By email: codereview@frc.org.uk

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Dear Sir Christopher,

Re: Review by the Financial Reporting Council of the Combined Code

We are writing, as chairs of the Shareholder Rights and Shareholder Responsibilities Committees, on behalf of the International Corporate Governance Network (ICGN). The ICGN is a global membership organisation of institutional and private investors, corporations and advisors from 47 countries. Our investor members are responsible for global assets of U.S. $9.5 trillion. The mission of the ICGN is to meaningfully contribute to the continuous improvement of corporate governance best practices through the exchange of ideas and information across borders. Information about the ICGN, its members, and its activities is available on our website: www.icgn.org.

The members of the ICGN have a keen interest in the quality and efficiency of capital markets and in particular how sound corporate governance practices can underpin corporate performance. Corporate governance has, in our view, a key role to play in overcoming the financial crisis and restoring confidence in the capitalist system. Thus we welcome the opportunity to participate in the review of the UK's Combined Code on Corporate Governance.

Our initial observation would be that in the United Kingdom shareholders have a range of rights that enable them to fulfil their responsibilities as active share owners if they choose to do so. Given that there seems to have been a reluctance to use these rights we open our comments on the subject of the role of institutional investors as we believe this is the area where the most significant policy improvements can be made.

Section 2 of the Combined Code: Institutional Investors

We believe strongly that institutional investors, whether asset managers or asset owners, have responsibilities as well as rights in relation to the companies in which they invest. The main responsibility is to act as an owner, monitoring the performance of their agents, the directors, and holding them accountable when they act inappropriately.

Whilst we recognise that the Combined Code is a code on *corporate* governance we are concerned that it is relatively mute on the role and accountability of the share owner in ensuring that governance standards are met in practice. ICGN has long maintained that for a soft law approach to corporate governance to be effective institutional investors need to monitor compliance with the Code and to engage with companies that apparently fall short on either or both the comply or explain basis. Companies in the UK do seem to have made significant progress over the last decade in formalising their approach to governance and being willing and able to explain non-compliance with accepted practice.

We believe there is a need for a clear and comprehensive code of best practice in relation to the fiduciary duties of institutional investors, both asset owners and asset managers, setting out their responsibilities and proposing ways to meet them in spirit and in letter. We are concerned that, without this, most will be tempted to free ride and do nothing or to create the appearance of being active but doing very little of practical effect. Of the shareholders with a genuine interest in being an active and involved owner, only a few will be able to justify the resource required to be effective given the highly competitive environment of the investment management industry. A market code would also potentially aid asset managers seeking to pass on the costs of engagement as there would be implicit recognition from asset owners who outsource investment activities that active ownership is resource intensive and thus costly.

The Institutional Shareholders' Committee made good progress in developing a code of best practice in relation to shareholder responsibilities but as it is not a full-time body it had no mechanism to ensure the implementation of the principles published in 2005. Whilst we recognise that some asset owners do assess the capabilities of their asset managers in relation to governance, this tends to be perfunctory and is not widespread. Tools are being developed to assist asset owners in making such assessments but a recognised market code of best practice in relation to institutional investors' responsibilities would ensure progress.

We would suggest that such a code, which would cover both asset managers and asset owners, be premised on a "comply (or preferably apply) or explain" approach. We would expect it would cover at least UK-based asset owners and asset managers regulated by the Financial Services Authority. Its application would be monitored by those with a vested interest in a long-term approach to investment and active ownership, namely the clients of the asset managers and/or the beneficiaries of the asset owners. Thus, those who do not believe that they have a role to play in corporate governance, say because of their investment style, can be explicit about that and set out the reasons behind their position. They would then be open to engagement by those who thought otherwise. A public statement of the approach an investment manager takes to corporate governance would also help companies understand their shareholder base and to engage it more effectively.

Although our preference would be for self-regulation, we recognise that to get the attention of all regulated investment management firms, it may be necessary to make the "apply or explain" requirement of such a code part of the more formal regulatory oversight of the industry. Perhaps an interim measure would be to reserve powers to incorporate certain share ownership activities into the regulatory framework, as with the requirement to disclose voting decisions, as part of any reform. To be clear, we believe that making either voting or engagement compulsory is not desirable and may well have unintended consequences, but disclosure of the approach taken could be made compulsory.

In our view, a code relating to institutional investors' responsibilities is the opposite side of same coin as the Combined Code and thus it would make sense for it to be embedded into the Combined Code. We attach for information the ICGN's own statement of principles of institutional investor responsibilities, for your consideration. We believe that the United Nations Principles of Responsible Investment are also relevant although these are intentionally high level.

We believe that the ultimate goal over time would be that asset owners and asset managers would:

- Publish a statement on their approach to responsible investment and share ownership, including whether they vote at company meetings and engage with portfolio companies on governance matters as a matter of course
- Where an active ownership approach is taken, publish their voting and engagement policy and each year report on how the policy has been applied and their voting record should be provided at least to beneficiaries and clients
- Disclose their own governance structures and ensure that they have formal and effective policies for dealing with conflicts of interest and risk management and report on the appropriateness of these annually
- Disclose their incentive structures for senior management and portfolio managers and how these, and other governance structures, ensure they act in the long-term interests of clients
- Disclose the incentive structure between asset owners and asset managers in general terms (i.e. not to contravene commercial sensitivities)
- Discuss the extent to which the CEO and CIO understand matters of responsible stewardship and take a lead on this internally and publicly

As noted above, we do not support making voting and engagement mandatory. On the former, experience suggests that mandatory voting often pushes investors to use low cost mechanised solutions. Yet, ‘comply or explain’ cannot work if shareholders do not give due consideration to the explanations given by companies. Voting templates and proxy agents are not in a position to do this. Mandatory engagement seems to have significant potential for ‘engagement lite’. Some might argue that even this would be better than nothing but experience suggests that all the activity results in very little tangible action. There is another risk that governance and engagement would not be properly integrated into the investment process and would thus cause considerable confusion for companies if, for example, the governance and investment teams took differing stances on an issue. And it must be recognised that selling the shares of a company with poor governance is as legitimate a response to concern as is engagement to encourage change. We are also wary of the emerging trend to engage via the media as this tends to undermine the relationship between boards and shareholders which in turn tends to result in hostile rather than constructive engagement. Although public debate can raise awareness of an issue, overall, asset managers should keep engagement private.

The time and resource required by both companies and investors for meaningful engagement can be significant. Investors, even ones well resourced in terms of governance activities, cannot engage with all the companies in which they invest and need to prioritise their engagement activities and may choose to devote their time to those companies where they have the largest investments or where there seem to be the greatest risks. Cooperating with other shareholders can be an effective way of addressing this limitation and ought to be made possible within a governance framework. It would be even more effective if more than the ‘usual suspects’ were to participate. But it must be recognised that investors quite rightly take different stances on the governance of specific companies and on the solutions to a weakness that is collectively recognised. Thus, although collective action through the investor bodies can be an effective, and more efficient, approach in some cases, it will not guarantee more widespread engagement.

The strengths of the Combined Code

In our opinion, the Combined Code provides a sound framework for a pragmatic approach to corporate governance both from company and shareholder perspectives. After all, much of what is recommended is common sense and formalises the leadership and management practices of many successful companies. It seems that the crisis in the UK is more a failure of some people in positions of responsibility than the principles themselves.

The main strength of a soft law approach to corporate governance is the ease with which it can adapt and evolve. It is our view that broadly speaking the Combined Code is robust and requires no major amendments. However, some minor amplification of certain points could be considered and we set out our suggestions below.

Firstly, there needs to be stronger emphasis of the fact that the Code is guidance and not regulation. Whilst we acknowledge that the FRC and others have made a considerable effort to reinforce the point that the soft law approach of the Code means it does not have to be complied with it has not always been interpreted this way by commentators and investors. As already noted, a 'comply or explain' approach has the advantage of being flexible, but flexibility has the disadvantage of requiring effort on the part of investors and companies to engage. Some companies express frustration that the Code is applied on a 'comply or else' basis and thus companies with a valid reason for taking a different approach may ultimately decide it is easier to comply, even if it is sub-optimal.

Boards and relations with shareholders

We would suggest that further consideration be given to the recommendation that half the board be independent non-executive directors. Whilst having an appropriate balance of independence is clearly critical to a strong board, the emphasis on independence rather than calibre (or relevant experience and expertise) does seem to have resulted in some weakness on certain boards, particularly those of companies with complex business models. Of course, independence and calibre are not mutually exclusive traits but boards frustrated with the reluctance on the part of shareholders to accept explanations for a different balance have, anecdotally, taken the path of least resistance and prioritised independence. We would recommend that further emphasis on calibre and relevant experience be made.

The importance of the leadership role of the board cannot be emphasised enough. This is particularly so in relation to setting high ethical standards and demonstrating integrity. In our experience, no matter how sound the governance structures it is the implementation that ensures effectiveness. A number of companies published in their 2008 annual reports a breakdown of how the board spent its time during the year. This information, along with the charters for the board and its sub-committees, provides an interesting insight into how the board works. Boards should, in our view, consider using the annual report to explain in more detail the scope of their activities, how time was spent and which issues have been priorities during the year.

It might also be beneficial to recommend that the non-executives meet without the executives in advance of or after every board meeting to ensure that developments can be discussed freely and doubts addressed as soon as possible. It seems that non-executive directors are sometimes willing to 'wait and see' because they are not sure enough of their position to challenge much better informed executive directors. To maintain collegiality with management, it would be good practice for the chairman or senior independent director to share with the chief executive, in general terms, the issues discussed at, and the tone of, these meetings.

We believe that there needs to be more frequent use of external advisors to facilitate board performance evaluations. In our view, the evaluations need to be more focused on people than on processes. Most companies tend to use an internally conducted survey-based approach that is unlikely to deal well with the people issues. A good chairman will be continually evaluating the performance of the board and the members of it. However, even good chairmen are not totally impartial. A formal process helps depersonalize criticism and also ensures that a fresh look is taken periodically. In addition, provided the facilitator is skilled, one-on-one interviews are an effective way in which to bring to the surface people and behavioural issues. Perhaps a recommendation to have an external review, say every two or three years, with internal ones in the interim period would strike the appropriate balance.

Indicative hours required of non-executive directors should probably be increased. This would rightly require a commensurate increase in fees, perhaps half of which could be paid in company shares (but not in executive incentive-style option grants). The original restrictions on the number of chairmanships and directorships were widely criticized when first introduced. However, recent developments would suggest that they were well founded and need not be reviewed.

Some of the additional time spent by non-executive directors could well be dedicated to site visits and to meeting institutional investors and attending capital markets days with investors and analysts. This should help increase the director's knowledge of the business and help establish direct links with the investor community. This later point is in our opinion particularly important for the chairman and the senior independent director.

We are concerned that the division of responsibilities between the various board sub-committees has resulted in something of a silo mentality emerging which risks duplication in some areas and omission in others. Risk management (see below) seems to have been one area where the work of the audit and remuneration committees might not have been adequately linked. It is not clear that reporting back to the board by committee chairs is sufficiently in depth to ensure that all the board members are aware of developments. This might be remedied by the chairman or the senior independent director being a member of all sub-committees.

We believe also that the role of the nomination committee could be strengthened. At present, it is not clear who exactly takes the lead at board level on ensuring there are suitable management development programs that contribute to succession planning or that the approach to board performance evaluation is appropriate. Most often it is the chairman. We suggest that the involvement of the nomination committee, of which the chairman is in a majority of cases a member, may well enhance the process and transparency. It might also be useful for the committee to have a role in the continuing performance evaluation of the executive board members. We are particularly interested to see succession planning prioritized as we believe that not only can a lot of damage be done to a company when it is poorly handled but that it helps prevent the development of 'star' CEOs who can hold the company to ransom both financially and in terms of market sentiment. In our view, one of the key tasks for the board is to hire and fire the chief executive, and a robust management development and succession program helps the board fulfil this responsibility.

We are aware of the debate around the annual re-election of directors and consider it a fine balance between accountability and stability. As shareholders in UK companies representing five per cent of the issued share capital can propose a resolution to remove directors, staggered boards are less of an entrenchment risk. However, the process is a time-consuming one thus it is unlikely that shareholders would use it lightly. There are a number of issues, remuneration being a topical one, where shareholders may well wish to hold the directors accountable for their decisions in a timely manner. Annual re-election of the chairman of the board and the committee chairmen would in our view achieve the appropriate balance. We do recognise that given the size of some boards this approach may result in annual re-election of all the non-executives, which may ultimately push boards to annual re-election of all directors for the sake of collegiality.

Training for non-executive directors continues to be a thorny issue. Anecdotally, some will admit to not being fully up to speed on key business issues, such as accounting reforms or IT trends. And although they are entitled to training at the expense of the company few seem inclined to ask for it. We are not proposing that a set qualification be required but that thought be given to how continued learning opportunities can be provided in a non-threatening way, such as private, one-to-one tutorials through business schools. Chairman skills and feedback on personal style could well be one area of focus. The Code might suggest that the board set an expected (not required) number of hours that directors would spend in external training so that individual NEDs would not feel embarrassed when they avail themselves of training programs.

We believe that there is an argument for further strengthening the role of the company secretary and increasing the resources available to the non-executive directors through that office. We believe that it is essential that the company secretary is not an executive director on the board as the secretary should be impartial. For smaller companies, perhaps the board can ask external counsel to fulfil this role (rather than having to hire a dedicated company secretary). Anecdotally, few directors use the facility to get independent information on board matters yet many feel that they are at a disadvantage to management in terms of depth of knowledge and understanding. The quality of board papers is also questionable and many directors complain of being swamped with detail from which it is difficult to distil the useful and material information. It does point to the need for a *board* secretary rather than a company secretary whose sole role is to support the board in its work.

Risk management

We believe that specific mention of the board's role in risk management ought to be made in the Combined Code. The most important step to improving a risk management system is board leadership on, and interest in, the issue. Without a clear and explicit tone from the top risk management is too easily dismissed as a compliance (read dull, housekeeping) matter rather than a business critical one.

Clear messages from the board about the risk appetite of the company and the importance of balancing risks and returns should help raise the profile of risk management as an issue. It should also have the effect of raising the status of the staff responsible for the implementation of the board's risk management processes. In addition, consideration should be given to requiring the appointment and dismissal of the head of risk and the head of internal audit to be a matter for board approval. To make this more than a rubber stamping exercise, both those roles should present regularly (in person) to the board and develop strong working relationships with the members of the audit or risk committees (whichever takes the lead on risk management). Although we are not recommending it, a decision to appoint to the board a director responsible for risk should be based on the overall contribution that individual can make to the work of the board. Otherwise it is likely he would be isolated and thus ineffective and would provide undue comfort to those on the outside.

In addition, the board should consider risk from two angles: firstly, oversight of the implementation of current processes and review of their adequacy; and secondly, 'blue skies thinking' through which to try to identify the 'unknown unknowns' and scope risk appetite going forward. The former ought to be an agenda item for board meetings whilst the latter is probably better suited to less structured meetings such as board dinners or off-site strategy sessions. The overriding consideration is that all risks are reviewed and good decisions are made.

We recognise that risk management is an extremely broad area with different categories of risk, with varying complexity, and with industry-specific differences. Thus, the optimal structure for dealing with risk management will depend on the company's circumstances. Nonetheless, boards should explain the approach taken and its level of involvement in oversight of risk management.

Remuneration

Although the level of disclosure on executive remuneration has increased markedly over recent years it has not always resulted in a better understanding of the mechanics of particular policies. It is noticeable that policies have become much more complex which has led to a further breakdown of trust between management, remuneration committees and shareholders, exacerbated in some people's view by the vote on the remuneration report. What is clear is that disclosure is not the same as communication. The quality of reporting could be vastly improved in some cases to ensure that it is clear how a policy achieves its stated objective to recruit, retain and motivate. There is no easy fix to this problem although one recommendation might be that remuneration committee chairmen meet annually with the company's major shareholders several months in advance of the AGM to discuss remuneration issues and the decisions of the committee over the past year. This would also provide feedback to the board on shareholder perceptions of how the company has performed and is expected to going forward.

We would note that there is also scope for improvement on remuneration-focused engagements with shareholders. In particular, shareholders would like to see more leadership from remuneration committee chairmen and less from the remuneration consultant. We recognise that remuneration is technical and complex but if the remuneration committee chairman is recommending shareholders support a remuneration policy he ought to be able to explain and justify it. Furthermore, there are issues regarding the timing of consultations which tend to coincide in preparation for the AGM 'season' (see below) and which often have very brief response periods.

The AGM season

Although possibly outside the scope of this review, we are concerned that the AGM 'season' in the UK is becoming increasingly condensed. If shareholders are to vote intelligently and to engage with companies on voting and other issues in a timely manner AGMs must be more spread out over more than the current dozen weeks in spring.

In closing, it is our opinion that too little responsibility for the effectiveness of the voluntary governance framework is borne by the institutional investors at present. Directors have been the focus of much criticism but institutional investors have also been shown to have contributed to the crisis through inadequate exercise of their rights as part owners of public companies. It is timely to review the appropriate roles of each of the main parties key to the successful realisation of the corporate governance framework.

We hope you find these comments helpful. If you would like to discuss them further, please do contact Kerrie Waring, Chief Operating Officer, either by telephone on +44(0) 207 612 7079 or by email at Kerrie.waring@icgn.org .

Yours sincerely,

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