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Dear Chris

LGIM'S RESPONSE TO THE REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE

LGIM believes the Combined Code is an effective code of governance within the UK that is well regarded and adds value. We believe the principle of "comply or explain" if used correctly is a superior form of governance than a formulaic set of regulations.

Broadly we believe that the current Code works well. However, in our May letter of response we highlighted three areas that require some amendment: The Role of the Non Executive Directors, Remuneration and Board Appraisal. The additional questions to which you have requested a response touch on each of these key areas and we welcome the opportunity to provide further feedback. Please refer to the appendix to this letter for LGIM's response to each of the issues raised.

LGIM believes that the Code does not require radical changes; nevertheless, some changes are necessary to increase the accountability of directors, namely through annual re-election and to reinforce the importance of good succession planning and board evaluation. In our view, these changes would help evolve current patterns of thinking and behaviour and will over time lead to better standards of corporate governance.

The Combined Code should remain as it has been a set of general guidelines applicable to all sectors of industry. The FRC should therefore take great care when considering the output from the Walker Review to ensure that any changes they consider are applicable to the wider Market.

LGIM believes, that in general the level of engagement we have with companies is good. Therefore care should be taken when developing any Principles of Stewardship that it is not too prescriptive and that Institutional Investors will not be compelled to provide greater disclosure on its engagement with companies. The main reason that LGIM can have open and direct discussions with management is because of our integrity and knowledge that we do not divulge this information publicly. It would also be counter intuitive to have a regulator controlling engagement because if anything, it would remove the value inherent in the process and turn it into a box ticking exercise.

On Executive Remuneration, the Code should re-emphasise the need to link remuneration to value generation and require all companies to improve transparency. LGIM through its engagement process has called for greater transparency and generally companies are not unreceptive to our requests but do not want to be disadvantaged by being the only company to do so. LGIM believes that all companies should have an element of their annual incentives in the form of

deferred shares and that it be subject to claw-back to ensure that directors interests remain aligned with that of its shareholders.

We welcome this opportunity to provide our view on possible changes to the Code and look forward to hearing from you once the review has been completed.

Yours sincerely

A handwritten signature in blue ink, appearing to be 'Angeli Benham', with a stylized, flowing script.

Angeli Benham
Corporate Governance Manager

Responses to Individual Questions Raised:

Responsibility of Chairman and NEDs

- **Would it be helpful to give further clarification on the role, key responsibilities and expected behaviours of the chairman, the senior independent director and/or NEDs, either in the Code or in non-binding guidance?**

LGIM believes that the Code itself provides adequate guidance on the role of the Chairman and to go further would become too prescriptive. However, it may be helpful to provide non binding guidance regarding the role of the NEDs. LGIM expect them take a more active role in the management of the business and to be of suitable quality and experience to be able to understand the risks inherent in the strategy. We would also expect them to meet and get to know the executives below the board.

- **Would it be helpful to provide further guidance on the time commitment expected of the chairman, the senior independent director and/or NEDs?**

In our initial response we said that the amount of time an NED should spend in the business should be determined by the size of the corporation, the complexity of the business and its product, the risks involved and its impact on the wider sector (e.g. whether the company is too big to fail and adversely effect the rest of society).

Given the differences between companies it would be very hard for the Code to specify the time commitment required. It is for the Board of each company to decide on what they believe is necessary. As a guide; LGIM would expect the Chairman of a large multinational company to spend at least 2 days per week on the job. A smaller, less complex company would require less time. It is even harder to quantify the exact time required of a SID, but as a minimum, the SID of a large multinational company should expect to meet with the Chairman at least once a month and be available to meet with shareholders. LGIM would require NEDs to have the spare capacity to spend more time with the Company from time to time and to delve deeper into the company's affairs. The time required to do this will vary depending on the size and complexity of the company.

Board balance and composition

- **Does the Combined Code give sufficient emphasis to the need for relevant experience among the NEDs collectively?**

The Code only refers to the Audit Committee where it requires at least one member to have recent relevant financial experience. LGIM believes that Financial Institutions with complex strategies/instruments should have on its board members with suitable qualifications and knowledge that will enable them to understand the risks inherent in these instruments. In addition, other regulated, high risk sectors such as the Oil & Gas and Extractive Industries should have members on their board with relevant experience and qualifications. Beyond this, we believe that it is for the Board to decide on the type of experience they require and it is not something the Code should allude to.

- **Does the independence criteria and the way it has been applied by boards of companies and investors have unnecessarily restricted the pool of potential NEDs and has the "nine year rule" resulted in the loss of continuity and valuable experience?**

The Code provides a useful and clear guide on independence which should be maintained. LGIM does not believe that its use has resulted in the loss of continuity and valuable experience because the Code allows companies to provide an explanation if they believe a director is considered independent or is important to the continuity of the board. The failings if any do not lie with the content of the Code but in its application. Too many companies use boiler plate explanations, i.e. "he has exercised independent judgement at board meetings" to explain why someone is considered independent.

Investors need companies to provide well thought out reason when explaining a director's independence highlighting why this person plays a vital role on the Board or how his experience would enhance the decision making process. Good succession planning will prevent the level of independent judgment decreasing. Rotation of roles and having directors with a wider skill sets are equally important.

LGIM does not believe that either the Code or its application has necessarily reduced the pool of potential Non Executive Directors, the increased responsibility placed on Non Executive Directors today and their own risk appetite may be a contributing factor.

- **Has the recommendation that the boards of FTSE350 companies comprise at least 50% independent non-executive directors has resulted in fewer executive directors sitting on boards and/or boards becoming larger.**

LGIM believes that this recommendation is a good mechanism to ensure that there is a sufficient body of representatives on the board to protect the interests of shareholders and to ensure that no group of board members have unfettered powers. In our experience there are very few companies that have boards that may be considered excessive and we remain unconvinced that compliance with this requirement is the cause. We believe that this provision is important and should be maintained in the Code.

- **Is more guidance in the Code, or elsewhere, needed on succession planning to ensure board composition is aligned with present and future needs of the business?**

Currently the Code requires directors to be satisfied that Plans are in place for orderly succession. Most companies would say they have plans in place, however; the experience of LGIM is that many companies have not gone far enough in setting sufficient processes in place leading to situations where Executives have become Executive Chairman or retention awards have been made to keep directors in situ until a replacement is found. LGIM believes that it is essential for Non Executive Directors to get to know those directors who are below the board and should give consideration to potential candidates from within the business. If there is no natural pool of talent from within the business the implications of this should be considered carefully and it may be appropriate to maintain a list of possible candidates should they need to recruit externally. The annual performance evaluation lends itself as an opportunity to discuss the future of directors and this succession and whether there is anyone within the business that is capable of promotion. We believe the Code should go further than its current requirement by requesting that succession planning be linked to the board review process.

Frequency of re-election

- **Would we support:**

- (a) **the annual re-election of the company chairman?**
- (b) **the annual re-election of the chairs of the main board committees?**
- (c) **the annual re-election of all directors; and**
- (d) **the binding or advisory votes on specific issues, or on the corporate governance statement as a whole.**

LGIM has found that the NEDs on many companies have played a very passive role and there is a lack of accountability. We believe the Code should address this by amending Section A.7 of the Code to require the Chairman and Chairs of the Board Committees to stand for annual re-election. Assuming this suggestion is adopted, we do not believe it would be necessary to have binding or advisory votes on specific issues or on the corporate governance statement. We believe that this should ultimately lead to the annual re-election of all directors.

Board information, development and support

- **Would it be helpful for the Code to provide more guidance either in the Code or as non-binding guidance on: requirement for NEDs to have sufficient knowledge of and information about the business either through relevant experience, information received, greater contact with operational activities of the company or through induction and on-going professional development. Secondly more information about the role of the Company Secretary?**

All companies would benefit from having directors with sector knowledge; however LGIM believes that the Code should only reinforce the need for NEDs to be highly qualified and have sector experience for regulated business such as Financial Institutions or where their operations are high risk such as the Oil & Gas and the Extractive Industries. LGIM believes that directors of all companies should have on-going training on key aspects of the business and on changes to the regulatory environment in which they operate. However the Code should avoid being too prescriptive and should leave each company to decide on how to implement on-going training. Non Executives should probe deeper into the affairs of the business and get to know senior management. It is for the Board to facilitate this process. In order to reinforce this requirement it may be helpful to re-word section A.5 of the Code but without being overly prescriptive.

We do not believe that it is necessary for the Code to provide guidance on the role of the Company Secretary beyond what is stipulated in part A.5 of the Code.

Board evaluation

- **Should the Code be amended to recommend that board evaluations be externally facilitated at least every 2 or 3 years for some or all companies?**

LGIM believes there is merit in external valuations being carried out at least once in three years as it may provide a different perspective to the way the board is managed. A number of companies that we have engaged with have already implemented such a policy but others despite their complexity or unusual board structure continue to believe that there is no need for external evaluation and that it would not add value. Therefore we would support this being a requirement for companies in the FTSE 350 Index.

- **Should the recommendation that “the effectiveness of all the main board committees should be evaluated every year” be relaxed in some way (e.g. recommend a rolling cycle of committee reviews)?**

On the assumption that the annual re-election of key committee chairs is adopted, a move to rolling cycle of committee reviews would be supported, because any concerns with the management of these committees can be addressed via engagement or through voting on the re-election of these key members.

- **How disclosures in the Annual Report might be more informative either in relation to the process that was followed and/or the outcomes of the effectiveness of the performance review.**

Some companies already provide adequate disclosure; however to assist companies non binding guidance might prove useful. LGIM would find it useful if companies provided more guidance on the process adopted for the review. It would also be useful if boards to could provide a description of what was covered in the previous year and what were the outcomes and what the board has done during the year to address those issues. This would provide a better measure of whether the process adopted by the company is in fact adding value.

- **Should companies provide an “assurance statement” and if so what should be covered in the statement?**

LGIM does not believe that an assurance statement is necessary and would just add extra burden on companies. We believe annual re-election of key directors would address issues of accountability and better disclosure on existing requirements without the use of boiler plate causes would be sufficient.

Risk management and internal controls

- **Should the board's responsibility for strategic risks and setting risk appetite – as set in the Turnbull Guidance – be made more explicit in the Code and is the current balance between the Code and the Guidance the right one?**

The current C1 and 2 should be expanded so as to require companies to establish a separate Risk Committee made up of independent directors who will work closely with the companies internal and external auditors to ensure that all risks have been identified and contingencies have been considered. The members of this Committee will have to comprise individuals that are financially competent and understand the sector in which it operates. However, care should be taken that any work conducted by the NED led Risk Committee does not devalue the work of the Executive Risk Committee.

Financial Institutions should be made to agree at board level their risk appetite and this will have to be reviewed by the Risk Committee to ensure that the level of risk that is being undertaken by management does not exceed the expectations of the Board. Any extension to this section of the Code should aim to complement the requirements of other regulations.

- **Is there a need for all or parts of the Turnbull Guidance to be reviewed?**

LGIM believes that the requirements of the Turnbull guidance are broadly still valid although the value of periodical reviews of any form of guidance should not be overlooked. Any review should distinguish between the requirements for companies that operate financially regulated business and those that do not. In most cases companies have followed the guidance and can demonstrate that they have a sound system of internal control although the ultimate test is that the business remains a going concern. In our view the main changes required are for businesses that operate in financially regulated businesses and should incorporate the findings of the Walker Review.

Remuneration

- **Should we be able to vote on individual remuneration packages?**

Other than a separate vote to approve the annual cash bonus, LGIM cannot see the merit in doing so as many packages will have already been decided and agreed with management. LGIM being a significant shareholder in most companies is already approached by many companies to review proposed changes to remuneration policy. Being able to vote on the remuneration report and the re-election of the Remuneration Committee Chair should be sufficient.

- **Should the Combined Code be revised to ensure consistency with the European Commission's Recommendations and, where appropriate, the FSA's proposed code on remuneration practice for financial institutions and the recommendations of the Walker Review?**

Yes, the Code should take into account any recommendations that the FRC believes are valid.

- **Are there any other changes to the Code, or additional guidance, required to reflect developments in best practice?**
 - Better disclosure on bonus awards, performance conditions set and achieved
 - Better disclosure on how remuneration committees exercised their discretion

- o Better disclosure on how the overall underlying financial performance was considered and why they considered performance merited the reward
 - o Requiring companies to introduce into service contracts the ability to claw-back a bonus payment that was made on performance that is later deemed inappropriate.
- **Should shareholders be given a more direct role in setting remuneration and, if so, how might this be achieved?**

No, it is for the Remuneration Committee to decide on remuneration however, the Remuneration Committee of all companies should be encouraged to consult with its top shareholders on new incentive schemes and any amendments to existing arrangements. This should also apply to an incentive package that is being considered for the recruitment of an individual where the package is outside standard policy. Many companies have already adopted this level of engagement with its major shareholders; however, the extent to which they listen to shareholder feedback vary significantly. Again having a vote on the Chair of the Remuneration Committee should alleviate some of these concerns.

SECTION 2: Implementation of the Combined Code

Quality of disclosure

- **Comment on: “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.**

LGIM believes that the comply or explain principle works well if companies embrace it as a set of good values by which to operate the board and one that will deliver shareholder value. These companies will usually produce good reports with detailed information. LGIM would not like the corporate governance section to become too verbose as the value in its content can sometimes be lost. Rather than concentrate on what areas are most important we believe it would be better to highlight the areas where better explanation is required. These are:

- What the board considers its risk appetite to be and why
 - Why a director is deemed independent and why the company considers his particular expertise to be valuable to the company.
 - How the board evaluation process is conducted what the outcomes from the previous year were and the extent to which management has acted on the recommendations. This includes the outcomes provided by external consultants and internal findings.
 - Where an internal candidate is found for a senior board role an explanation of what process the nominations committee adopted.
 - The risks identified by the board and what steps or procedures they can implement if they became a material threat.
 - Other issues relate to remuneration which has been covered in the previous section.
- **Whether it would be appropriate for the FRC or the FSA to undertake greater monitoring and enforcement of the “comply” or “explain” statements, and if so what form this might take.**

LGIM does not believe that it would be appropriate for either body to take a greater role in the monitoring and enforcement of the comply and explain statements. Currently, it is the role of the The Financial Reporting and Review Panel to monitor and report back to the FSA any non compliance on disclosure requirements. This procedure should be maintained. However, Corporate Governance of UK Listed companies could be greatly improved if all companies that obtain a UK Listing were compelled to adhere to UK best practice. Currently there is no requirement for companies that are registered overseas, i.e. Bermuda, Jersey etc. but have a listing in the UK Stock Market to comply with the Combined Code. We do not believe relying on their foreign domicile is a sufficient explanation for non compliance with the Code. Changes to this requirement would greatly improve current disclosure of foreign companies who are laggards in terms of transparency and good corporate governance standards.

Engagement between Boards and shareholders

- **Comment on: “The framework proposed by Sir David Walker, and the appropriate role for the FRC.”**

LGIM supports the viewpoint that the FRC should develop the Principles of Stewardship as a natural extension from the Combined Code.

However, we question whether it is are the appropriate body to enforce the Principles of Stewardship and whether a more appropriate body would be the FSA. This is because

institutional shareholders vary with their investment approach and therefore may be unable to adhere to the guidelines due to their different styles.

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

The FSA has given guidance to shareholders on collective engagement and we believe that other than giving its approval of collective engagement organisations such as the FRC or IMA should not get involved in any collective engagement that may occur from time to time.

- **Whether further guidance on best practice for companies, investors or proxy voting services, either in the Combined Code or elsewhere, and whether the practices currently recommended in Sections D and E continue to represent best practice?**

LGIM believes that the practices in Sections D and E remain valid. To go beyond this would make the Code too prescriptive.

- **What other steps might be taken, by the FRC and 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?**

LGIM has experienced a few problems when attempting to engage with the companies in which we invest. This has tended to be when dealing with companies that are majority owned, i.e. founder is on the board or family trust. The Chairman should aim to meet with their larger shareholders at least once in 18 months. We do not believe that the FRC or anyone else can or should compel engagement. What it can do and does well via the Code and the ISC Statement of Principles is to encourage engagement.