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Dear Chris

Financial Reporting Council – Review of the Effectiveness of the Combined Code –Progress Report and Second Consultation

IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey showed that at the end of 2009 IMA members managed holdings amounting to 44% of the domestic equity market.

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

IMA supports good governance and the flexibility afforded by the "comply or explain" framework in the Combined Code and concurs with the current consultation that successive codes and the operation of the "comply or explain" regime have led to a steady improvement in "governance standards since the first code was introduced in 1992[1]". The quality of corporate governance depends on behaviour and not process, and the current system of "soft law" underpinned by some form of regulation is better able to react to developments, take account of different circumstances and is preferable to a legislative approach.

Thus although it is now apparent that in the run up to the crisis these were failings in banks' governance and investors' scrutiny and challenge, these were largely failures in

[1] Page 3

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execution rather than of the current regulations and guidelines. These did not cause the crisis, nor would changes to governance have prevented it, but the experience prompts an examination of the framework to make it more effective – particularly at times of stress.

We welcomed the Walker Review which focused on the governance of BOFIs that are systemically significantly. The Review largely left unanswered the question on how the Recommendations are to be implemented - it states that "except in a few cases where responsibility for a proposed initiative is for the FSA, it is envisaged that most of the Recommendations will be incorporated as provisions and guidance in the Combined Code[2]".

IMA supports many of Walker's Recommendations, but not all, and a number we believe should be modified. The consultation on these recently closed and as the final Recommendations are still undecided, we consider it premature for the FRC to seek to address now whether and how they should be implemented in the Combined Code. In addition, the FRC's CP was issued in July and was open for consultation during the peak holiday season. We do not believe this has given respondents sufficient time to consider the issues fully or their implications.

It is part of the quality brand of a London listing that UK incorporated companies with a Premium listing adhere to the "comply or explain" approach in the Combined Code. We believe the Code should cover all UK listed companies and that there should not be special provisions for BOFIs within it. The majority of the banking institutions that have been casualties of the crisis were listed entities subject to the Combined Code: Royal Bank of Scotland; HBOS; Northern Rock; and Bradford & Bingley, although there are others that are outside its scope, for example, the London and Dunfermline and West Bromwich Building Societies were mutuals and Landsbanki, Heritable, and Kaupthing Singer and Friedlander were UK subsidiaries of Icelandic banks. The steps the Government took in relation to a number of such institutions has shown that they are "too big too fail" and, as such, they are underpinned by the tax payer.

Thus systemic issues arise with unlisted as well as listed institutions and both require a distinctive approach as to how they are regulated and their governance. To ensure that all such institutions are addressed, the general consensus of our members is that those Recommendations that address systemic issues, such as those on the governance of risk, Recommendations 23 to 27, and remuneration, Recommendations 28 to 39, should be implemented by way of FSA guidance rather than amendments to the Combined Code.

Other of the Recommendations, however, could benefit all listed companies in terms of facilitating engagement and enhancing governance and should be incorporated into the Combined Code under a "comply or explain" regime tailored to a particular company's circumstances as summarised below.

[2] Page 10

- Better aligning the roles of the chairman, NEDs and SID as set out in the Code with Recommendations 6, 9 and 11. The Code should also specify that chairmen are responsible for overseeing communications on governance matters with investors and should be encouraged to inform the whole board of investors' concerns. Also the SID should not act as an intermediary - to do so questions the unitary board structure (Recommendation 11) - but he/she should be more proactive and, if warranted by the nature and/or extent of the concerns, should take independent soundings from investors and ensure an appropriate response from the whole board.

- Although we do not support Recommendation 10 on the annual re-election of the chairman, boards could be made more accountable and the contribution of individual directors enhanced through the annual re-election of the chairs of the main committees. This has the general consensus of the industry. Some of our members, however, would go further and support the whole board standing for re-election every year.

- Requiring improved training for NEDs (Recommendations 1 and 2) and it should be clear that this extends to the chairman in that, in accordance with the Code, a chairman is only considered independent on appointment.

- Improvements to board evaluation procedures. We do not consider Recommendation 12 goes far enough in that this is one of the key means whereby investors obtain assurance on the effective operation of a board. There should also be more informative disclosures about the process followed and any actions taken as a result (Recommendation 13). However, there should not be a mandatory separate dialogue with the chairman or disclosure of "the nature and extent of communication by the chairman with the major shareholders".

We do not believe there should be a sub-set of companies subject to the Code, for example, FTSE 100 or FTSE 350 companies, or companies in specific sectors. We consider the Code's "comply or explain" regime allows sufficient flexibility for those listed entities where requirements may be too onerous for their circumstances. There are also areas in the Code that a number of our members believe could be reviewed as set out below.

- The requirement in A.3.2. that the boards of FTSE 350 companies comprise at least 50% independent NEDs. This could have inadvertently reduced the effectiveness of boards in that it is important that there are sufficient executive directors on a board to facilitate the board's understanding of the risks the company faces and how these are managed.
- The emphasis on succession planning increased through a provision that encourages the chairman to report annually on the process followed and progress made.
- The requirements to disclose specific risks and uncertainties in accounts are not necessarily derived from the Combined Code but there should be some rationalisation and the disclosures improved in that frequently they are inadequate or have become boilerplate. As noted, the consensus is that Walker's

Recommendations 23 to 27 on risks should be implemented by FSA guidance to address the systemic risks in BOFIs. That said, there should be a review of requirements for listed companies more generally and there could be scope for certain of these Recommendations being applied to large complex groups. For example, the audit committee's terms of reference should be expanded to include oversight of the company's risk appetite and future risk strategy (**Recommendation 23**).

- Although we do not believe the Code should address Walker's Recommendations on remuneration, currently in the UK investors only have rights in relation to remuneration issues at board level where they have a non-binding advisory vote on the remuneration report. In the event the suggestion that there should be an annual re-election of the chairs of all committees is not adopted, we consider companies would be more willing to address investors' concerns on remuneration if the Code specified that when there is a significant vote against the remuneration report, the chair of the remuneration committee should stand for re-election in the subsequent year.

IMA agrees with Walker's proposal for the ISC's Statement of Principles to become the core of the Principles for Stewardship and that these should be separate from the Combined Code. However, the FRC should not seek to facilitate collective engagement by managers or mandate adherence to the Principles as a matter of best practice. To do the latter is to endorse one investment style over another and does not take into account that managers are fiduciaries acting on behalf of their clients. Walker's Recommendations fail to consider this or the impact that they could have on the competitiveness of the UK market. In this context, the framework in the ISC Statement of Principles remains sound and is adhered to – as demonstrated in the IMA's survey on engagement. The ISC is currently in the process of amending the Statement of Principles and designating it as a Code. Investors that sign up to the Code will be expected to disclose how it is applied and the ISC will list them on its web-site. We consider this should be given time to take effect.

Set out in the attached annex are our detailed comments on the matters raised in the CP. We trust that these and the above are self-explanatory but please do contact me if you require any clarification or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall, Director – Corporate Governance and Reporting

IMA'S DETAILED COMMENTS ON THE MATTERS RAISED IN THE CP

SECTION ONE: THE CONTENTS OF THE COMBINED CODE

The Guiding Principles

IMA welcomes the guiding principles that:

- where there is demonstrable need, best practice will be clarified through amendments to the Code or additional, non-binding guidance;
- more informative disclosures will be encouraged where not constrained by regulatory requirements; and
- an increase in the level of prescription will be avoided.

The responsibilities of the chairman and the non-executive directors

The Combined Code does not attempt to define the roles and responsibilities of the chairman and non-executive directors in full. The main responsibilities of the chairman are set out in the supporting principle to Section A.2, and of the non-executive directors in their capacity as members of the board in the supporting principles to Section A.1. Further, non-binding, guidance is set out in "Good Practice Suggestions From The Higgs Report".

Issues for further consideration identified in the CP are set out below.

> *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.*

IMA agrees that chairmen are crucial to good governance. They are responsible for the culture of the board and the organisation as a whole, and for ensuring that the board operates effectively. Moreover, in the build up to the crisis, certain bank's boards were dominated by the Chief Executive resulting in ineffective oversight by NEDs and shareholders' concerns being ignored. It is also now apparent that within certain boards independent thought and an ability to challenge were missing.

Thus we would welcome the roles of the chairman and NEDs, as set out in the Code, being better aligned with **Walker's Recommendations 6 and 9** in that they are relevant for all listed companies and not just BOFIs. In addition, on occasion investors are concerned that the matters they raise are not reported to or discussed with the full board. As well as being responsible for the leadership of the board, the chairman ultimately oversees communications with investors. We are aware of instances when the chair's role was weakened in that he/she became too closely associated with the management. A safeguard to help address this would be if the Code was amended to clarify that chairmen are responsible for overseeing communications with investors on governance matters and they should be encouraged to inform the whole board of investors' concerns (whether expressed directly or through brokers and advisers).

Similarly, we agree that **Walker's Recommendation 11** on the role of the SID should be incorporated into the Code. However, he/she should be more proactive and not only be accessible to shareholders if communication with the chair becomes difficult, but, if warranted by the nature and/or extent of the concerns, should take independent soundings from investors and ensure an appropriate response from the whole board. We do not consider the SID should act as an intermediary for the NEDs - to do so questions the unitary board structure - and that this text should be deleted.

> *Whether it would be helpful to provide further guidance on the time commitment expected of the chairman, senior independent director and/or NEDs.*

Undoubtedly the quality of the NEDs' oversight would be enhanced if they devoted more time to their role. However, we do not agree they should be required to spend at least 30 to 36 days a year in their role **(Walker's Recommendation 3)**. This is too inflexible and could be too onerous - particularly in the context of the broad span of firms that are considered BOFIs, and certainly for companies beyond this. What is important is that boards have the right skills – better to have a few days of someone who makes a valuable contribution than a month of someone who adds very little. Also requiring such a high commitment would eliminate the possibility of an executive of a major company becoming a NED at another and further reduce the pool of available talent. The general consensus of our members is that there should be a principles based approach to such a requirement in that it should be for boards to decide how best they are structured and whether the members have sufficient time.

As regards the chair, the recent experience with banks means that many of our members consider banks, or BOFIs, should be chaired by those with relevant banking experience, and a track record of successful leadership **(Walker Recommendation 8)**. Although particular weight should be given to the latter, we do believe some industry experience is important and that the chair's expertise should be kept up to date. The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity and all that that entails **(Walker Recommendation 7).** However, we do not believe these Recommendations need to be extended beyond BOFIs and they should be addressed by the FSA's ongoing supervisory processes as for Recommendation 4**.**

Board balance and composition

Section A.3 of the Code addresses board balance, composition and independence. Its recommendations include that there should be a strong presence on the board of both executive and non-executive directors, with a minimum level of independent non-executive representation. It also sets out some criteria against which the independence of non-executive directors should be assessed, and states that undue reliance should not be placed on particular individuals when deciding the membership of board committees. Elsewhere, the Code recommends that the three main board should consist entirely or mainly of independent non-executive directors.

IMA'S DETAILED COMMENTS ON THE MATTERS RAISED IN THE CP

The FRC is looking at Section A.3 in its entirety to consider whether there is evidence to support this perception and, if so, how this section might be amended to help chairmen and nomination committees strike a better balance when considering the composition of the board.

IMA supports the unitary board concept and agrees that in order for a board to fulfil its role effectively, its members collectively need to have both relevant experience and a broad range of skills; it needs to refresh its membership while ensuring continuity; and it needs to guard against becoming so large as to make proper debate impossible.

The banking crisis has highlighted the need for a pool of talented and experienced NEDs to perform a more effective oversight role. It is important that all listed companies, not just BOFIs, have high quality NEDs committed to ensuring that their businesses are run effectively. NEDs should have fewer posts and be more involved in the companies on whose boards they sit. Undoubtedly there is a need to increase the pool of talented individuals who could serve as NEDs and we are concerned that certain of Walker's Recommendations could shrink the pool of suitable candidates:

- requiring non-executives to have such a high time commitment (Recommendation 3);
- although not a specific recommendation, potentially increasing the regulatory burden on NEDs (Recommendation 4); and
- requiring the chairman to stand for annual re-election (Recommendation 10).

Issues for further consideration identified in the CP are set out below.

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

IMA considers that relevant experience is particularly important in respect of BOFIs and considers that this is better ensured through the FSA's approved persons' regime, FSA interviewing candidates and enforcement than the Combined Code.

> *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.*

We believe that the independence criteria in the Code and the way they have been applied may have unnecessarily restricted the pool of talent available and they could be reviewed. For example, someone who has been an employee of the company or the group within the last five years would not be considered independent and a number of our members consider their experience and knowledge could be useful but would be lost after five years. That said, we would not want to see a pattern emerging where a Chief Executive on retirement immediately became a non-executive director of the same company.

The Walker Review also proposes easing the nine year rule "there should be greater readiness to extend NED tenures beyond their 3 three year terms (the so-called "9 year rule")" and that "boards should be ready to justify and explain any imbalance that has arisen without feeling pressured to increase the size of the board[3]".

In general, IMA members consider the "9 year rule" an important control and if companies consider a NED has particular experience that they value, then they should explain why their term should be extended and investors would accept reasoned explanations.

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.

It is important that a board has the right balance in terms of executives and non-executives. There should be sufficient non-executives to challenge, monitor performance and strategy, and address matters such as remuneration and succession where executive directors may be conflicted. However, in certain instances the pendulum may have swung too far in terms of the number of non-executives on boards. There should be sufficient executive directors to facilitate the board's understanding of the risks faced and how these are managed. A number of our members believe there may be a case for the requirement that the boards of FTSE 350 companies comprise at least 50% independent NEDs to be reviewed in that it may have inadvertently reduced the effectiveness of boards.

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.

As noted, IMA supports the existing concept of the unitary board but it can only be effective if the individual members have the right skills, conduct themselves with integrity and exercise sound judgment. This is difficult, if not impossible, to ensure other than through selection procedures and evaluation.

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

[3] Paragraph 3.11.

IMA'S DETAILED COMMENTS ON THE MATTERS RAISED IN THE CP

Frequency of director re-election

Section A.7 of the Combined Code recommends that all directors should be subject to re-election at least every three years, except for non-executive directors who have served more that nine years who should be subject to re-election every year. There is no statutory restriction on the length of terms that can be served by directors, meaning that there is nothing to prevent companies from putting some or all directors up for re-election more frequently than recommended by the Code.

The issues for consideration in the consultation is 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; or*
- *binding or advisory votes on specific issues, or on the corporate governance statement as a whole.*

IMA supports measures to increase directors' accountability to investors. However, we do not agree that the chairman should stand for re-election on an annual basis **(Walker Recommendation 10).** This is somewhat of a "nuclear option" and may potentially only destabilize boards. It is also inconsistent with the concept of the unitary board in that the board as a whole should be accountable**.**

A means of making boards more accountable and the contribution of individual directors enhanced that has the general consensus of the industry in that it is supported by the Institutional Shareholders' Committee (ISC)[4] is if the chairs of all the main committees (remuneration, nomination and audit) stand for re-election every year. If support for any individual falls below 75 per cent (including abstentions), the chairman of the board should stand for re-election the following year. This would be a powerful incentive to resolve concerns during the intervening period.

Certain of our members, however, support the entire board being put up for re-election annually. They argue that this is more equitable than singling out individual directors, which might also exacerbate existing difficulties in finding chairmen for the audit and remuneration committees.

One or two of our members, rather than focusing on the performance of individual board members, believe there may be other ways in which voting could be used to

[4] The ISC paper, Improving Institutional Investors' Role in Governance, issued in June, had recommendations for both investors and all listed companies, not just banks and financial institutions. It is at http://www.investmentuk.org/press/2009/20090520-2-01.pdf

increase the accountability of the board, for example, through an advisory or binding vote on the risk report or the corporate governance statement.

In this context, we do not consider that a different approach should be taken to the re-election of BOFI boards and believe that such a requirement should be introduced for all listed companies through an amendment to the Combined Code.

Board information, development and support

Section A.5 of the Code states that the board should be supplied in a timely manner with information that will enable it to discharge its duties, and that all directors should receive induction on joining the board and regularly update and refresh their skills and knowledge. It recommends that all directors should have access to the advice and services of the company secretary, and to independent professional advice at the company's expense where they deem it necessary.

Issues for further consideration identified in the consultation are the ways in which non-executive directors individually and collectively could obtain sufficient knowledge of, and information about, the business to be able effectively and constructively to challenge the executive, whether through:

- *prior relevant experience;*
- *the information they received;*
- *greater contact with the operational activities of the company; and*
- *induction and ongoing professional development.*

IMA supports improved training for chairmen and NEDs and welcomes a BOFI board having to provide thematic business awareness sessions on a regular basis and each NED being given a personalised approach to induction, training and development which is reviewed annually with the chairman. There should be dedicated support if needed **(Walker Recommendations 1 & 2)**. We believe this is relevant to all listed companies not just BOFIs and that more guidance on these issues should be provided, either in the Combined Code or in non-binding guidance.

We also consider that there would be some merit in having a register of suitable, in some way qualified, non-executives, with a structure of on-going training and even an Institute of Non-executives and a charter mark. The IOD already has a Chartered Director qualification that IMA supports.

Board evaluation

Section A.6 of the Combined Code states that the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors, and state in the annual report how it has been conducted. The Code does not specify how the evaluation should be conducted.

IMA'S DETAILED COMMENTS ON THE MATTERS RAISED IN THE CP

Issues for further consideration identified in the consultation are:

- *whether the Code should be amended so that board evaluations are externally facilitated every two to there years;*
- *whether the recommendation that the effectiveness of board committees should be reviewed every year should be relaxed; and*
- *how disclosures in annual reports should be made more effective.*

IMA supports the board undertaking a formal and rigorous evaluation. But we do not consider **Recommendation 12** goes far enough in that this is one of the key means whereby investors obtain assurance as to the effective operation of the board. We believe:

- external facilitation should be expected of BOFIs every year given their regulated status and the public interest aspect and not every second and third year as proposed - although the latter should be sufficient for listed companies generally;
- the results should be discussed by the NEDs together and that, depending on the results of the review, changing board representation should be considered as part of that process; and
- where there is external facilitation, there should ***not*** be any other business relationship that could give rise to a conflict of interest.

Investors would like to see more informative disclosures about the process and actions taken as a result. IMA supports **Recommendation 13** and believes a form of "assurance statement" on the board evaluation review and other aspects of board effectiveness, such as the working methods of the board, how its composition served the business needs and succession planning merits further consideration.

However, we have concerns that in indicating "the nature and extent of communication by the chairman with the major shareholders", the recommendation envisages a mandatory separate dialogue with the chairman. As part of the operation of the unitary board, the whole board should be aware of investors' concerns and be responsible for the response, not just the chairman. Moreover, although such disclosures highlight the importance of such communications, they are likely to become boilerplate and formulaic. In the event that they are not, then they could well have the effect of dumbing down the engagement process.

Risk management and internal control

Section C.2 of the Combined Code states that companies should maintain a sound system of internal control, the effectiveness of which should be reviewed at least annually with the review being reported on in the annual report. Further guidance on this subject, including recommendations on disclosure, is set out in the Turnbull Guidance, which was last revised in 2005.

IMA'S DETAILED COMMENTS ON THE MATTERS RAISED IN THE CP

Listed companies are required under the Companies Act 2006 to include in the Business Review a description of the principal risks and uncertainties facing the company, and under the FSA's Disclosure and Transparency Rules the main features of the internal control system as it relates to financial reporting. In addition, IFRS 7 requires companies to set out how they manage financial risks and a summary of the information that key operating decision makers use to manage those risks. All of these disclosures are monitored by the Financial Reporting Review Panel (FRRP), which is part of the FRC.

Issues for further consideration identified in the CP are set out below.

- *Whether the board's responsibility for risk – as set out in the Turnbull Guidance - should be more explicit in the Code, and whether the current balance between the Code and the Guidance is right.*

IMA considers that the Combined Code in Section C and the Turnbull Guidance, supported by the Business Review provisions in the Companies Act 2006 address risk issues but it would be helpful if there was some rationalisation of the disclosures in that they can be difficult to analyse being spread throughout the accounts. There are also issues around the adequacy of the disclosures about the specific risks and uncertainties which in many instances have become boilerplate.

- *Whether all or parts of the Turnbull Guidance should be reviewed.*

The Guidance was last amended in 2005 and, whilst we believe it remains sound, it is appropriate that it should now be reviewed to determine if it needs to be updated. Any review is likely to prompt companies to undertake an examination of the effectiveness of their systems of internal control to see if they need to be modified and updated.

- *To what extent the mechanisms recommended for banks and financial institutions would also be appropriate for other listed companies.*

In many instances, during the recent financial crisis, it became apparent that the boards and management of financial institutions failed to fully appreciate the risks on their balance sheets. The consensus between our members is that Walker's Recommendations 23 to 27 on risks should be implemented by FSA guidance to address the systemic risks in BOFIs.

As regards the listed sector more generally, IMA supports the unitary board and the board as a whole should retain responsibility for risk management. However, we recognise that it may be necessary to delegate certain functions to sub-committees, particularly where independence may be an issue, and there are concerns that the demands placed on the audit committee can be great, particularly for large complex groups, such that insufficient time may be dedicated to risk management. We consider there should be a review of requirements for listed companies more generally and there could be scope for certain of the Recommendations being applied to large complex groups. For example, the audit committee's terms of reference should be expanded to

include oversight of the company's risk appetite and future risk strategy (**Recommendation 23**).

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

IMA agrees that there are overlapping disclosures relating to risk management and internal controls which can make their analysis difficult in annual reports and we would support some rationalisation. However, this is not necessarily a Combined Code or FRC issue.

Remuneration

Section B.1 and Schedule A of the Combined Code contain recommendations on the level and make-up of remuneration; Section B.2 sets out the procedures to be followed when setting remuneration for executive directors, including the composition and remit of the remuneration committee.

Listed companies are also subject to the Directors' Remuneration Reporting Regulations 2002 ("the 2002 Regulations"), which require disclosure of the remuneration of individual directors and the company's remuneration policy, on which shareholders are given an advisory vote at the annual general meeting.

Issues for further consideration identified in the CP are set out below.

- *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.*

There is widespread agreement on the need to reform of remuneration structures in BOFIs where incentives that encouraged excessive risk taking may have contributed to the financial crisis. There are a number of moves afoot to address them – both by the FSA and European Commission. Such measures should be introduced by the FSA and only apply to BOFIs and not more generally through the Combined Code.

The same systemic issues do not apply to other types of financial institution or to listed institutions generally which played no part in the present crisis. Thus we do not consider that there need to be changes to the Code to address Walker's Recommendations 28 to 35 and 37 or to ensure consistency with the European Commission's recommendation. Nor do we consider a code for consultants would necessarily be effective (**Walker's**

Recommendations 38 and 39). The proposals on conflicts seem particularly weak and we believe they should be brought into line with, for example, FSA's requirements. Many remuneration consultants are already subject to professional standards which have stricter requirements than those in the proposed voluntary Code and we believe that there should be a levelling up.

As regards the listed sector more generally, we consider that remuneration policies as a whole should be discussed at board level, and the whole board should take responsibility for them, but not necessarily for the remuneration of individual employees. As regards individual board members where independence is an issue, the remuneration committee should continue to decide. The Code's provisions in this regard work well except that currently in the UK investors can only engage with remuneration issues at board level and even then only have a non-binding advisory vote on the remuneration report. In the event the earlier suggestion that there should be an annual re-election of the chairs of all committees is not adopted, IMA considers that companies would be more willing to address investors' concerns on remuneration if the Code required that when there is a significant vote against the remuneration report, then the chair of the remuneration committee should stand for re-election in the subsequent year.

SECTION 2: THE IMPLEMENTATION OF THE COMBINED CODE

The Combined Code operates on the basis of "comply or explain". To be fully effective "comply or explain" requires companies to provide their shareholders with the information they need to judge the adequacy of the company's governance arrangements, and it requires investors to consider those arrangements on their merits, even where they deviate from the Code.

The quality of disclosure by companies

Issues for further consideration identified in the CP are set out below.

- *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.*

In general the "comply or explain" mechanism works well. However, its operation could be improved if the usefulness of companies' disclosures were more meaningful. Meaningful disclosures facilitate engagement, reduce the amount of time and resources required of investors and companies, and lessen the perception of a "comply or else" approach as investors cast fewer votes against management and fewer conscious abstentions. In this context, certain of our members have commented that:

- there can be a reticence for certain companies to "explain" non-compliance with the Code leading them to comply when this may not be in the best interests of the company;

- disclosures and explanations are increasingly becoming standardised and of limited use; and
- not all companies provide adequate explanations for non-compliance and some consider any explanation will suffice.

IMA considers that there may be some merit in changing the terminology from "comply or explain" to "apply or explain". This could encourage companies to be more willing to explain where it was appropriate to do so, rather than feeling compelled to comply in all circumstances. We note that this would need to be agreed with the FSA as it would require a change to be made to the Listing Rules and Disclosure and Transparency Rules.

- *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.*

Neither the FRC nor the FSA should undertake formal monitoring and enforcement of the "comply or explain" element of the corporate governance statement. We consider such intervention could reduce the valued flexibility of the current system. Nor would a review that checked whether an explanation had been provided be effective as often it is the adequacy of the explanations that is the issue or instances of compliance when it is not necessarily in the best interests of the company. This could not be assessed from the limited review envisaged.

Engagement between boards and shareholders

Section D.1 of the Combined Code states that the board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place, and places particular responsibility on the chairman, and to a lesser extent the senior independent director, for ensuring that this happens. Companies are expected to disclose what steps have been taken to ensure that the board understands the views of major shareholders. The Code also identifies particular circumstances in which dialogue with shareholders is encouraged, for example if considering appointing the CEO to be chairman (Section A.2.2).

Section E of the Code is directed to institutional shareholders and their agents and sets out a number of principles, such as the need to enter a dialogue with companies based on a mutual understanding of objectives, to make reasoned judgements when a company chooses to depart from the Code, and to make considered use of their votes. Unlike companies, investors are currently under no obligation to disclose how they have applied the Code as the Listing Rule requirements described in the previous section do not apply to them. More detailed best practice on engagement for investors is set out in the Statement of Principles issued by the ISC, which is endorsed in Section E.

ANNEX

IMA'S DETAILED COMMENTS ON THE MATTERS RAISED IN THE CP

The CP notes two key concerns. First, that too few investors are willing or able to engage and secondly, on the quality of engagement, the perceived box-ticking approach and the inconsistent positions within fund managers. It may be helpful to put these concerns into context.

Fund managers are fiduciaries acting on behalf of their clients. They offer their clients a choice and take a range of approaches to managing money. Some believe that actively engaging with investee companies will achieve better returns. Others believe the best way to send a signal to a badly managed company and maximise returns for their clients is to sell their holding. In the build up to the current crisis, fund managers used both approaches but neither was effective in preventing it.

Those of our members that do engage will do so actively and will accept reasoned explanations. Although agencies that issue voting recommendations may be prescriptive in the way they apply the Code's provisions, comply or else, managers will consider these recommendations but ultimately make their own decisions based on the information received. In this context, it is important that both investors and companies actively engage on the issues and that there are meaningful disclosures to facilitate engagement.

Moreover, as regards the inconsistent positions within fund managers, most company meetings with fund managers will be on issues about company strategy/performance and not longer-term stewardship and in the main are attended by portfolio managers and research analysts. But fund managers often employ governance experts, with voting and other agencies to assist, and in some cases these individuals may have different lines of communication with companies, for example, via the Company Secretary or NEDs. Fund managers seek to ensure that different messages do not pass along these different channels of communication and that this could be helped if the chairman and NEDs were encouraged periodically to attend road shows with the portfolio managers.

Issues for further consideration identified in the CP are set out below.

- *The framework proposed by Sir David Walker, and the appropriate role for the FRC.*

IMA agrees with Walker's proposals that the ISC's Statement of Principles should become the core of the Principles for Stewardship and that these should be separate from the Combined Code (see comments below on Section E). However, the FRC should not seek to mandate adherence to the Principles as a matter of best practice. **(Walker Recommendations 16 and 17)**. To do so is to endorse one investment style over another and does not take account of the fact that managers are fiduciaries acting on behalf of their clients. In this context, we do not agree with **Walker's Recommendations 19 and 20,** but do support the ISC, which brings together the main investor bodies in the UK and thus represents the consensus thinking of the major part of the UK's investment industry, reviewing the Principles to ensure they remain

effective **(Walker Recommendation 18).** We consider this should be on a biennial basis as is consistent with the FRC's review of the Combined Code**.**

- *What role, if any, it would be appropriate for the FRC to play in encouraging collective engagement.*

IMA supports the objective of improved cooperation and more collective engagement between shareholders; the ISC[4] has referred to the need to enhance the ability of institutional investors to cooperate together so that there is a critical mass of involvement. However, we do not consider that this is a role for the FRC or that, as stated in the Walker Review, a Memorandum of Understanding would help "establish a flexible and informal but agreed approach" to collective engagement. Such an approach could easily become overly-bureaucratic, and not reflect the way institutional investors operate and communicate with companies. Our members are also concerned that the existence of a standing executive would diminish the influence of individual investors when engaging bilaterally with investee companies. Whilst they have no objection to the creation of a mechanism which facilitates discussion between investors, they would be concerned if this discussion led to direct engagement, in that engagement should be carried out by the shareholders concerned, either jointly or individually, and not under the umbrella of a separate body or organisation.

- *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 Combined Code continue to represent best practice.*

As regards, the FRC expanding Section E of the Code, IMA had concerns when requirements, which seek to encourage institutional investors to enter into a dialogue with companies, were first introduced into a Code for listed companies. The requirement to "comply or explain" against the Code is part of the quality brand of a London listing that UK incorporated companies with a Premium listing adhere to. We did not consider that this was the right locus for the obligations of institutional investors, and in seeking to address them, the Code was not keeping within its mandate. Nor is it clear how obligations in the Code for institutional investors would "bite" and if anyone could ensure such obligations are effected in practice. Few fund managers are listed in their own right in that they tend to be subsidiaries of banks or insurance companies, independent entities, or even partnerships.

We also continue to have concerns that certain of the provisions in Section E of the Code are not always practical. For example, it imposes obligations on fund managers:

- To take steps to ensure their voting intentions are translated into practice. A fund manager will typically invest in hundreds of UK companies which together could have as many as 1,000 meetings a year. Tracing the votes at every meeting would be an enormous task and the chain votes go through can mean that it is not always possible in practice.

- To attend AGMs where appropriate and practicable. Realistically fund managers can only attend a few AGMs - the majority of meetings fall in the same few months of the year and can be at various locations throughout the UK.
- To give an explanation to the company, in writing where they do not accept the company's position, where appropriate. Fund managers will as a matter of course advise companies of these situations but requiring explanations to be in writing puts additional pressure on resources at a time when managers are busiest. Otherwise they could become standardised, undermining investors' assessments and leading to a general dumbing down of the evaluation process.

The responsibilities of investors in relation to the companies in which they invest are clearly set out in the ISC's Statement of Principles. The Statement recommends that investors should:

- publish a policy statement on engagement;
- monitor and maintain a dialogue with companies;
- intervene where necessary;
- evaluate the impact of their policies; and
- report to clients.

This framework remains sound and is adhered to – as clearly demonstrated in the IMA's survey on engagement which benchmarks the industry's adherence to the Principles. The ISC is currently in the process of amending the Statement of Principles and designating it as a Code. Investors that chose to sign up to the Code will be expected to disclose how it has been applied, "comply or explain" and the ISC will list them on its web-site. We consider that this should be given time to take effect before and consideration is given to the development of other guidance.

- *What other steps might be taken, by the FRC or others, to encourage both companies and investors to be more proactive about regular engagement.*

IMA considers that there are sufficient initiatives at present such that no further action should be taken to encourage more proactive engagement at this time.