.

### *The supply of non-executive directors*

Some smaller companies have raised concerns about the supply of good quality non-executive directors, often linking this to a perceived greater unwillingness on the part of larger companies to allow executive directors to take on external roles.

There is some evidence to support this perception, with the number of finance directors in the 150 largest companies holding non-executive positions having fallen from 41 per cent to 27 per cent over the last twelve months<sup>10</sup>. While partly attributed to the turnover of finance directors in these companies, this trend is perhaps understandable in the current economic climate and with the time commitment expected of both finance directors and non-executive directors, particularly when the latter chairs the audit or remuneration committee. The FRC considers it reinforces the need for companies of all sizes to look beyond the “usual suspects” when seeking suitable candidates for non-executive directors, in order to enhance the diversity and effectiveness of the board.

### *The balance of executive and non-executive directors*

When the FRC reviewed the Code in 2009, some commentators raised concerns that the recommendation that independent non-executive directors should comprise at least half of the board of FTSE 350 companies was contributing to a reduced executive presence on boards. The FRC said that it would keep this under review. The latest data suggests that there has been no change since 2009 in the average number of executive directors, which remains at three directors<sup>11</sup>.

## **Board evaluation**

In the 2010 Code, the FRC recommended for the first time that the evaluation of the boards of FTSE 350 companies should be externally facilitated at least every three years. While only one year into the first three year cycle, early indications are encouraging and suggest that the majority of companies will undertake such a review during those three years.

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<sup>8</sup> ‘Board Structure and Non-Executive Directors’ Fees’; Deloitte; September 2011

<sup>9</sup> Manifest - The Proxy Voting Agency, on behalf of the FRC

<sup>10</sup> ‘2011 UK Board Index’; Spencer Stuart; November 2011

<sup>11</sup> ‘Board Structure and Non-Executive Directors’ Fees’; Deloitte; September 2011

The number of companies carrying out externally facilitated board reviews in 2010/11 increased by just over seven per cent over the previous year in the FTSE 100 and just fewer than ten per cent in the FTSE 250.<sup>12</sup>

While the market for providing evaluation services is still relatively new, anecdotal evidence suggests that it appears to be developing as hoped in terms of the quantity and quality of providers and the variety of approaches that they offer. The FRC continues to hear some concerns about the availability of good quality service providers and the ability of companies to identify them, but not as frequently as in previous years.

### **Annual elections**

The most controversial change made to the Code in 2010 was the recommendation that FTSE 350 companies should put all directors forward for re-election every year. Notwithstanding the reservations expressed at the time the change was made, data provided by Practical Law Company<sup>13</sup> shows that 80 per cent of FTSE 350 companies put all directors up for re-election in 2011, up from only ten per cent in 2010. This figure rises to 88 per cent for FTSE 100 companies only. Many of the remaining companies indicated that they would review their practice in the light of market developments, so the expectation is that the uptake will be even higher in 2012.

### **The board's responsibility for risk**

The UK Corporate Governance Code was amended in 2010 to clarify that the board's responsibility for risk extended beyond oversight of the company's risk management and internal control systems to determining the nature and extent of the significant risks it is willing to take in pursuit of its strategy.

Earlier in 2011 the FRC held a series of meetings with directors, risk managers and internal auditors, investors and advisers to discuss how boards were carrying out this role and what challenges they faced. It was clear from these discussions, a summary of which was published in September 2011<sup>14</sup>, that boards are making considerable efforts to understand and oversee the main risks facing the business.

The issues with which companies were grappling included understanding their exposure to risk and how this might change, identifying the information and assurance that the board needed to carry out its role, embedding the right risk culture throughout the company, and the increased velocity of risk which had highlighted the importance of effective crisis management. As a result of these discussions the FRC intends to update its guidance on risk management and internal control (the 'Turnbull Guidance') during 2012.

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<sup>12</sup> 'Report on Board Effectiveness'; Association of British Insurers; September 2011

<sup>13</sup> Practical Law Company; December 2011. Note: all figures exclude investment trusts.

<sup>14</sup> 'Boards and Risk'; Financial Reporting Council; September 2011

## Reporting by Listed Companies

The annual report is the main channel of communication from the company to its shareholders, the market and other stakeholders. It is therefore in companies' own interests to give a clear and balanced account of their performance and position and - in the corporate governance statement - of how the board carries out its role and how shareholder interests are safeguarded.

The Financial Reporting Review Panel aims to review 300 sets of accounts every year, and has a specific remit to look at the disclosures in the Business Review. In addition the FRC has reviewed a sample of 60 corporate governance statements. This report summarises some of the findings of these reviews.

The FRC welcomes the efforts being made by many companies to provide real insight into their governance arrangements. There are many examples of interesting and informative reporting, including among FTSE 250 and Small Cap companies, some of whose reports were as good as or better than many FTSE 100 companies.

Overall, corporate reporting is improving, but there are still too many examples of generic and boiler-plate reporting. A continued effort is needed to bring the general standard up to the level of the best and to find new ways of communicating. The FRC's new Financial Reporting Lab will provide an opportunity for companies and investors to come together to develop and experiment with new reporting formats.

The FRC recognises that the narrative reporting requirements placed on companies can sometimes hinder rather than help their attempts to communicate, and welcomes the initiative taken by the Department of Business, Innovation and Skills to rationalise these requirements. Depending on the outcome of the Department's review, the FRC may need to amend those provisions of the UK Corporate Governance Code which state that disclosures must be made in the annual report, in order to fit the proposed new reporting structure.

### Explanations

For the 'comply or explain' approach to be seen as credible it is essential that, where companies choose not to follow the UK Corporate Governance Code, they set out clearly the reasons for their decisions so that shareholders can reach a view about whether the arrangements the company has put in place protect their interests.

While the majority of companies provide informative explanations - Grant Thornton estimate that about 70 per cent of explanations by FTSE 350 companies fall into this category<sup>15</sup> - others do not refer to the specific circumstances of the company, or do not explain what steps have been taken to ensure that the relevant principles of the Code are being met. In a very small number of cases, companies fail to provide an explanation for non-compliance, which is a breach of the Listing Rules.

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<sup>15</sup> 'Corporate Governance Review 2011'; Grant Thornton; November 2011

The FRC is currently holding discussions with companies and investors about the type of information that should be provided if explanations are to be useful to shareholders, with the aim of identifying common criteria that companies can refer to when preparing their corporate governance statements. The FRC will publicise the results of these discussions and, if appropriate, incorporate any agreed criteria into the next version of the UK Corporate Governance Code.

The FRC will also consider whether other steps could be needed to ensure such criteria will be consistently applied. For example, one approach could be to invite shareholders to contact the Financial Reporting Review Panel if a company had failed to respond to their request for a clearer explanation. If the Panel agreed that the explanation failed to meet the agreed criteria, it could raise the issue with the company. In such circumstances, however, it would need to be made clear that the judgement whether the governance arrangements adopted by the company (as opposed to the description of those arrangements) were satisfactory remained a matter for the shareholders. For that reason, the FRC would also encourage investors to highlight examples of good and bad quality explanations.

### **The chairman's statement**

In the preface to the 2010 edition of the UK Corporate Governance Code, the FRC suggested that company chairmen make a personal statement on how they have applied the Code's principles on the role and effectiveness of the board. The hope was that, by encouraging chairmen to put their personal stamp on the report, this would provide greater insight into the reasons for the governance arrangements the board had put in place and reduce the risk of boiler-plate reporting.

A substantial number of chairmen have responded to this challenge and some companies have gone further, with the chairs of the main board committees also reporting personally. In some cases, these statements focus mainly on process and procedure, but others make a real effort to explain the thinking behind, for example, the composition of the board or the main decisions taken during the year. The FRC would encourage other companies to follow these examples.

### **Boardroom diversity**

The FRC announced in October 2011 that it will amend the UK Corporate Governance Code to require companies to disclose their policy on boardroom diversity, including gender, and to report annually on how it is being implemented. These changes will not come into effect until 1<sup>st</sup> October 2012, but the FRC strongly encourages companies to report voluntarily on these matters in their next annual report. The FRC will review these disclosures and report its findings in its next monitoring report.

In its report on the initial response to the Lord Davies' recommendations, Cranfield University School of Management found that 56 per cent of FTSE 100 companies and 35 per cent of FTSE 250 companies reported that they have a policy on boardroom diversity<sup>16</sup>.

### **Board evaluation**

When the FRC consulted on revisions to the UK Corporate Governance Code in 2009/10 there was strong support from investors for the Code explicitly to require companies to report on the process followed when carrying out the board review and on the outcomes of that review. The FRC did not make it a requirement but shares the view that this information is useful, not least because it can provide reassurance to shareholders that the board is taking its responsibilities seriously and seeking to ensure it is effective. It is therefore keeping disclosures on board evaluation under review.

Although it is still the case that information about the review process and outcomes is only provided by a minority of companies, it is more widespread than in previous years. Grant Thornton estimate that 37 per cent of FTSE 350 companies now give an informative description of the process and 24 per cent summarise the main outcomes<sup>17</sup>. This practice is more prevalent in FTSE 100 companies<sup>18</sup>.

While recognising that there may be sensitivities about disclosing some findings from board effectiveness reviews, the FRC has seen good examples of companies that have summarised the main outcomes and the steps being taken to address any areas where the board identified room for improvement, and would encourage other companies to do the same. The FRC can see no such sensitivities about disclosing how the evaluation was carried out if the company believes the process has been rigorous.

It has come to the FRC's attention that not all companies that use external advisers identify them in their annual report. The FRC considers that this information should be provided as a matter of course, as it is for other external advisers such as auditors and remuneration consultants.

### **Business model, strategy and risk**

A requirement to disclose the company's business model was added to the UK Corporate Governance Code in 2010. It was felt that an explanation of the way in which the company believes it will generate value over the longer term would enable shareholders and other users of the report to come to a more informed view about whether the company's strategy would deliver that value, and the extent to which the company understood and was addressing the main risks to that strategy. It was also hoped that it would encourage greater integration of reporting on strategy and risk.

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<sup>16</sup> 'Women on Boards: Six Month Monitoring Report'; Cranfield University School of Management; October 2011

<sup>17</sup> 'Corporate Governance Review 2011'; Grant Thornton; November 2011

<sup>18</sup> 'Report on Board Effectiveness'; Association of British Insurers; September 2011

As with all new requirements, it will take time before best practice emerges. A survey by Deloitte found that about one-third of FTSE 350 companies attempted to describe their business models and noted that “an area where detailed requirements have not been laid down is allowing companies the freedom to develop their own interpretations of the disclosure”<sup>19</sup>. Companies will need to experiment and innovate to discover how best to convey their business models in a way that resonates with readers. This is why business model reporting has been identified as a priority project for the new Financial Reporting Lab.

In its annual report published in September 2011<sup>20</sup> the Financial Reporting Review Panel noted widespread improvement in the description of principal risks and uncertainties and of the actions taken by boards to mitigate their effects.

The FRC also notes that there is evidence of greater integration of reporting on strategy and risk, with a number of companies including tables in their reports setting out the company’s strategic objectives and/or key performance indicators, the main risks to achieving those objectives and how those risks are being mitigated. This is by no means the only way in which this information can be integrated, and the content of these tables is sometimes fairly limited, but it illustrates that it can be done relatively simply.

While recognising the improvement that has already been made, and some of the difficulties companies face in reporting meaningfully on risk and how it is mitigated and managed (for example, by companies that are SEC registrants), the FRC believes that this is an area where more effort is still needed. Specifically, the FRC believes that reporting should focus on strategic risks and the major operational risks inherent in their business models and strategies, rather than generic risks applicable to all companies.

### **Audit committees**

The FRC strongly shares the view expressed in a recent report that “[while] the role and the authority delegated to the audit committee by the board, as described in its terms of reference, are frequently repeated within the report... how the audit committee actually discharges those responsibilities is rarely covered”<sup>21</sup>. Very few audit committees report the key decisions taken or judgements made by the committee.

The FRC believes this threatens to undermine confidence in audit committees. At a time when there is considerable scepticism about the effectiveness of audit and audit committees, the report provides an opportunity for committees to demonstrate that they are carrying out their role effectively.

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<sup>19</sup> ‘Gems and Jetsam: Surveying Annual Reports’; Deloitte; 2011

<sup>20</sup> ‘Annual Report 2011’; Financial Reporting Review Panel; September 2011

<sup>21</sup> ‘The Buck Stops Here? New Challenges for Audit Committees’; Institute of Chartered Accountants for England and Wales and BDO; 2011

For this reason the FRC will consult early in 2012 on proposals to amend the UK Corporate Governance Code to extend the reports that the audit committee gives to the board and which subsequently appear in the annual report. Subject to consultation, the intention is that these changes should take effect from 1<sup>st</sup> October 2012.

The FRC will also consult on proposals to require clearer reporting on how the external auditor is selected. Recommendations on what companies should disclose about the selection process were incorporated into the FRC's 'Guidance on Audit Committees' in 2008 but, disappointingly, these have been followed by only one-third of companies<sup>22</sup>.

### **Remuneration Committees**

Similar criticisms can also be made of reporting by remuneration committees. While many reports now include more detail of the processes and procedures followed by the committee, which is to be welcomed, relatively few of the sample reviewed by the FRC provide much insight into the reasons why the committee made the decisions that it did. Specifically, the link between remuneration policy and the company's strategy and approach to risk is rarely described clearly. In the current climate, companies need to be more transparent about these issues.

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<sup>22</sup> 'Gems and Jetsam: Surveying Annual Reports'; Deloitte; 2011

## Stewardship and Engagement

As of December 2011 the Stewardship Code has attracted 234 signatories, including 175 asset managers, 48 asset owners and 12 service providers<sup>23</sup>. This is a good start and a clear indication that the market is willing to take the concept of stewardship seriously. There is also some evidence that investors are taking account of their stewardship responsibilities in their general contact with companies, even though there is a considerable way to go in the integration of governance and investment decision-making. The challenge is now to build on this initial success.

A positive aspect of the eighteen months of the Stewardship Code has been the wide base of interest. Signatories and supporters range from large asset managers to smaller, specialised investors. They include proxy voting agencies and investment consultants, who play an important role in setting the culture and values of the market. They also include a wide range of UK pension funds and other asset owners, as shown in this table.

### Types of Owners

Type	Number
Defined Benefit Pension Schemes	31
Defined Contribution Pension Schemes	2
Foundations	2
Insurers	3
Investment Trusts	8
Mutuals	2

*Source: Financial Reporting Council*

*Note (i): These figures include only those owners that have formally signed up to the Stewardship Code. There are many others that have published statements of support.*

*Note (ii): Of the defined benefit pension schemes, 18 are public sector schemes and the remainder corporate or third sector schemes.*

The involvement of asset owners is critical because of their role in awarding investment mandates. If asset owners, as clients, make it clear to their fund managers what they expect by way of stewardship, their managers will have a real incentive to deliver. Over time the Stewardship Code will then become a significant driver of change.

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<sup>23</sup> A full list of signatories can be found at: <http://www.frc.org.uk/corporate/stewardshipstatements.cfm>. One organisation is classified as both an asset manager and service provider.

The FRC has thus welcomed the active support for the Code from the National Association of Pension Funds (NAPF), and will continue its efforts to involve other asset owners more directly, including sovereign wealth funds, charitable foundations and insurance companies. It will also be looking at ways of building stewardship into the investment activities of defined contribution pension schemes, which are set to play an increasing role in UK equity markets.

The FRC also welcomes the growing debate on whether the concept of stewardship should apply to global equities and other asset classes. While the Stewardship Code was drafted with UK equities in mind, the concept that underlies it should have broader national and international relevance.

## **Reporting on Stewardship**

Since December 2010, the Financial Services Authority has required all firms authorised to manage funds on behalf of others to state whether they apply the Stewardship Code (under Conduct of Business Rule 2.2.3). Those that do so are expected under the terms of the Code to comply or explain with its principles and report on how it has been applied. The Code thus remains voluntary, but there is no doubt that the FSA rule has encouraged investment managers to consider their stewardship responsibilities and to sign up to the Code.

As might be expected with such a large and diverse group of signatories, the quality of reporting is variable. The better statements report against each of the Code's seven principles with sufficient detail to and convey a real sense of how the signatory approaches its responsibilities. This is important because the statement is a primary source of information for those who the Code is ultimately intended to benefit, the asset owners who award investment mandates and, behind them, their beneficiaries.

There are signs that the market is beginning to scrutinise statements with the aim of differentiating the level of stewardship on offer. This is encouraging, especially if differentiation becomes a widespread practice among a range of participants, because it should ultimately mean that stewardship becomes a factor in choosing investment managers. Those that choose not to comply with a specific principle will need to deliver an increasingly meaningful explanation in order to generate and retain business. In the meantime a good yardstick for investors to consider when drafting their statements is the standard they would themselves expect of companies in corporate governance reporting.

The FRC's own survey of statements suggested four areas where disclosure could be enhanced.

First, the reporting of how conflicts of interest are managed is frequently weak. This is a point also made by Fair Pensions in its report on fiduciary duties<sup>24</sup>. Relatively few signatories state categorically they always seek to place the interest of their clients first. This could be because they feel under legal constraint or because the interest of the client itself may not be clear (as, for example, might be the case with an investor who had a significant holding of both equity and

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<sup>24</sup> 'Protecting Our Best Interests: Rediscovering Fiduciary Obligation'; Fair Pensions; 2011.

bonds in the same issuer). However, discussions with signatories to the Stewardship Code at a workshop held in September 2011 concluded that investors could usefully give more thought to this issue.

Second, many statements around the principle on collective engagement focused on membership of collective bodies. While this is welcome, it skirts round the main reason for this principle, which is the need for investors to be able to join forces at critical moments to ensure that boards acknowledge and respond to their concerns. This may require a more strategic approach on the part of shareholders as well as the further development of leadership within the investment industry. The FRC would encourage the investor community to debate these issues further.

Third, few statements provide much detail about how the signatory uses proxy voting agencies. This is being actively debated in the EU with several Member States pressing the European Commission for regulation. Critical to the debate on this will be the way in which investors use the recommendations provided by proxy advisers. A clear sense that they are being used responsibly will help alleviate pressure for excessively prescriptive regulation of these agencies.

There is also an issue around accessibility. The FRC website provides a link to all signatory statements, but these are not necessarily easily accessible via another route. It would help if statements were easy to find and also if each statement explained how the signatory could be contacted, preferably by identifying the contact details of an individual who can handle queries from those wishing to discuss stewardship issues, including possible collective engagement. A review carried out by the FRC found that over 40 per cent of statements provided no contact information whatsoever, and that many others did not include either an email address or telephone number for the contact.

Finally, the FRC would encourage signatories to review their statements each year to see whether they need refreshing, and to consider these points when doing so.

### **Reporting to clients**

When the FRC launched the Stewardship Code, it announced that the Institute of Chartered Accountants in England and Wales (ICAEW) had agreed to develop guidance on reporting to clients or beneficiaries through a supplement to the AAF 01/06 guidance on assurance reports on internal controls of service organisations. This was issued in March 2011 and the FRC wishes to record its appreciation to the ICAEW.

The guidance aims to provide an approach to reporting which minimises bureaucratic interference while providing clients and beneficiaries with appropriate assurance. While take-up to date has been limited, the FRC has heard from asset owners that they are requesting to see their managers' AAF reports and, from managers, that asset owners are beginning to include this in their tender documents when awarding mandates. This is supported by data in the NAPF's

engagement survey, published in December 2011, which stated that 32 per cent of respondents would be seeking to verify managers' stewardship activity formally under the AAF 01/06 framework<sup>25</sup>.

### **Engagement: the company perspective**

Discussions with companies present a mixed picture. Some larger companies say there is a growing interest on the part of some institutional investors to discuss a wider range of strategic and governance issues, and some additional interest in meeting with chairmen for strategic discussion, although usually it falls to the company to initiate those discussions. Investment bankers also reported that shareholders have become more critical over takeover proposals, and that there have been instances where shareholders pushed back on these, although it is too early to discern a trend.

However the majority of companies, in particular smaller companies, say they have noted relatively little change in approach to engagement or in the identity of those who are normally involved. The FRC was told that some shareholders still seemed to focus too much on specific issues of a short term nature such as share buybacks. Complaints were also made that shareholders on occasion vote against the board without discussing their concerns with companies first.

Companies perceive that there is still a long way to go before the investment and corporate governance functions within institutions become properly integrated. One indicator of integration is whether corporate governance specialists and portfolio managers or analysts jointly attend meetings with companies. 23 of the 41 asset managers that responded to the stewardship survey carried out by the Investment Management Association (IMA) said that this happened on at least some occasions<sup>26</sup>.

The survey also found that matters relating to strategy and performance are usually handled by the portfolio managers and investment analysts, while stewardship specialists handle aspects such as corporate governance and socially responsible investment. Integration seems to be less of an issue in smaller boutique investment houses, where fund managers will often undertake much of the engagement activity.

Where companies express concern, they may overlook the fact that managers will often be following the voting instructions of their clients, which will not always be identical. Linked to this, there continues to be a concern on the part of companies that some investors are uncritical in following the recommendations of proxy voting agencies even when this conflicts with the result of their own engagement. Overseas clients in particular are seen as more inclined to rely on proxy advisers.

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<sup>25</sup> 'NAPF Engagement Survey: Pension Funds' Engagement with Investee Companies'; National Association of Pension Funds; December 2011

<sup>26</sup> 'Adherence to the FRC's Stewardship Code'; Investment Management Association; May 2011

## Engagement: the shareholder perspective

Shareholder views on the attitude of companies are similarly mixed. There is anecdotal evidence that some companies are making a greater effort to engage, with more chairmen taking the initiative of contacting key shareholders. Yet there is also criticism that some companies are becoming less responsive to shareholder votes and more inclined to ignore a significant “oppose” vote as long as they win majority support. Insofar as the Stewardship Code aims to promote better relations between companies and their shareholders, this reaction is counterproductive and ultimately risks undermining the concept of ‘comply or explain’.

The IMA’s survey provides useful evidence about the extent of stewardship activity and offers illustrative examples of collective engagement. Along with the numbers of signatories, the activity described in the IMA’s report provides a good starting point for the Code, although it needs to be recognised that the quantity of engagement is not necessarily a measure of its quality.

Comments from larger companies suggested that they felt able to have meaningful discussions with the majority of their main shareholders, although some questioned whether investors had enough people with the right skills to cope with the quantity of engagement that was being sought. This includes the ability to bridge the gap that sometimes exists between understanding of governance and remuneration on the one hand and business context, strategy and financial development on the other. This is one aspect of the integration of investment and governance discussed above.

The IMA found that 27 out of 41 asset managers surveyed had some or all mandates that referred to the Stewardship Code<sup>27</sup>. This is a good start, especially since the survey covered a period before the introduction of the FSA’s Conduct of Business Rule in December 2010.

Since then the FRC has noted an increase in interest among investment consultants, while the NAPF’s engagement survey issued in December 2011 found that 63 per cent of respondents already made reference to the Stewardship Code in their contracts with investment managers and/or their Statement of Investment Principles, or intend to do so in the future<sup>28</sup>. A separate survey of pension funds found that three-fifths of participating funds reported that trustees have formally discussed the Stewardship Code<sup>29</sup>.

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<sup>27</sup> ‘Adherence to the FRC’s Stewardship Code’; Investment Management Association; May 2011

<sup>28</sup> ‘NAPF Engagement Survey: Pension Funds’ Engagement with Investee Companies’ National Association of Pension Funds; December 2011

<sup>29</sup> ‘Responsible Business: Sustainable Pension’; UKSIF; 2011

## AGMs and voting

While a conscientious approach to voting is an important ingredient of stewardship, the FRC does not believe the success of the Stewardship Code should be measured by the volume of “oppose” votes at general meetings. The Code makes it plain that shareholders should be prepared to vote against management where they have serious concerns that are not being addressed, but reaching this point can indicate a failure in the relations between companies and their shareholders. What matters is considered voting, and sometimes a demonstration of shareholder support for a company may be as important as a vote against.

Against this background, overall voting turnout is important. In the first six months of 2011 the average turnout was 70.9 per cent, three per cent higher than in 2010. This compares with an increase of only two per cent between 2008 and 2010<sup>30</sup>. It is difficult to say to what extent this increase can be attributed to the Stewardship Code, as turnout has also increased in some other European markets, but the average UK turnout remains much higher than the European average of 62.6 per cent.

Following the decision by many FTSE 350 companies to put all directors up for annual re-election as recommended in the 2010 UK Corporate Governance Code, the FRC commissioned PIRC to research the levels of dissent on director elections, in order to assess whether annual elections had an impact on voting patterns<sup>31</sup>. Voting on all directors every year gives shareholders an ability to signal their concerns about particular aspects of governance, for example the effectiveness of the board committees, by differentiating in the way they vote on individual directors.

As yet there has been no discernible impact. The data actually shows a slight decrease in the level of dissent, with an average of 1.65 per cent of votes against directors of FTSE 350 companies in 2011 compared to an average of 2.03 per cent in 2010, although both figures are very low and below the European average<sup>32</sup>. Nor is there any notable change in the levels of opposition in companies that moved to annual elections in 2011, either compared to their previous voting patterns or those companies that did not put all directors up for election.

The research also looked at all cases where ten per cent or more of votes cast opposed the re-election of an individual director, and at the results for directors of companies that had received more than ten per cent opposition on other resolutions in at least three of the last five years.

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<sup>30</sup> ‘2011 Voting Results Report: Europe’; ISS; September 2011

<sup>31</sup> Unless indicated, all data on director elections was produced by PIRC on behalf of the FRC, and is based on an analysis of voting at companies in the FTSE 350 Index as of October 2011.

<sup>32</sup> Average vote against directors across 17 European markets was 2.8% in the first six months of 2011. Source: ‘2011 Voting Results Report: Europe’; ISS; September 2011

There are a small number of examples where higher than normal votes against a director might be linked to governance issues or where persistent concerns about governance issues appear to have led to higher votes against particular directors, for example higher votes against remuneration committee members in cases where there has been long-running concerns about remuneration policy. But in other cases there appears to be no such correlation, and it is not possible to discern a trend.

As before, the FRC would encourage institutional investors to attend general meetings where they have particular issues of concern. While recognising the practical constraints, attendance at selected meetings can be a powerful and visible demonstration of the exercise of stewardship, as well as adding value to the meeting itself. The FRC therefore applauds the efforts of the few institutional investors who are prepared to attend meetings and encourages others to do likewise.

The FRC has noted with concern the tendency of some companies that have reincorporated abroad but remain listed in London also to move the location of their annual meeting. This discourages UK based investors, both institutional and retail, from attending and their participation becomes all the harder if there is no inter-active remote link, with the result that the annual meeting loses substantially in meaning and value.

### **Barriers to stewardship**

According to the IMA report, the most significant barriers to stewardship from the shareholder perspective were (in descending order): lack of resources, limited influence as a result of the size of holding, concerns over acting in concert and being made insiders, differing opinions among portfolio managers and shareholders, and lack of client demand.

Some of this is the consequence of the UK's model of widely dispersed ownership. Asset managers responding to the IMA survey had an average of 450 holdings in UK companies alone, with asset owners averaging only slightly fewer holdings<sup>33</sup>. The tendency of some long term investors to scale back their holdings of equities and/or diversify into international holdings is also a factor. A report by the Foundation for Governance Research and Education<sup>34</sup> highlighted the impact of changes in investment management practice, while discussions with signatories highlighted concerns around volatility in driving asset allocations away from equities.

Where asset managers are no longer a major shareholder it is harder for them either to justify the application of resources or to be sure that their views will be taken as seriously. The evidence for this trend is so far anecdotal, but it does pose a challenge to the effective exercise of stewardship which needs to be watched.

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<sup>33</sup> 'Adherence to the FRC's Stewardship Code'; Investment Management Association; May 2011

<sup>34</sup> 'An Investigation into Stewardship: Engagement between Investors and Public Companies: Impediments and their Resolution'; Foundation for Governance Research and Education; 2011

Insofar as institutional investors do feel their individual influence is waning, this highlights the importance of collective engagement. Institutions therefore need to find a way of working together more strategically and proactively. This implies continuing effort on behalf of representative bodies, and less formal groupings such as the Corporate Governance Forum.

It also requires further encouragement to overseas shareholders to become involved. In the coming year the FRC will, for its part, continue its effort to promote the concept of stewardship internationally. It is encouraging to see stewardship codes and principles being adopted in other markets, including most recently the newly revised Singapore Code of Corporate Governance, which may provide a useful impetus to its sovereign wealth funds.

It would help if ways could be found to allay lingering concerns about acting in concert. While both the Takeover Panel and the Financial Services Authority have offered comfort statements to institutions on this point, more could arguably be done. The FRC would on balance support a review at the European level of the concept of “acting in concert”, while recognising the risk that this might lead to a tighter definition than at present.

In the event that such a debate is launched during the course of 2012, it will be incumbent on shareholders to make clear what they need out of such a review and to develop strong arguments against those arguing for a restrictive regime.

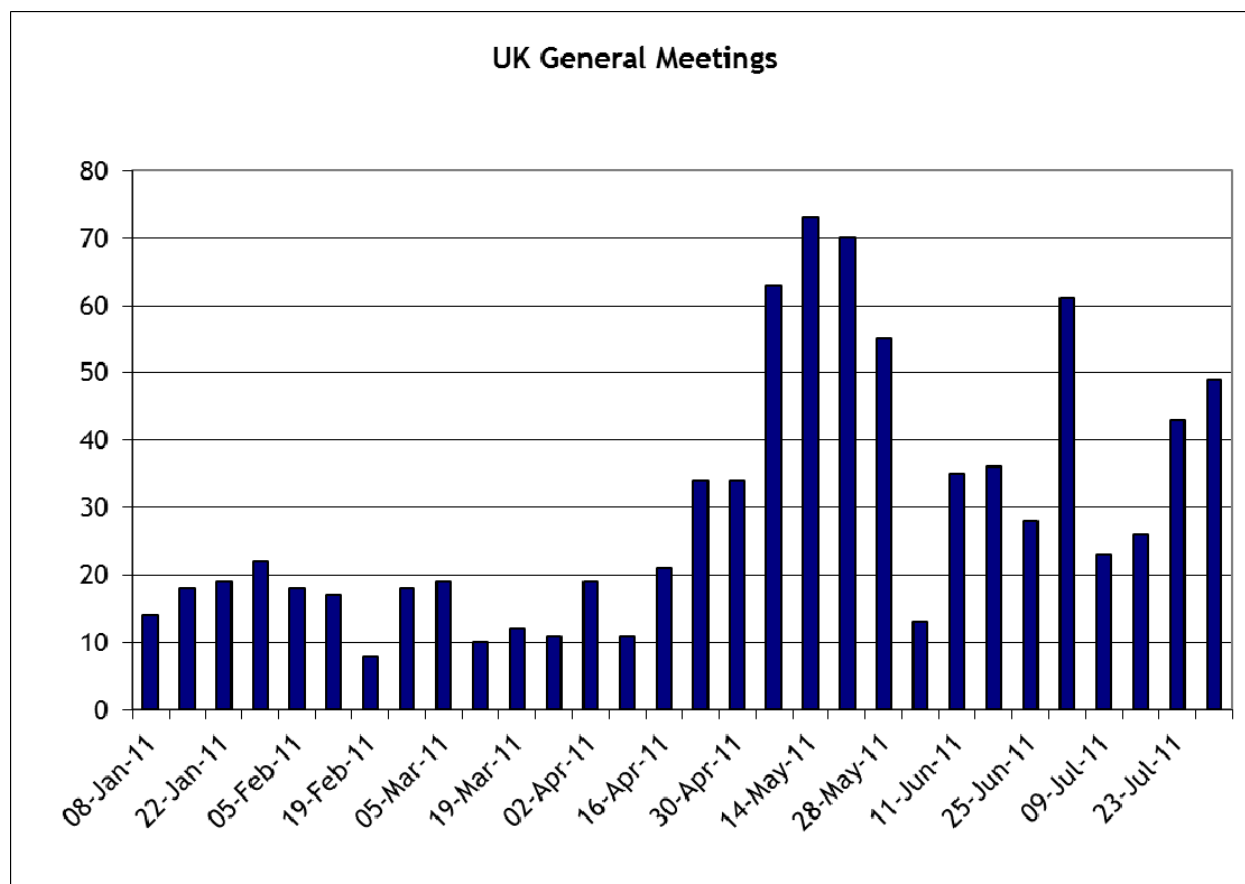
A welcome development is the apparently growing readiness of some investors to be made insiders for a limited period. This can increase the quality of engagement and, where capital-raising is concerned, lead to arrangements that reduce the fees. In determining this approach, it is important that investors ensure that those personnel who are made insiders have the authority to speak for the institution as a whole.

As for asset owners, one barrier frequently raised by pension funds is competing priorities. Corporate engagement inevitably slips down the agenda when funds are struggling to fill large deficits in volatile markets, and busy trustees are not always equipped to hold their asset managers to account. Against this background, the FRC is pleased at the interest in stewardship being shown by investment consultants. It is important to remember that pension funds themselves do not necessarily need to be directly involved in engagement and that this task falls more naturally to their asset managers in many cases.

The critical point is getting the mandate right and in recognising that the different roles played by different players depending on where they are in the investment chain. Feedback has suggested that the Stewardship Code is not clear enough on this point, and this is one issue on which the FRC would expect to consult in 2012.

Conversations with owners also suggested that there is some confusion as to what is meant by “stewardship”, with some equating it solely with socially responsible investment. The FRC believes that greater clarity on this point would also be desirable.

Another barrier to effective engagement is the concentration of general meetings over a short period of time. The table below shows that over 250 UK listed companies held their annual general meetings in May 2011 alone. This makes it very difficult for investors with large portfolios to scrutinise properly the resolutions being put forward, even more so when they have global portfolios, and undoubtedly contributes to the frustrations felt by companies.



Source: Manifest – The Proxy Voting Agency

While this unhelpful concentration clearly needs to be addressed, there is little prospect of the peak being smoothed out in the short-term. The FRC believes this puts the onus on companies and investors to ensure that there is on-going engagement throughout the year.

## Next Steps

As explained earlier in the report, the FRC proposes to make limited revisions to both its codes which, subject to consultation, will take effect from 1<sup>st</sup> October 2012. These revisions will be specifically targeted at strengthening the current framework rather than fundamentally changing it, and our aim will be then to leave both codes unchanged for a further two years, unless unforeseen circumstances arise.

The FRC has already announced that it will introduce into the UK Corporate Governance Code a requirement on companies to report their policy on boardroom diversity, and to consult on changes to extend the remit of, and reporting by, the audit committee. It is possible that further changes may be proposed as a consequence of the Sharman Panel of Inquiry into “going concern” and the BIS consultation on narrative reporting, the outcomes of both of which are expected to be known in the first few months of 2012.

The FRC will also consult on updates to its guidance notes on audit committees, to reflect the proposed changes to the UK Corporate Governance Code, and on risk management and internal control, to reflect the revision made to the Code in 2010 and subsequent discussions with companies, investors and advisers.

As far as the Stewardship Code is concerned, it not currently envisaged that new principles will be introduced but it may be helpful to clarify the language in certain places, for example on the different role of asset managers and asset owners. Areas where the FRC might consider strengthening the language include conflicts of interest, collective engagement, and the use of proxy voting agencies, and possibly a recommendation that investors disclose their policy on stock lending.

The FRC also hopes to stimulate discussion around performance metrics that can help all parties know what the Stewardship Code is achieving. This will hopefully provide visible confirmation that the market is building on the year’s good start and delivering meaningful change.

The FRC will continue to monitor the quality of reporting by both companies and investors, including the areas highlighted in this report. Particular attention will be paid to the quality of explanations provided by companies that deviate from the UK Corporate Governance Code, with the aim of identifying and promulgating the type of information that should be included in a meaningful explanation.

However the most important activity for the FRC will be to facilitate improvements in governance and stewardship by promoting awareness of the two codes, helping all participants understand where the weaknesses in execution lie, and tackling barriers and threats to the effective oversight of companies by their owners, including the threat of inappropriate regulation. This will include international outreach and working with other regulators for practical solutions to problems that arise, as well as engaging with companies and investors.



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