



FRC RESPONSE TO THE EUROPEAN COMMISSION GREEN PAPER ON THE EU CORPORATE GOVERNANCE FRAMEWORK

The Financial Reporting Council is the UK's independent regulator responsible for regulation and standard setting in corporate governance, accounting, auditing and actuarial matters. We are the sponsors of the UK's Corporate Governance and Stewardship Codes which apply to companies and investors respectively and seek through our work to promote investment and market confidence. We therefore welcome the opportunity to respond to the Green Paper

General comments

The paper is based on a solid analysis and asks sensible and relevant questions. It rightly cites the widespread support among companies, investors and regulators for the comply-or-explain concept, but it is also right to ask how this could be made to work better, how we can best tackle short termism and how to improve the contribution made by shareholders.

Strong corporate governance arrangements which provide confidence to investors will make Europe's capital markets more attractive to investors and thus contribute to economic recovery and prosperity. High, and increasingly convergent, standards across the European Union will help cement the single market and assist in the efficient allocation of capital.

If European citizens are to have confidence in the single market and its ability to generate growth, jobs and prosperity, it is critical that Europe has deep open capital markets able to provide long term funds to business at reasonable cost. Good corporate governance is an essential ingredient to this, but not in itself sufficient. Little will be achieved by introducing rules for their own sake and we recommend the application of rigorous impact assessment for all measures introduced at the European level in order to avoid negative implications for growth, company start-ups and the cost of capital.

Without proper cost benefit analysis there is a risk of unintended consequences. In particular Europe should avoid measures which would tend to limit access to its capital markets and restrict the rights of capital providers.

It is also important to differentiate between corporate governance in banks and other large or complex financial institutions, which may pose a systemic

risk, and other companies, which do not. Whereas some increase in regulation of the former may be called for after the financial crisis, there was no obvious general failure of governance in the broader corporate economy which would warrant radical solutions.

The priority should therefore be to make existing approaches work better rather than impose radical change which would add unnecessarily to the regulatory burden and tend to stunt economic recovery.

In any case there is a wide disparity in approach to company law and in ownership structures in European national markets. One size does not yet fit all in Europe and we are mindful of Commissioner Barnier's own statement that Europe should be "united but not uniform."

Measures taken at European level should therefore be designed to support a framework which facilitates high standards across the entire EU without imposing uniform solutions that do not fit individual market structures and cultures. Such a framework should continue to be based upon consensus around principles, transparency, and incentives to deliver.

Against this backdrop we make the following thematic observations before addressing the specific questions in the paper.

Long termism

We are wary about the interpretation of the raw statistic presented in the paper that turnover on major exchanges is now running at 150 per cent of aggregate market capitalisation and that this means the average holding period is eight months. The average figure sheds little light on actual behaviour, and it is dangerous to draw the general conclusion that all investors now have short term horizons.

The high average turnover rates could simply reflect the possibility that the same small slither of company capital is turning over very rapidly, while the bulk remains in long term ownership. More evidence and analysis is needed on holding periods and turnover patterns before we can determine firm policy implications and define appropriate regulatory responses.

That said, it is clear from the available figures that some regulatory arrangements affecting long term investors such as pension funds and insurance companies have led unintentionally to diminished long-term investment in equities, especially when coupled with a relentless market focus on increasing liquidity through initiatives such as MIFID. For further detail please refer to our answer to question 13.

When revising Directives the Commission should systematically ask whether such unintended disincentives have been created for markets to think long term. We believe the Commission currently has an opportunity to signal its determination to move away from short termism by repealing the quarterly reporting requirement in the Transparency Directive as these create short term trading opportunities, generating commission income for market intermediaries.

We also agree that there may be pressures on fund managers towards a short term approach, for example where there is extremely short term focus (e.g. monthly or quarterly) on investment performance or if remuneration practices are not calibrated to encourage a long term approach to delivering performance. We therefore welcome the discussion on mandates provoked by the paper and would broadly support a requirement on fund managers to disclose the principles of their remuneration arrangements.

Comply or explain

The comply-or-explain principle is recognised at the European level as an important tool for delivering good corporate governance but the Green Paper raises questions about its effectiveness. We believe that the flexibility that it offers is positive for economic activity. Particular care must be taken at a time when many EU countries badly need to restart growth not to replace it or water it down with arrangements which might stifle entrepreneurialism.

It is important to dispel two misconceptions at the outset.

First, the frequent assertion that comply-or-explain is self-regulation is incorrect. Indeed a comply-or-explain approach depends on regulation to make it effective. There must be a formal requirement for transparency, so that entities covered by the regime are obliged to state publicly whether they comply with relevant provisions, explain publicly when they do not and demonstrate how the resulting governance arrangements meet the relevant principle. Those to whom the explanation is directed need some form of sanction in cases where the explanation is unacceptable. In the case of shareholders the sanction ultimately is their legal right to dismiss boards. The comply-or-explain approach thus uses regulation to enhance accountability. It does not allow companies to regulate themselves.

Second, the political debate sometimes seems to revolve around the idea that there is a choice between two systems or ideologies: formal regulation or comply-or-explain. Even in the UK, however, where the comply-or-explain principle is probably most developed, market participants also recognise the need for regulation, including effective shareholder rights. The key challenge for Europe lies in deciding on the mix of formal regulation and comply-or-

explain provisions which will deliver the most effective outcomes in terms of companies' ability to generate wealth and employment over the long term.

Appended to this response is a paper setting out the argument for comply-or-explain as an essential part of an effective governance framework. It identifies a number of ways in which the comply-or-explain concept can be beneficial. These include:

1. It may be possible to achieve more robust outcomes than are available through negotiation of directives and regulation. An example is the arrangement for audit committees. Before the introduction of the 8th Company Law Directive in 2006, the UK had already achieved virtually universal compliance with Code requirements for listed companies to have fully independent audit committees. Audit Committees became a statutory requirement with the introduction of the Directive, but, because member states could not agree on the level of independence required, the Directive only requires one member of the committee to be independent. The UK Code outcome was thus more robust.
2. Codes can be modified regularly to take account of changing market circumstances and to encourage incremental increases in standards, thus promoting continuous improvement. In the UK the FRC normally reviews the Corporate Governance Code every two years. In other member states such as Germany, there is an annual review. It is not possible to amend legislation this frequently and Codes are therefore more adaptable. The FRC's current consultation on amendments relating to board diversity is an indication of the inherent flexibility of this process.
3. Codes frequently focus on behavioural expectations which are difficult to capture in regulation or where regulation would be premature. For example, the practice of board evaluation has been growing in the UK since it was first recommended in the UK Corporate Governance Code in 2003. This is now being extended to encourage regular evaluation by an independent external reviewer, which in turn is encouraging the development of a more professional market in board reviews. The Code has thus brought about a change in culture with regard to board reviews and enabled expectations with regard to standards to be progressively raised. A regulatory approach would have been more difficult, since it would have involved a one-off requirement to conduct board evaluation that would be difficult to impose when the market in board reviews was not yet developed.

4. By identifying a set of general principles and enabling them to be applied flexibly in markets with different cultural and legal backgrounds, Codes are a useful instrument for promoting gradual convergence across the EU. An example is the way in which they have been used to introduce the concept of independent directors throughout the EU.

We therefore believe that comply-or-explain should be retained as an important principle in EU corporate governance, but we agree with the view expressed in the paper that it should be made to work more effectively. This requires higher standards on the part of shareholders, an issue which is discussed in the section of stewardship below. Taking the European market as a whole, there is a need for more reliable monitoring and a better quality of explanations.

In the UK, compliance with the Code is monitored in a number of ways. Investor organisations such as the Association of British Insurers, as well as governance service providers such as ISS, Manifest and PIRC, scrutinise every resolution at every general meeting of every company listed on the main market for compliance with the Code. Private sector organisations with an interest in corporate governance monitor overall trends. An example is the annual report by Grant Thornton, the accountancy firm. Finally an active financial press picks up on deviations and thus plays an important role in monitoring.

However, in the light of the RiskMetrics report to the Commission of 2009, we recognise the need to review our approach. It is clear that regulators should pick up on instances where there is no explanation for a breach of the Code. The latest Grant Thornton report shows there are still instances of this and we are currently considering how to address this. The Financial Reporting Review Panel, which reviews narrative and financial reporting, already monitors on behalf of the Financial Services Authority the mandatory corporate governance disclosures required under the 4th and 8th Company Law Directives, and we are considering whether this role might be extended. Also, starting this year, we plan to publish an annual report on progress under the Corporate Governance and Stewardship Codes.

The RiskMetrics report also raised concerns about the quality of explanations. The Green Paper suggests that this might be improved by making company corporate governance statements regulated information within under the Transparency Directive. This would give regulators the power to intervene directly where explanations were deemed to be inadequate. There is a real danger that this approach could lead to situations where regulators were usurping the right of shareholders to assess the acceptability of explanations which is an essential pillar of the comply-or-explain concept.

Such an approach cannot therefore be contemplated until and unless there is a clear consensus in each market about what constitutes an explanation. The Green Paper refers to the Swedish requirement for each company to “state clearly which code rules it has not complied with, explain the reasons for each case of non-compliance and describe the solution it has adopted instead.” Similarly, the UK Code states that in providing an explanation companies should illustrate how their actual practices are consistent with the relevant principle of the Code (the Code is divided into high-level principles and more detailed provisions, with only the provisions being subject to comply-or-explain).

This is a good starting point for a debate for determining an approach which will need to account for the distinction between principles and provisions, the level of detail required in explanations, and the extent to which the reason given should be specific rather than generic. Only once such clarity and consensus are reached would it be possible to define the limit of regulatory oversight so that it did not intrude on shareholder judgements.

This would avoid the risk of a compliance-driven box-ticking approach, in which companies, through their lawyers, would be tempted to check in advance with regulators whether an explanation was appropriate, thereby placing shareholders out of the loop. Once such clarity was in place, an alternative to systematic regulatory oversight might be for shareholders to be encouraged to refer to the regulator explanations which in their view clearly failed to meet the agreed criteria, if engagement with the company had failed to elicit a more informative explanation. The regulator would then be able to insist on a better quality explanation. This should provide a particular boost to the quality of explanations, especially in countries where they are weak. It would thus help develop high standards across the EU.

The FRC intends to facilitate a consensus on explanations in the UK market and stands ready to share its experience with other code sponsors through the European Corporate Governance Code Network.

Stewardship

This issue needs to be considered in conjunction with the earlier Green Paper on Corporate Governance in banks and financial institutions, which asked about stewardship codes. The Commission’s survey of responses showed that a clear majority of respondents felt institutional investors should adhere to a code of best practice, while the report of the European Parliament on the paper called (Paragraph 60) for legislation requiring all those authorised to manage investments on behalf of third parties in the EU to state publicly whether or not they apply and disclose against a stewardship code; if so, which one and why, and if not why not.

We share the Parliament's view and welcome the evidence of general support for stewardship codes. We also note the trend for others in the EU to develop stewardship codes, notably EFAMA and Eumedion, while, in Germany, the Bundesverband Investment, also sponsors a code. The FRC's Stewardship Code has also attracted interest and support from significant overseas investors including a formal statement of compliance from Ontario Teachers Pension Plan. We were thus perplexed by the scepticism towards stewardship codes expressed in the Frequently Asked Questions document published by the Commission to accompany the current Green Paper. The evidence suggests that the concept of stewardship has gained momentum. It would be right to harness this as part of a framework designed to make shareholders more effective.

Indeed, the further development of stewardship codes sits well with the focus in the current paper on fiduciary duties and investment mandates. Asset managers will take their stewardship obligations - and therefore their adherence to stewardship codes - more seriously if they are called on to do so by their clients. We have seen from public statements by some asset owners in the UK that they regard the Stewardship Code as giving them helpful leverage in this respect.

The challenge for policy-makers is to stimulate further progress without restricting investor choice. Institutional asset owners, such as pension funds, should think carefully about their fiduciary obligations to their beneficiaries without being forced to abandon their right to choose the investment approach that best fulfils their fiduciary obligations, which in some instances may have legal weight. A distinction will also need to be made between investment managers whose approach may involve a focus on trading returns as an alternative to long term ownership and stewardship. What matters is that the asset owner's choice of investment manager is more informed and better considered than may sometimes be the case at present.

This suggests an expectation on those who award investment mandates that they consider their investment objectives carefully and ensure that their mandates properly reflect this. Award of mandates should be based on satisfactory answer to questions relating, *inter alia*, to the desired balance between risk and return, time horizons, performance benchmarks, consideration of the value achieved through payment of dealing commissions and the alternative of diverting some of this money towards paying for effective engagement, and whether the asset owner wishes its manager to comply with a stewardship code.

Admittedly there is a risk that a sudden trend to stewardship might mean companies were swamped with fund managers seeking to engage with them. This would be counterproductive, but can be dealt with through a positive attitude by both asset owners and managers to collective engagement in

which the largest holders take the lead (see also remarks on proxy advisers below). There is less risk of a free rider problem if smaller shareholders are more willing to direct their votes to support in a considered way a reasonable challenge from larger holders.

By obliging asset owners to consider their fiduciary duties more carefully when issuing mandates, it will be possible to enhance the accountability of asset managers to their clients. This would in turn reinforce the effectiveness of stewardship codes because those to whom the explanations for non-compliance are directed would be more likely to withdraw business from asset managers who failed to live up to expectations. Similarly, a more considered approach to mandates will encourage asset managers to develop new products more focused on long term commitment and engagement as is already starting to happen in some markets in Europe.

Finally, it is impossible for stewardship to work on a pan-European basis as long as the operation of the cross border voting chain remains unreliable. The Commission is right to draw attention to concerns in this area. We welcome the Commission's commitment to further work in this area. It should redouble its efforts to fix this - possibly through a full scale enquiry into the role and effectiveness of custodians. It should ensure that any new regulations under the Securities Law Directive are enforced.

Minority shareholder rights, proxy agencies and retail investors

The paper rightly recognises the important need to strengthen the rights of minority shareholders in markets where a block holder model is prevalent. We note the statements by the European Corporate Governance Forum aimed at strengthening the rights of shareholders with regard to related party transactions and significant takeovers and would urge the Commission to follow through on these with appropriate regulation.

We share the concerns expressed in the paper about proxy voting. The UK Stewardship Code calls on investors to explain how they use advice from proxy voting agencies. We believe investors would be better placed to address this if the agencies provided more information about their work, for example with regard to resources applied, their approach to dialogue with companies, and their policy with regard to conflicts of interest. In the first instance any regulatory response should therefore be directed to the imposition of disclosure requirements in these key areas.

Finally, we believe that more attention should be paid to the rights of retail investors many of whom find it difficult to exercise their votes because of the failure of custodians to address their needs. Enfranchisement of retail holders makes sense in markets where there are concerns about low turnout at general meetings. It also creates a possibility for large institutional investors

with the resources and clout to engage with companies effectively to work with retail investors in raising the quality of debate and decision-making at general meetings.

This could be achieved by creating additional options for large shareholders with a track record of stewardship to solicit proxies from other investors if they felt this would serve the interest of their beneficiaries. In cases where a proxy voting agency had issued flawed advice, this could create and draw attention to an alternative voting option. In cases where investors wished to challenge an issuer's governance arrangements or strategy, it would create a more open and lively debate.

We therefore believe the proposal on proxy solicitation referred to in the paper merits further consideration. It would be necessary to find an approach acceptable to both issuers and investors and to set a framework for facilitating proxy solicitation which would prevent abuse by short term speculative traders, but the result could contribute to the strength and vibrancy of the European capital market, an objective which should apply to all measures introduced at the European level in the wake of this consultation.

Specific answers

1. Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and listed companies be established? If so are there any appropriate definitions and thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.

We believe that thresholds can be usefully applied to Codes but they should be used sparingly and with due regard to cost benefit considerations.

The inspiration for this question is presumably a view that the regulatory burden on small and medium enterprises should be smaller than that on large companies. Yet this fails to take account of one of the principal benefits of good governance which is that, by bolstering the confidence of shareholders, it facilitates access to capital at a reasonable price.

Lower standards applied to smaller companies might involve a smaller regulatory cost, but the differentiation is likely to increase the cost of their capital as well as making them less attractive to bank lenders. The cost of imposing thresholds could therefore easily exceed the benefits. Companies would also face a sudden and potentially disruptive increase in governance requirements as they crossed the threshold.

A comply-or-explain approach also enables companies to decide what balance is most appropriate for them and to tailor their response accordingly. In addition, those that choose to opt for a lower compliance burden have the choice of listing, for example the AIM market in London and on the NYSE Alternext market in the Eurozone.

2. Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting the development and application of Codes for non-listed companies.

Corporate governance standards aim to enable companies to make robust strategic decisions, manage risk and be accountable to those that provide their capital. The third objective is less relevant for unlisted companies, since their shareholders are insiders and much better able to hold management directly to account. The need for corporate governance measures directed at unlisted companies is thus substantially lower.

That said, some governance principles aimed at listed companies and relating to decision making, risk management and disclosure may also have application to unlisted companies, especially if they raise money in the bond market. They could be encouraged to consider what aspects of national codes could be relevant to them.

3. Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?

Separation of powers so that no one individual has unfettered authority is internationally recognised as good governance practice¹. The issue is whether this can only be achieved by prescriptive rule. The UK experience shows that a code approach, using comply or explain, works. There is no formal requirement but the overwhelming majority of UK listed companies have now separated the roles.

¹ The OECD Principles of Corporate Governance state: In a number of countries with single tier board systems, the objectivity of the board and its independence from management may be strengthened by the separation of the role of chief executive and chairman, or, if these roles are combined, by designating a lead non-executive director to convene or chair sessions of outside directors. Separation of the two posts may be regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision-making independent of management.

The International Corporate Governance Network's Global Corporate Governance Principles describes the role of the chair and says "this role will be most effectively carried out where the chair of the board is neither the CEO nor a former CEO."

This approach also allows flexibility for exceptional situations where a combined role may be desirable, for example, when a chief executive has become incapacitated or has been dismissed as a result of crisis and the chairman has temporarily to take executive charge. Any prescriptive rule would need to take account of these exceptions but it would be hard to draft rules without knowing in advance when the need for exceptions would arise.

A code provision accompanied by a comply-or-explain approach creates pressure to ensure exceptions do not become permanent, as can be seen from the decision of Marks & Spencer to revert to this structure after its recent experience of combining the roles.

We would therefore be keen to see the separation of powers covered in national codes but opposed to it being a formal EU requirement.

4. Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance i.e. at national, EU or international level?

Recent experience with banks has shown the importance of effective boards. Critical to this effectiveness is the right balance of expertise and independent challenge as well as a structure which protects against group think. Boards must tailor their structure to maximise their effectiveness, but requirements will vary from case to case.

Some boards, such as those of large banks or high tech companies, may have a particular requirement for technical expertise. But a concentration of technical expertise limits boards' ability to stand back and challenge and it is imperative that every board seeks the most effective mix. We therefore agree that recruitment policies should be specific, and that this should be included in codes as part of the comply-or-explain regime. The UK Corporate Governance Code states, for example, that the "nomination committee should evaluate the balance of skills, experience, independence and knowledge on the board and, in the light of this evaluation prepare a description of the role and capabilities required for a particular appointment."

We would be concerned that imposing formal requirements on the expected profile of directors would not be justified on cost-benefit grounds and that prescription at national or European level might lead to boiler-plate specifications that did not allow for differentiation of individual company needs. It is, in any case, very difficult to see how a requirement could be imposed at international level.

5. Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?

The Financial Reporting Council is currently consulting on whether to introduce such a requirement into the UK Corporate Governance Code. We consider that the representation of women on UK boards is generally too low, but it is important to emphasise that the diversity issue goes beyond gender balance, which will not of itself ensure an effective board. HBOS, one of the largest UK banks to fail, counted four women on its board, giving it a high gender diversity score among large UK companies. Boards need a level of diversity which will strengthen their decision-making and risk oversight and limit the risk of “group think”.

We would therefore be concerned if boards were encouraged to approach the diversity question purely in terms of gender. The mix of skills required is one which will produce the most effective board. It is likely to include a range of skills, expertise, independence, professional background and geographic origin.

That said, gender balance is a potentially useful indicator of whether boards have properly assessed the mix they require. A board with no or too few women on it is unlikely to be sufficiently diverse to protect against group think. A well-managed board evaluation is a useful way of establishing whether boards have got the mix right. The FRC consultation on diversity also addresses this issue.

6. Should listed companies be required to ensure a better gender balance on boards? If so, how?

We find it difficult to see how quotas will contribute to board effectiveness, and feel they would be hard to justify while the best practice route has not yet run its course. The academic literature quoted in the paper suggests a correlation between company performance and the number of women on the board, but it acknowledges that there is no proof of causality and the results are nuanced.

While it has been clearly shown that the introduction of quotas in Norway increased the numbers of women on boards, we are not aware of evidence that this improved their effectiveness. We therefore consider that a best practice approach, including company-set targets which have delivered results in Australia - and as recommended by Lord Davies in the UK - remains the best course for the time being. We also believe that policy makers should target efforts on understanding why too few women rise to the top of the executive ranks which provide the pool from which directors tend to be drawn.

7 Do you believe there should be a measure at EU level limiting the number of board mandates a non-executive director may hold? If so, how should it be formulated?

Directors must have sufficient time to meet their obligations, but a formal limit on mandates is a blunt instrument. Its effectiveness would vary from person to person. A busy executive may have time for only one mandate. The same might be true of individuals who held responsible positions in the non-commercial sector. The chair of a complex company will have less time than a non-executive director with no committee positions.

Instead of limits, directors should disclose responsibilities entailing time commitments that might affect their ability to fulfil their responsibilities and letters of appointment should set out the time commitment expected of each director, as currently required under the UK Corporate Governance Code. Board evaluation should also test whether directors face time constraints. This type of requirements sits well in codes, especially since there is evidence of shareholder monitoring.

8. Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

Yes, we consider that external evaluation has an important role to play. While the market is at a stage of relative infancy, it would not be appropriate to introduce a formal requirement at least as long as the market for evaluation remains undeveloped across the EU, but we have noted in several answers above, on diversity and time commitment, for example, that a well-constructed independent board evaluation is a good test of whether best practice principles are being implemented in ways that deliver effective boards.

Code sponsors should consider the need for independence criteria which might include a recommendation that to qualify as independent a board evaluation should not be conducted by the same search agent who is responsible for recruiting new directors to the board. The UK Corporate Governance Code requires companies to disclose whether the external facilitator has any other connection with the company.

The consultation document suggests that external board evaluation is particularly valuable at a time of crisis or when communication between board members has broken down. When this point is reached, however, the damage is done. The contribution board evaluation can make is to assist boards in enhancing their effectiveness and warn of looming issues so that they can be corrected before trouble strikes. One question that should therefore be asked in a board evaluation relates to resiliency and the ability of the board as a group to cope with stress.

We agree that shareholders do not need to see details of the evaluation, but they need to know about its scope and boards should confirm that action has been taken to respond to implement recommendations.

We need to improve our understanding of the appropriate scope of board evaluation and to strengthen the market in external evaluation. There are signs that the market is starting to deliver on both fronts, and it is therefore probably not necessary for formal official intervention at this stage. In adopting a best practice, code driven approach to the corporate governance issues laid out in the paper, the Commission could stress the reliance it was placing on board evaluation as a means of delivering progress. Were the skills and scope of board evaluation to fail to develop in ways that justify this reliance the need for formal regulation of corporate governance standards might have to be revisited.

9. Should disclosure of remuneration policy, the annual remuneration report (a report on how remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?

Yes. There are arguments that some aspects of disclosure tend to promote a ratchet effect on remuneration but given the level of disclosure in some markets, it is difficult to justify moving in the direction of less transparency.

10. Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

A distinction has to be made between different types of remuneration. It is appropriate to submit remuneration involving dilution or the issue of shares to directors to a binding vote in advance because such share-based incentives can significantly affect shareholders' rights. This practice has worked well in the UK for many years.

In other areas there are difficulties with a binding vote. The remuneration report deals with what has happened over the company's financial year. A binding vote to reject it would serve no purpose because money paid out cannot normally be reclaimed. A binding vote on policy which was forward-looking would in theory be enforceable but raises questions about whether companies would seek to limit their obligations by offering only a high level policy in advance as appears to have been the case in the Netherlands. There are also questions about what would happen if changed circumstances caused them to wish to change their policy in the course of the year.

An advisory vote on the remuneration report is therefore still more likely to be the most practicable solution. The difficulty is that it may be ignored by companies. Experience in the UK shows that companies which suffer a large adverse vote tend to revise their remuneration policy in consultation with their shareholders. They are more likely to do so if directors are subject to

annual re-election. Where this is not the case, an alternative approach would be to insist that the remuneration committee submit itself to re-election after two significant protests in a row, since this would indicate a lack of willingness to respond to an advisory vote.

11. Do you agree that the board should approve and take responsibility for the company's "risk appetite" and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risk?

The FRC has had extensive discussions with companies in recent months from which a strong view has emerged that risk is intimately connected to strategy for which the board has an absolute responsibility. The term 'risk appetite' is understood by financial companies since it can be calculated numerically, but it is confusing for non-financial companies for whom such precise financial calculations are difficult. It is nonetheless imperative that all boards understand how much risk the company is taking and that they understand and monitor the risk profile associated with their strategy.

Shareholders will have a better understanding of the risks a company is running if it is able to explain its strategy in way that lays out the main risks and opportunities. Companies should therefore describe their business model in their annual report. This report needs to capture the business model not in a static way, but also explain how the strategy - and therefore risk profile - is changing and evolving. Environmental and social risks should be included in the picture insofar as they have a material impact on the company, as is already required under the Transparency and Accounts Modernisation Directives.

As noted in the FRC's response to the Green Paper on the corporate governance of financial institutions, EU Directives already require disclosure of some relevant information. For example, the disclosure of principle risks and uncertainties is required under the Transparency Directive and disclosure of internal controls over financial reporting is required under the 4th Company Law Directive. These requirements might usefully be consolidated and perhaps enhanced. We would therefore support carefully elaborated requirements at European level to introduce effective business model reporting by companies.

12. Do you agree that the board should ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

Yes. The board should ensure that proper arrangements are in place, but we do not support effectiveness statements such as those required by the Sarbanes-Oxley Act.

13. Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.

We consider that the solvency rules applied to insurance companies have led them to reduce their exposure to equities. In the UK their exposure to equities has fallen sharply over the last 20 years, removing a source of long term stability and focus from the equity market. The Solvency II proposals should be reviewed to ensure this problem is not compounded.

The rules on accounting for pension fund deficits have also had an unintended behavioural impact because their reliance on the AA bond rate for discounting liabilities has encouraged sponsors to match investments to the valuation of liabilities, especially since they have been required to carry the deficits on their balance sheets. While we agree that accounting standards should aim to uncover and expose deficits, we believe that the behavioural reaction has contributed to a sub-optimal outcome, including the closure of many defined benefit pension schemes. Anecdotal evidence suggests that the pension funds of UK listed companies have now only a very limited portion of their investments in equities. As with insurance companies, official statistics show a sharp decline in equity holdings by pension funds. The IASB is about to consult publicly on its future agenda priorities. The EU could encourage the IASB to review its pension accounting arrangements, and in particular the discount rate for measuring liabilities in order to reverse this trend.

By its focus on trading liquidity, the Markets in Financial Instruments Directive (MiFID) appears to have stimulated greater interest among market participants in trading strategies. This plays to the commercial interests of investment banks because of their dependence on dealing profits. The current review of MiFID offers an opportunity to enquire whether it has unintentionally led to a promotion of short-termism.

When reviewing all Directives with a financial market impact, the Commission should ask whether they have acted as a disincentive to a long term approach by investors. A further example is the Transparency Directive requirement for quarterly reporting which was opposed by long term investors when it was introduced. It serves to create trading opportunities for investment banks and is not needed as long as requirements on companies to disclose market sensitive information promptly are properly enforced. The current review of the Transparency Directive is an opportunity to make quarterly reporting voluntary – a deregulatory move which would also send a strong signal that the EU was anxious to restore a better market balance between long and short term interests.

Although it is beyond the remit of the Green Paper, we also note that differential taxation of debt and equity encourages companies to gear up and encourages share buybacks rather than dividends. A progressive dividend policy, which requires companies to generate increasing amounts of cash into the distant future, is a very good long term incentive on management, but has become a lesser priority for many companies, partly because of the tax incentives and partly because buybacks are a means for managements to manipulate their share price in the short term.

14. Are there measures to be taken, and, if so, which ones as regards the incentive structures for, and performance evaluation of asset managers managing long-term institutional investors portfolios?

Asset managers should be remunerated in ways that align their interests with those of their clients. This is true both in terms of their fee structures and the remuneration of individual fund managers. Little is known for certain about how individual fund managers are rewarded but it appears that bonuses normally relate to fund performance against benchmarks. In many cases this performance may be measured over long as well as short periods, creating incentives which are in practice less short term than widely believed and than is implied in the paper.

It would help, however, if clients were in a better position to ensure that alignment is appropriate. As far as fees are concerned this means greater flexibility in structure. For example, those for whom engagement over the long term is important to the delivery of their investment objectives may wish to pay a specific fee for engagement with other fees and conditions adjusted accordingly.

The principles on remuneration set out in the Alternative Investment Fund Managers Directive, particularly their reference to set appropriate incentives with regard to risk taking, may be a good starting point for further consideration of this issue. Any measures taken at EU level should be consistent across the financial industry as a whole while respecting the particular peculiarities of individual markets.

15. Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with investee companies? If so, how?

Yes. Please refer to the comments on stewardship above. We believe there is scope to require trustees and others who issue investment mandates to consider these issues when hiring fund managers. This requirement could usefully refer to the desirability of an asset manager following a stewardship code. It should also be extended to those who place mandates with asset managers for the investment of defined contribution pension schemes.

However, it should not restrict the freedom of institutional investors to determine the investment style which best suits their needs.

16. Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

Conflicts of interest may sometimes play a significant role in deterring asset managers from following through on engagement, though fiduciary responsibilities would mitigate this risk and end-client demand for stewardship will increase the commercial requirement for engagement. It would certainly help if asset manager governance was independent from group ownership structures and if there was a requirement to report on the management of conflicts which might exist if they are part of a wider financial group. Another conflict which may affect all asset managers who are not part of a financial group is pressure from companies for whom they undertake pension fund management to vote in a particular way. The proposal in question 16 would not address this.

The UK Stewardship Code requires signatories to have and disclose publicly a robust policy for managing conflicts of interest. This approach means each asset manager who sign up to the Code needs to consider the policy in relation to the particular conflicts that affect its business. This is an appropriate starting point, but the ability of institutions to manage conflicts needs to be monitored closely, and the effectiveness of existing regulatory requirements such as those in MIFID and the AIFMD kept under review. Regulation may eventually be needed if the market fails to address this problem.

17 What would be the best way for the EU to facilitate shareholder cooperation?

We believe it is necessary to clarify the EU rules on acting in concert in order to make it clear that shareholder collaboration on governance issues is permissible when it is not designed to lead to a change of control, i.e. by replacing a majority of the board.

The paper asks about proxy solicitation and cross border voting. We would support an initiative in this area and refer to our general comments above.

18 Should EU law require proxy advisers to be more transparent, e.g. about their analytical methods, conflicts of interest, and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?

Please refer to our comments above. We would favour a disclosure regime, but are uncertain at this stage about the value of a code of conduct. It is important to remember that regulating organisations such as proxy voting agencies will add to their importance and confirm their role in the system. Ideally shareholders should rely less on them.

We would also be wary of regulations which gave issuers the power to delay publication of proxy advisers' reports or influence their content. This would undermine the independence and usefulness of the advice.

19 Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisers to provide consulting services to investee companies?

Not at this stage. We believe the transparency route should be tried first.

20 Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

We believe companies have a fundamental right to know who owns their shares and controls votes at their general meetings. European legislation should provide for this, even though the logical consequence would be an end to bearer shares which remain popular in some jurisdictions. Ideally the right approach would be electronic registration of shares within a central depository. This would by-pass the need for custodian and sub-custodian chains, make direct communication between companies and their shareholders easier, and reduce the risk of votes going astray.

We are concerned that under the present system custodians appear to maintain no real time records of ownership and reconcile positions in omnibus accounts relatively infrequently. This makes it much harder to track the consequences of stock lending on ownership, adding to the risk of "empty voting" and to companies' difficulty in understanding who controls their votes.

It is not clear to us that the adoption of an electronic register would facilitate cooperation between shareholders unless the register was open to all shareholders to inspect. This raises issues about privacy which need careful consideration.

21. Do you think that minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

We support the recent statement by the European Corporate Governance Forum supporting a requirement for a shareholder vote on significant related party transactions.

We do not believe that directors should be specially appointed to represent the interests of minority shareholders in companies with block holders as this would undermine the concept of independent directors. A more effective way is to emphasise and enforce the obligation of all directors to act in the interest of the company and ensure that relevant committees, in particular audit and remuneration, are fully independent.

Generally speaking we are against the provision of additional voting rights to block holders as the evidence shows these increase the cost of capital and add to the risk of management entrenchment. Given the recent political debate in the EU on this subject we would not advocate the imposition of a mandatory one-share-one-vote regime, but we would argue strongly against corporate governance measures moving away from one-share-one-vote. This would include the introduction of any new provisions to give certain selected shareholders extra voting rights or additional dividends.

22 Do you think minority shareholders need more protection against related party transactions? If so, what measures could be taken?

See answer to question 21 above.

23 Are there measures to be taken, and if so, which ones, to promote at EU level employee share ownership?

European company law already provides for employee share schemes and for employees to be consulted, for example, over takeovers. We do not see a need for further measures in this area. Although individuals might run the risk of lack of diversification if their savings are all tied up in employee share schemes, we believe that, on balance, these schemes are useful and that it may make sense to promote them through tax concessions.

A decision to do this is one for national governments rather than the EU, however. Also we do not believe that a large emphasis on employee share ownership will necessarily lead to greater long termism. Lehman Brothers, whose staff owned a large proportion of its business, did not pursue a sustainable long term strategy. Also the preponderance of staff ownership turned out to be an obstacle to refinancing the company when it got into difficulty.

24 Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

Explanations should be sufficiently informative to enable shareholders to make a considered decision. Each market should develop an understanding of what this entails. Please refer to our comments on comply-or-explain above.

25. Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?

No. We are opposed to this for reasons set out in our general comments above. However, as set out in our earlier comments, there may be a role for monitoring bodies to play if shareholders bring to their attention cases where companies have provided explanations that fail to meet certain agreed criteria.

Annex 1

The FRC has published the following paper on Effective Corporate Governance, which is available separately on our website www.frc.org.uk

Executive Summary

The productive capacity of most economies in the world depend on the sustainable creation of value by companies – over 70% of world trade is controlled by just 500 companies. How these companies are run is therefore of fundamental importance to economic efficiency, stability and growth.

Given its significance, it is understandable to observe real public interest in corporate governance and considerable value in getting things right. The latter requires an evidence based approach to policymaking – one backed by theoretical and empirical findings. Whilst academic research has provided valuable insight into the value of corporate governance, it has not identified the perfect framework for improving corporate governance. This is not surprising. In Europe the diversity of legal systems, ownership structures and other factors mean that there is no single set of rules, framework or plan to achieve good corporate governance. Flexibility of policy across economies is therefore desirable.

The objective of this paper is to identify the essential components for promoting corporate governance. These components include regulation - where necessary - to establish basic standards of conduct and transparency - codes to encourage best practice, and shareholder rights as well as responsibilities to promote accountability. It also identifies the key benefits of codes.

The paper provides arguments in favour of proportionality, flexibility and targeting – all features inherent in a system where best practice is encouraged through codes. The paper argues that codes:

1. are effective in changing behaviour
2. are adaptive to the needs of companies
3. can be more effective at raising standards than law
4. evolve easily over time in response to changing economic circumstances
5. reduce the risk of moral hazard
6. help standards of corporate governance converge between countries
7. incentivise innovation and encourage thought leadership
8. are less costly than law

Corporate governance must be informed by theoretical and empirical evidence so that it may lead to the efficiency, stability and growth desired. The FRC hopes that this paper contributes to this debate.

One - Introduction

"The proper governance of companies will become as crucial to the world economy as the proper governing of countries"

James D. Wolfensohn, President of the World Bank, 1999

Good corporate governance supports the sustainable performance of companies and in doing so supports the global economy – Mr Wolfensohn's prediction in 1999 has come to pass. This is evident from the growth of large corporations and their prominence in global economic activity – as these companies grow, their economic footprint and the quality of their governance systems has wider economic consequences ²:

- Of the 100 largest economies in the world, 52 are companies.
- Over 70% of world trade is controlled by just 500 companies.
- In 2002, almost a third of world output came from 200 companies.

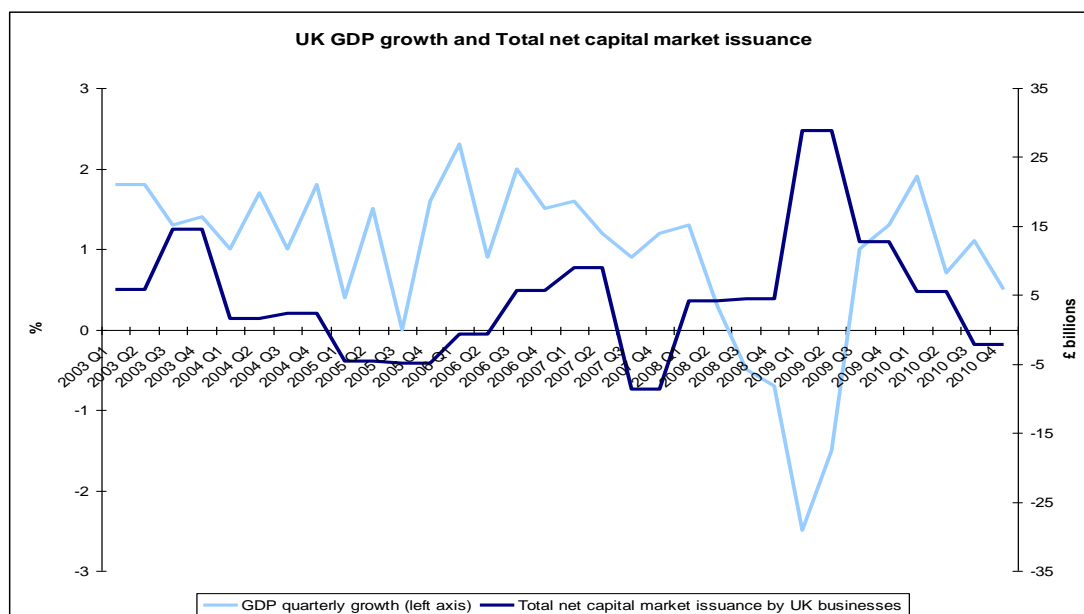
At the London Stock Exchange (LSE, 2009), combined market capitalisation was £3.7 trillion in 2010 or 112% of UK GDP in that year³. Over £21 billion was raised through London's exchange in 2010 and £366 billion over the last 10 years.

Confidence in corporate governance is integral to confidence in capital markets and to the cost of capital. During the recent financial crisis, capital markets played an important part in supporting the UK economy, despite high levels of macro-economic risk and uncertainty. As GDP in the UK fell during 2008 and 2009, companies on the FTSE were able to shore up their balance sheets through the sale of corporate bonds, equity and commercial paper (Chart 1). The effects of the recession could have been much deeper had these companies been unable to raise capital in the way they did.

² Data available at: <http://www.stwr.org/multinational-corporations/key-facts.html>

³ ONS data and FRC calculations. UK GDP are at 2006 basic prices and can be found at: http://www.statistics.gov.uk/downloads/theme_economy/Real-time-GDP-database.xls

Chart 1: the contribution of capital markets to the UK economy during the recession⁴



Given the significance of corporations and their continued growth, the systems by which they will have to operate through compliance with codes and/or law will have major consequences for economic growth. The efficiency of capital markets and future trajectory of economic growth will depend on policy decisions made now.

What is Corporate Governance?

In this paper, corporate governance is defined using the definition from the Organisation for Economic Co-operation and Development:

“The system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance”.

⁴ Data for total net capital market issuance are half-yearly. Trends in Lending, Bank of England, April 2011.

An alternative answer is to think of corporate governance as a means to establish a system of control between the board and management as well as accountability from the board to the shareholders. This system of control and accountability facilitates long-term sustainable economic growth by aligning incentives between those who manage and those who own companies.

Two - The components of a corporate governance framework

The FRC believes that an effective corporate governance framework requires a number of components: rights to enable shareholders to hold companies to account; the availability of information needed to assess the performance and governance of companies; and an expectation of certain behaviours on the part of companies, promulgated either through law or codes. In general, the FRC believes that the law is appropriate for imposing basic standards of conduct and transparency while codes are more effective in encouraging best practice.

The following section sets out how these different components contribute to an effective corporate governance framework. The appropriate balance between them will vary from country to country. For example, the corporate governance challenges are very different in markets where shareholder ownership is highly dispersed, such as in the UK and the Netherlands, than in those where it is highly concentrated, such as in France and Germany. Flexibility in responding to these structural differences is essential.

Shareholder rights and responsibilities

Shareholders play a crucial role in holding boards to account, and so require rights which they must exercise responsibly. Prior to the recent financial crisis, the focus of governance was on the “supply side” i.e. the role of directors. Policymakers now recognise that the “demand side”, and the need to promote and remove obstacles to shareholder engagement, is at least as important⁵.

Researchers have studied the influence of shareholders on corporate governance and have found that compliance with codes is systematically higher in firms where shareholders have appointed one or more directors and where institutional investors participate in AGMs⁶. This is likely to be driven by one of the fundamental purposes of corporate governance (see definition), that of maintaining accountability between the board and its shareholders.

The rights and responsibilities of shareholders are defined by a varying mixture of law and code in different countries. Relative to other jurisdictions in the world, such as the US, the governance systems of the EU feature strong shareholder rights. Directive 2007/36/EC sets out a number of basic rights such as the right to information. National company law is also crucial in setting out the rights of shareholders. For example, UK law

⁵ See UNCTAD 2009.

⁶ See Gompers et al 2003.

allows shareholders to call a general meeting with 5% of the share capital, and remove the board with a majority of the votes.

The recent crisis highlighted the need for shareholders to use their rights effectively. The mere existence of shareholder rights will not ensure good governance. In response to growing concern on this subject the FRC published The Stewardship Code in July 2010⁷. This code aims to promote dialogue between company boards and investors as a basis for improving the quality of corporate governance and long-term company performance.

Other EU Member States have also taken action to address this issue using different methods. For example, the Netherlands Corporate Governance Code issued in 2008 contains a number of best practice provisions which shareholders are expected to comply with or explain why they have not. In 2010 the Portuguese securities and insurance regulators (CMVM and ASP) issued a set of recommendations addressed to mutual fund and pension fund managers.

The design of shareholder rights and responsibilities must take account of prevailing ownership structures. Structural differences based on ownership could cause significant differences in the ability of shareholders to hold boards to account.

In the UK, shareholdings in excess of 6% are rarely observed in the largest corporations. Only 16% of the largest UK companies have a shareholder with more than a 25% stake, and in just 6% of these is there a majority shareholder⁸. By contrast, in France and Germany, there are much larger concentrations of ownership: in 85% of the largest German companies and 79% of the largest French firms, there is at least one shareholder with a stake in excess of 25% of the total. Over half the companies in both countries, there is a single majority shareholder.

Both models have strengths and weaknesses. A more dispersed ownership structure is likely to mean less risk of minority shareholder interests being expropriated, however, it can also create barriers to effective organisation of shareholders in holding boards to account. The opposite may also be true in a concentrated structure of ownership.

⁷ The UK Stewardship Code can be found at: <http://www.frc.org.uk/corporate/investorgovernance.cfm>

⁸ The data can be found at the CEPR web page: <http://www.cepr.org/pubs/Bulletin/meets/518.htm>

Accurate and relevant information

To be able to influence the performance of companies, investors must have the right information on which to base their decisions and to be effective, engagement between them and the board should be based on accurate and relevant information. Without confidence in information, capital markets would not exist.

There is evidence that poor governance increases the cost of capital⁹. Investors use information on companies' management, strategy and risk exposure when assessing their investment risk. It therefore follows that accurate and timely information produced through good governance decreases the perception of risk and so reduces the cost of finance.

Good corporate governance also minimises information asymmetries between management and investors through the provision of standards that promote transparency and standardisation of information across industry.

The importance of information is reflected in both law and codes. National and EU legislation provide for basic rights to information which are likely to be better achieved by law. For example, Directive 2007/36/EC provides shareholders with rights to information relating to the general meeting, while Directive 2004/109/EC requires traded companies to publish an annual management report setting out, amongst other things, their key risks. Codes can build on this by setting flexible targets for sharing information which is relevant to a company's specific context and in its shareholders' interest.

Company behaviour

As explained, shareholder rights and the availability of accurate and relevant information are crucial for effective governance. They make up the "demand-side" of corporate governance. The "supply-side" is equally as important. This consists of standards of behaviour expected of companies. Standards are used by directors to structure their companies and processes so that they can meet corporate objectives in a sustainable and efficient way.

⁹ See Zhu, 2009.

These standards – just as with provisions on the demand side - involve both law and codes, and the balance between the two differs between countries. For example, requirements to disclose directors' remuneration and provisions allowing shareholders to vote on this matter are set out in law in some EU Member States, including the UK, but in codes in some other countries.

Most EU Members States use a combination of company or securities law and “comply or explain” codes of best practice. The law sets the essential requirements whereas the code sets the standards regarded as best practice. This difference in objective is important. It reflects how, in many cases, the law may be less effective in setting standards of best practice. This is because codes can use broad principles such as ‘every company should be headed by an effective board’ whereas law must be more prescriptive for it to be enforceable.

Differences in expectations can also be observed in the varying corporate structures of European boards. For example, the UK is the only country in the EU with all of its listed companies governed by a unitary board¹⁰. The European averages for board structures are:

- Unitary – 27%
- Two-tier – 42%
- Mixed System – 31%

Rather than reflecting a ranking of quality of corporate governance, these differences are a reflection of the variety of legal provisions in Member States, as well as differences in the historical development, attitudes toward business and perceptions of what best drives economic growth. The FRC believes in the importance of diverse approaches as stated in the Report of the Reflection Group in April 2011.

The Benefits of Diversity Between Countries

“The different corporate governance systems of the Union should not be viewed as an obstacle to free enterprise within a single market, but as a treasure trove of different solutions to a wide variety of challenges that has been experienced and overcome.”

Report of the Reflection Group on the Future of EU Company Law

¹⁰ See Heidrick and Struggles, 2011.

Three - Features of codes that encourage best practice in corporate governance and change behaviour

Since the early 1990's, governments and regulators have relied on codes to encourage the development of best practice in how businesses are organised and how they behave. This part of the paper outlines the factors that contribute to the success of codes and the arguments against replacing them with rules.

1. Codes are effective in changing behaviour

Codes have a proven track record in changing behaviour. For example, the first UK code, issued in 1992, recommended the separation of the chairman and chief executive. Table 1 below shows the steady increase in the percentage of firms in the FTSE 350 that separated the role of the chair and chief executive between 1995 and 2010. When the recommendation was first made, only a minority of companies were in compliance; over 95% of companies now comply. This has been achieved without recourse to law.

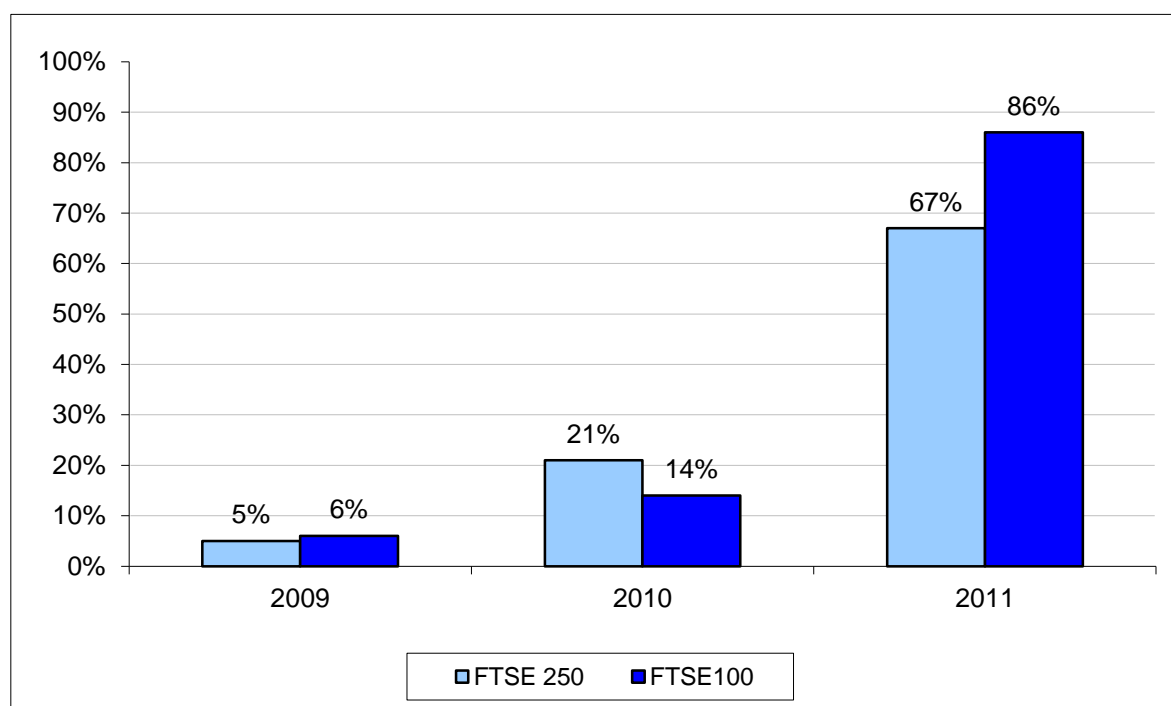
Table 1. Separation of the role of Chair and CEO in the UK¹¹

	Non-executive Chair	Total Chair	%
1995	82	173	47.4%
2000	169	263	64.3%
2005	247	313	78.9%
2010	335	350	95.8%

Once a code is well established, and respected, changes then can be made quickly and also lead to rapid compliance. The annual election of directors included in the UK Code for the first time in 2010, is a good example of how codes can have an immediate impact. The graph below shows the dramatic increase between 2010 and 2011. This is expected to promote the accountability of directors to shareholders and so should have material benefits in the long term performance of the company.

¹¹ Owen, (2006) NB – data from 2010 are taken from Grant Thornton Evolving with the Code (2010). The two data sets between this and the other years is different, however, the benefits of including the data set are likely to outweigh discrepancies in methodology due to the strong trend observed in previous years.

Chart 2. Boards with annual elections in the UK¹²



* Annual elections were introduced in 2010. The data in chart 2 for 2011 is not yet complete. The final result may be different to these figures.

2. Codes are adaptive to the needs of companies

Flexibility is preferable when considering corporate governance measures that may differ depending on the context and interpretation of different market participants. The governance of corporations in any advanced economy will cover numerous corporations. In the UK, the LSE covers 1,400 companies in around 40 different sectors. These companies differ in many ways – size, geographical coverage business ethos, shareholder sentiment. These differences have implications on what is required of corporate governance.

In Germany, as in other countries, there is a link between the size of the firm and the use of justifications for adopting alternative approaches – smaller companies were found to have taken more advantage of the ability to explain rather than comply than larger companies¹³.

Law can be adapted to vary by size too but its overall flexibility in meeting the many different dimensions of companies is limited.

¹² 2011 data from Addleshaw Goddard LLP. Data between 2009-2010 is from PIRC

¹³ See Seidl and Sanderson, 2007.

3. Codes can be more effective at raising standards than law

Much of the debate over corporate governance conflates law and codes. However, they are quite different tools. Because codes are flexible and can be tailored to different contexts, standards can be higher than those set out in law, which need to be consistent and capable of being reasonably applied to all companies that are caught by them.

An example: Audit committees

The history of the formation of audit committees in the UK illustrates how codes can set and achieve higher standards.

Directive 2006/43/EC (the 8th Company Law Directive) requires all listed companies to have an audit committee (or body carrying out an equivalent function) and for at least one member to be an independent director. The Directive was issued toward the end of 2006 and it was implemented in 2008 in most Member States.

Prior to the Directive there was no legal requirement on companies in the UK to have an audit committee, although the UK code recommended audit committees in 1992. The initial recommendation was that all members should be non-executives, of which the majority should be independent. In 2003 the recommendation was changed to state that all members of the committee should be independent.

The Grant Thornton survey for corporate governance in 2006 found that 100% of FTSE 350 companies had audit committees, of which 88% were fully independent. A survey commissioned by the FRC in 2006 of 465 smaller listed companies found that 99% of them had audit committees, and 57% had fully independent committees¹⁴. This compares well with the Directive's requirement of at least a single member of the board being independent and is just one example of the effectiveness of codes.

¹⁴ The survey was conducted for the FRC by Manifest. Sample calculated as follows: Those companies in the Small Cap/Fledgling indices as at the date of their AGM, where the AGM date was between 1 Sep 2005 to 31 Aug 2006. The total sample included 465 UK listed companies.

4. Codes evolve easily over time in response to changing economic circumstances

Investor expectations create a powerful incentive for companies to adopt best practice. By progressively reflecting and codifying views on best practice, codes promote continuous improvement over time. Regular and open dialogue between standard setters and market participants is key to this, as is the fact that the flexibility of codes allows for a transitional period in which companies can first help develop then accept and finally adopt best practice.

Codes are also easier and quicker to change than law. Capital markets are dynamic and innovative, providing a variety of sources of growing investment opportunities for investors. These opportunities are linked to a growing need for improved investor information, and so governance systems need to be able to adjust both in a proportionate and timely manner to be effective. In both respects, codes are useful tools as they can be used to react quickly to developments, to the emergence of new products, to new information asymmetries¹⁵ and to advances in governance practice. This is because codes can be redrafted and implemented without legislative change.

For example, in the Netherlands, the State Secretary for Economic Affairs established a committee to study the relationship between corporate social responsibility and corporate governance. The committee made specific recommendations which were then adopted by the code. This process began in May 2008 and was completed by the end of the year¹⁶.

5. Codes reduce the risk of moral hazard

Research has found that rules may have unintended consequences whereby mandatory regulations push boards toward compliance as a box-ticking exercise and provide lesser effort toward forward-looking strategy. This creates the impression of good corporate governance when the reality may be quite different.

¹⁵ See Petow 2007

¹⁶ See Pierce 2010

In a strict rules-based regulatory environment, shareholders may feel that corporate governance is being monitored effectively when it is not. Their involvement in stewardship could decline in proportion to this confidence even though regulation may be lagging behind market developments. Also, in cases where shareholders and regulators views conflict, shareholders may feel less able to influence standards as they hold relatively less power.

If companies were only accountable to regulators, this could create 'moral hazard' which is a change in behaviour resulting from changes to risk exposure. Codes can help to avoid this as investors will look to the corporate governance metrics of companies and use this as part of their investment decision. This will also drive better corporate behaviour.

6. Codes help standards of corporate governance converge between countries

As the main group holding boards to account, shareholders take the lead in driving best practice. Their activity at international level can act as a converging force on the quality of corporate governance as countries seeking international investment adopt what those investors see as best practice, but in a way that adapts them to their local needs and economy. Indeed, the latest pan-European study found that corporate governance frameworks were converging across the EU¹⁷.

In Europe, a study of 300 companies in 17 countries also found convergence. Ratings for board structure and functioning, and particularly for disclosure, have risen in every country and industry. However, shareholders' rights and duties and takeover defences have not changed significantly¹⁸. This may be an area to focus on in the future.

Global international investors can add value by pushing for best practice in countries that do not have sufficient local investor power or the capital markets to develop their codes and standards.

¹⁷ See Riskmetrics 2009

¹⁸ See Wojcik 2006.

7. Codes incentivise innovation and encourage thought leadership

Flexibility of codes drives an intelligent and healthy debate within companies about what would constitute good governance, rather than an unthinking compliance mind set.

This enables companies to pay greater attention and care to governance issues. Codes provide flexibility for companies to justify why they have not met a specific provision by providing an explanation which can take the form of an alternative approach. However, the underlying principle of the code must be met. This approach incentivises innovation in governance practices in a way which is adaptive and may develop best practice further. Alternative approaches to meeting the requirements of codes are beneficial as they are tailored specifically to the circumstances of the individual company. This is likely to yield efficient outcomes.

8. Codes are less costly than law

Codes can be less costly than a rules-based system. Companies have the incentive to assess the relative costs and benefits of standards through the flexibility of codes. However, the justification of not applying the code will need to be given to shareholders and therefore must be credible. With rules, standards are applied without direct regard to cost for specific companies and the likelihood of disproportional impact across different companies. Without proportionality, the system is not only inefficient but companies will also be more likely to seek ways of getting around best practice, creating a culture of avoiding corporate governance measures.

Studies have found that the cost of Section 404 of the US Sarbanes Oxley Act (SOX) exceeded its benefits in its initial years. This explains why the majority of companies were initially negative toward it. SOX was seen as having a positive influence only in later years when the front loaded costs were overcome.

Based on costs from SOX¹⁹, a similar approach in the UK's largest firms would cost, on average, £2.18 million per company in the first year. This would place total cost for the top 200 FTSE companies by market capitalisation at around £436 million. Additional costs to the economy through de-registration and loss of economic output would increase the total cost to the European and global economy.

¹⁹ FRC calculations based on average cost of SOX per firm. FEI survey is available at: http://www2.financialexecutives.org/files/spacer.cfm?file_id=1498

As in the US, these costs would most likely decline quickly in the UK as companies adapt and reduce associated overheads. However, the value added of rules over codes is not proven. Codes can achieve good outcomes without these costs and are also flexible enough to benefit smaller companies.

Four - Conclusion

This paper has shown that there are a number of key components necessary to make corporate governance work effectively. Shareholders must have appropriate rights but must also be able and willing to take forward their duty of stewardship. Companies must engage with shareholders to maintain a system of checks and balances which are conducive to the long term sustainability of business but must also adhere to the principles of best practice and not treat it as a box-ticking exercise.

These key components are shown to be well grounded within a principle-based system which is based on proportionality, flexibility and targeting that cannot be achieved through a one size fits all approach. The paper underscores the need to promote freedom of choice in achieving best practice, whilst at the same time enforcing necessary standards through regulation. At this critical juncture in a period of economic recovery, a continued focus on flexibility is appropriate.

Codes provide this flexibility. They encourage a better corporate behaviour and raise the overall standards of best practice. By evolving over time to meet the needs of business and by doing so at lower cost whilst also remaining receptive to the needs of different businesses, codes are effective in changing behaviour. Finally, codes encourage companies to innovate through alternative measures and also reduce the risk of moral hazard by promoting shareholder engagement.

Total compliance to the letter of corporate governance standards is not the right test for judging effective governance; continuous improvement of behaviours and standards in pursuit of achieving best practice is. Companies and regulators would do well to focus on this and shareholders would do well to encourage them.

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