NAPF Response to the FRC Combined Code Review

October 2009

Introduction

The NAPF is the leading voice of workplace pensions in the UK. Our member schemes currently account for around 80% of private funded pension saving in the UK, by size of assets and by the number of consumers benefiting. NAPF members manage around £790 billion in pension fund assets.

The NAPF has welcomed the FRC's review of the Combined Code and this further opportunity to respond concerning possible changes. The NAPF's comments on the latest proposals in this review are detailed below.

Should you wish to discuss any of our comments please contact David Paterson, Head of Corporate Governance.

SECTION 1: THE CONTENT OF THE COMBINED CODE

Introduction

The FRC intends to adopt three guiding principles when assessing the lessons to be learnt from the financial crisis and the case for changes to the Code and its accompanying guidance during the next phase of the review.

These are:

- Where there is a demonstrable need for best practice to be clarified or strengthened, this will be addressed either through amendments to the Code or additional, non binding guidance;

- Where not constrained by regulatory requirements, we will seek to rationalise disclosure requirements in the Code to encourage more informative disclosure on the issues of most importance to investors and to discourage boiler-plating and box-ticking; and

- We will seek to avoid an increase in the overall level of prescription in the Code and to preserve its principles-based style.

In addition, if there is evidence that the Code may inadvertently have made it more difficult for boards and committees to operate effectively, changes to the relevant sections of the Code will be considered.

The FRC would welcome views on these guiding principles.

NAPF: There is general agreement among members that wholesale overhaul of the Code is not needed and that the principles above should be followed.

The responsibilities of the chairman and the non-executive directors

Specific issues for further consideration include:

- Whether it would be helpful to give further clarification of the role, key responsibilities and expected behaviours of the chairman, the senior independent director and/ or the non-executive directors, either in the Code or in non-binding guidance;

- Whether it would be helpful to provide further guidance on the time commitment expected of the chairman, senior independent director and / or non-executive directors.

NAPF: In general we believe that further codification would not be helpful. However shareholders need to be provided with the information needed to assess the effectiveness of the board in carrying out its role. The chairman should be expected to report to shareholders on the way in which directors have discharged their responsibilities.

Board balance and composition

Specific issues for further consideration include:

- Whether the Combined Code gives sufficient emphasis to the need for relevant experience among the non-executive directors collectively;

- Whether the independence criteria and the way they have been applied by boards of companies and investors have unnecessarily restricted the pool of potential non executive directors, and in particular whether the so called "nine year rule" has resulted in a loss of continuity and valuable experience;

- Whether the recommendation that the boards of FTSE 350 companies should comprise at least 50% independent non-executive directors has resulted in fewer executive directors sitting on boards and/or boards becoming larger;

- Whether more guidance is needed, in the Code or elsewhere, on succession planning and the need to ensure that board composition is aligned with the present and future needs of the business.

NAPF: Again we would avoid additional guidance. We do not believe that the "nine year rule" has been damaging, partly because most investors see it as no more than a marker that succession and refreshment should be addressed. There is some evidence of a reduction in the number of executive directors on boards which we see as an undesirable trend, but that has to be balanced against the comfort which is derived from non-execs being in the majority. We would like to see a report from the nomination committee develop which would cover these issues.

Frequency of director re-election

Views are invited from companies and investors on whether changes to voting would increase accountability to shareholders and which, if any, of the following options they would support as recommendations for possible inclusion in the Code:

- Annual re-election of the company chairman;
- Annual re-election of the chairs of the main board committees;
- Annual re-election of all directors;
- Binding or advisory votes on specific issues, or on the corporate governance statement as a whole.

NAPF: Members are divided on the merits of annual elections but on balance there is a growing preference for them.

Board information, development and support

Specific issues for further consideration include:

- Whether the Code should be amended to recommend that board evaluations should be externally facilitated at least every two or three years for some or all companies;
- Whether the recommendation that the effectiveness of all the main board committees should be evaluated every year should be relaxed in some way, for example to recommend a rolling cycle of committee reviews. Some commentators considered that after the initial evaluation there was limited value in subsequent annual reviews;
- How disclosures in the annual report might be made more informative, either in relation to the process that was followed and/ or the outcomes of the effectiveness review.

On the last issue, the FRC believes that the proposal for an "assurance statement" merits further consideration as it may provide a means of enabling investors to obtain more relevant information while allowing some other disclosure requirements in the Code to be rationalised, and would welcome views on what might be covered by such a statement.

NAPF: we believe that board evaluation was one of the most important innovations of the Higgs review but agree that its application varies considerably in quality. Higher standards would be encouraged by external facilitation accompanied by appropriate disclosures with a particular emphasis on outcomes and actions.

Risk management and internal control

Specific issues for further consideration include:

- Whether the board's responsibility for strategic risks and setting risk appetite – as set out in the Turnbull Guidance - should be made more explicit in the Code, and whether the current balance between the Code and the Guidance is the right one;

- Whether there is a need for all or parts of the Turnbull Guidance to be reviewed;

- To what extent the particular mechanisms recommended for banks and financial institutions would also be appropriate for other listed companies; (For example, there were mixed views among commentators about whether separate risk committees were necessary for companies with less complex business models.)

- How reporting on risk might be improved, for example by rationalising existing disclosure requirements or providing guidance on good communications tools.

NAPF: given the importance of risk management especially in the light of the financial crisis, we believe that a full review of the Turnbull guidance is merited. For less complex businesses a combined risk and audit committee will probably suffice. As noted elsewhere the key will be good disclosure of its role and effectiveness.

Remuneration

Specific issues for further consideration include:

- Whether to revise the Code to ensure consistency with the European Commission's Recommendations and, where appropriate, the FSA's proposed code of remuneration practice for financial institutions and the recommendations of the Walker Review;

- Whether any other changes to the Code, or additional guidance, are required to reflect developments in best practice;

- Whether shareholders should be given a more direct role in setting remuneration and, if so, how this might be achieved.

NAPF: as noted in our earlier response we believe that the current model serves neither shareholders nor management well and we believe that a thorough review of accepted best practice is warranted. The aim should be a simpler structure which better aligns interests over the longer term and exposes management to significant financial risk in the event of failure to achieve the goals set. This may best be achieved by deferral of cash bonuses into shares and the mandatory build up of material shareholdings by management.

SECTION 2: THE IMPLEMENTATION OF THE COMBINED CODE

Specific issues for further consideration include:

- The extent to which it would be possible and desirable to rationalise the disclosure requirements set out in the Code. We would particularly welcome the views of investors on what information is of most value to them, and the views of companies on what information is most costly to produce;
- Whether it would be appropriate for the FRC or the FSA to undertake greater monitoring and enforcement of "comply or explain" statements, and if so what form this might take.

Views are invited on these issues, and on whether there are any other actions that the FRC might take to encourage more informative disclosure.

NAPF: we agree that there are frustrations around the operation of the comply or explain model but that it remains the right approach. At core is the need for boards and investors to demonstrate that they have fulfilled their fiduciary responsibilities (referred to several times in the FRC commentary in this Review). There is a need to encourage "integrity of reporting" by both. We believe that this should start with the audit process, the chairman's statement and the business review. In each there needs to be more thought given on producing a report which is a balanced statement of the risks, opportunities, weaknesses and strengths of the organisation and its performance over the year under review. These requirements are not new, but too many companies will not tolerate a negative comment from their auditors and seek to emphasise the company strengths over the risks.
Likewise investors should be required to state publicly their compliance with the ISC Code (or its successor).

Engagement between boards and shareholders

Specific issues for further consideration include:

- The framework proposed by Sir David Walker, and the appropriate role for the FRC;
- What role, if any, it would be appropriate for the FRC to play in encouraging collective engagement;
- Whether further guidance on best practice for companies, investors or proxy voting services would be helpful, either in the Combined Code or elsewhere, and whether the practices currently recommended in Sections D and E of the Code continue to represent best practice;
- What other steps might be taken, by the FRC or others, to encourage both companies and investors to be more proactive about regular engagement and with a longer term focus than the annual results presentations.

Views are invited on all of these issues.

NAPF: Members believe that effective engagement and collaboration is best conducted based on a commonality of views on a case by case basis rather than an institutionalised structure. However it is reasonable for the FRC to ask for evidence that *the mechanisms are in place to facilitate such engagement (which we emphasise will be the exception rather than the rule) and for the FRC to report publicly its views on those mechanisms.*

Sections D & E represent best practice in our view. However compliance standards vary. We believe that failure to vote at a company meeting is a control weakness which should be disclosed and explained to clients of the investment manager. Likewise a vote against management should be supported by a letter of explanation. We note in the responses to the earlier consultation document that several companies identify the divide between the governance or compliance team and the investment managers as an ongoing issue. Investors need to demonstrate that voting decisions are made in such a way as to be clearly in the interests of their clients.

David Paterson
Head of Corporate Governance