Report

FRC Financial Reporting Council

December 2013

Developments in Corporate Governance 2013

The impact and implementation of the UK Corporate Governance and Stewardship Codes

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Introduction

This is the FRC's third annual report on the impact and implementation of the UK Corporate Governance and Stewardship Codes, and the last to be issued under my chairmanship. I would like to take the opportunity to pay credit to the way that many companies and investors have risen to the challenges we have laid down over the last few years, and to highlight some areas in which there is still more work to do.

Shortly after I became chairman in 2010 we made some significant changes to the UK Corporate Governance Code and published the first Stewardship Code. Further changes to both Codes were made in 2012, which took effect this year.

There are now high levels of compliance with the new recommendations added to the UK Corporate Governance Code in 2010, including the almost universal adoption of annual director elections among FTSE 350 companies. The level of early adoption of some of the changes made last year, such as having a clear policy on boardroom diversity, is also encouraging, particularly as companies have also had to implement significant new statutory requirements on reporting and remuneration this year.

There has been a similarly positive response to the Stewardship Code, to which there are nearly 300 signatories. While it is still early days, there are some reports of better engagement with and by large companies and growing demand from owners for their investment managers to apply a stewardship approach. If these trends become more widespread – and the jury remains out for the moment – the Code will begin to have the impact we are seeking.

There is a temptation to make continual changes to the Codes in order to raise the bar or go into greater detail, and a danger that they are seen as a "Christmas tree" on which stakeholders wish to hang their favoured policies. This needs to be resisted unless those policies also serve the primary objectives of the Codes, which is to improve the governance and stewardship of listed companies so that their owners can benefit from the long-term success of those companies.

While the FRC will always be willing to revise the Codes when it is necessary – and we are currently considering possible changes to the UK Corporate Governance Code for 2014 – tinkering for no strong purpose is just a distraction. More effective application of, and reporting on, existing Code principles may often have a greater impact on actual standards of governance and stewardship than managing further change. For the FRC, this means finding ways to help companies and investors implement the Codes more effectively, and to monitor how well they are doing so.

One area of focus for companies needs to be succession planning, the quality of which has been highlighted as a cause for concern in many contexts during 2013. The FRC will undertake a project in 2014 to identify good practice that might help companies meet the Code principle that "plans are in place for orderly succession for appointments to the board and senior management… to ensure progressive refreshing of the board".

For investors, there is a need to tackle the barriers to engagement with companies and greater accountability down the investment chain to the real owners of those companies. Many of these cannot be addressed directly through the Stewardship Code, so the FRC will need to continue to work closely with market participants and other regulators. But while these barriers are real, they should not be used as an excuse for inactivity on the part of investors or companies.

Accountability requires transparency, so the FRC will continue to press for meaningful and understandable reporting from both companies and investors.

Notwithstanding the high levels of compliance with the UK Corporate Governance Code, the variable quality of explanations remains its Achilles heel. While companies are getting better at describing their actual governance arrangements, many still struggle to articulate clearly why they have chosen to deviate from the Code.

Investors, meanwhile, need to aspire to the same level of transparency as they themselves expect of the companies in which they invest. Many statements on the Stewardship Code give little insight into investors' actual practices.

For companies and investors concerned about the prospect of future legislation or further changes to the two Codes, the best defence is to demonstrate that there is substance behind their statements of good intent. While progress has been made in this regard, there is clearly more still to do.

BARONESS HOGG
Chairman, Financial Reporting Council
December 2013

Overview

This report has three main purposes: to report on the quality of compliance with, and reporting against, the UK Corporate Governance and Stewardship Codes and on regulatory and other developments in the UK listed sector in 2013; to give the FRC's assessment on the quality of engagement between companies and investors; and to indicate to the market where the FRC considers further efforts are needed to bring necessary improvements in governance and stewardship.

The early indications are that companies are responding in a positive manner to the changes introduced to the UK Corporate Governance Code in October 2012.

Although formally most companies are only required to report in 2014 on how they have applied the 2012 version of the Code, many are already disclosing their boardroom diversity policies and the level of audit tendering activity has increased.

Early adoption of the new reporting recommendations on the activities of the audit committee and confirmation that the report and accounts are fair, balanced and understandable has been less widespread although, anecdotally, the FRC understands that many companies are reviewing the processes by which they make these disclosures in preparation for doing so in the next report.

Reported compliance with the Code remains high, with the majority of companies either complying with all, or all but one, of its provisions. All but two FTSE 350 companies now hold annual director elections, a recommendation added to the Code in 2010, as do over 40 per cent of smaller listed companies even though the Code provision does not formally apply to them.

High compliance levels do not reduce the need for companies to provide a meaningful explanation when they choose not to follow the Code. In 2012, the FRC set out criteria for clear explanations, and in this report has assessed whether they have improved over the last twelve months. The results are mixed. While companies are getting better at describing their actual governance arrangements, many still struggle to explain clearly the rationale for deviating from the Code.

The quality of reporting on corporate governance more generally, while having undoubtedly improved over the years, also remains variable. There are many good examples of reporting by mid- and small-cap companies, but in general their reporting is less informative than that produced by larger companies. While recognising the greater resources available to larger companies, the FRC does not believe that the size of a company should be a determining factor in the level of transparency investors can expect.

All companies should be capable of explaining clearly how they are governed. By bringing together companies and investors the Financial Reporting Lab can play an important supporting role. It recently reported on how companies might implement the recommendations on audit committee reporting that were added to the UK Corporate Governance Code last year, and a project on risk reporting is likely in 2014.

The FRC is extending the approach taken by the Lab into other areas of activity that do not relate directly to reporting. For example, it hosted a series of meetings earlier in the year on board evaluation, a concept first introduced into the Code ten years ago. Participants felt that there was now much greater recognition of the value of regular reviews, and that best practice had improved significantly, although some companies had concerns about the variable quality of independent reviewers.

One issue to emerge from those meetings was that many boards had identified succession planning as an area in which they needed to improve. If boards are to remain effective they must keep under review the balance of skills and experience needed to develop and oversee the delivery of the company's strategy, and anticipate the need for changes rather than being purely reactive. Greater attention to ensuring there is a sufficient pool of senior executive talent within the company may also help to develop the pipeline of future female executive directors.

For these reasons, the FRC will undertake a project in 2014 with the aim of identifying and spreading good practice in succession planning and, more generally, how the nomination committee can play its role effectively. There is no presumption on the FRC's part that this will necessarily lead to proposed changes to the Code or formal guidance.

The FRC is considering whether to make changes to the Code in 2014 in relation to risk management and reporting, remuneration and the work of the audit committees as a consequence of major reviews carried out by the Sharman Panel, the Government and the Competition Commission respectively, and is consulting on its proposals. However, once any changes that it concludes are necessary have been incorporated, the FRC's intention is to focus primarily on helping companies to implement the best practices already set out in the Code more effectively, and to monitor whether they are doing so.

The focus on effective implementation also applies to the Stewardship Code. While not ruling out further fine-tuning of the Code in 2014, the FRC believes the main priority must be to encourage and assist signatories to the Code to deliver on the commitment they have given, and to monitor whether they are doing so.

The Stewardship Code now has nearly 300 signatories, of whom approximately two-thirds are asset managers. Between them, current signatories own or manage a significant proportion of UK listed equities and have the potential to become the critical mass of investors needed to oversee and engage with companies with the aim of achieving a long-term return to savers.

The Stewardship Code, unlike the UK Corporate Governance Code, is still in its infancy and behavioural change will take time. There are some encouraging signs that more engagement on a wider range of issues is taking place between large companies and their major shareholders. However, this is not the case across the listed sector as a whole, and there are real concerns of an emerging "engagement deficit" affecting mid-market companies.

Where investors hold shares in a large number of companies and/or allocate a relatively small proportion of their overall investments to UK equities, they inevitably have to stretch their stewardship resources thinly. Pressure on those resources is as significant a constraint for investors as it is for companies. In practice this means investors are able to engage only with those companies in which they have large holdings or about whom they have concerns. In these circumstances, effective collective engagement is all the more important, and the FRC welcomes the recent report on the proposed investor forum from the Collective Engagement Working Group.

For many companies outside the upper reaches of the FTSE Index, the only engagement is around the annual general meeting. Some companies have complained to the FRC that shareholders will often not engage with them in advance to discuss any concerns, and that votes against often come as a surprise. If investors do not intend to adhere to the practice set out in the Stewardship Code, which is to notify investee companies if the intention is to vote against or abstain, this should be made clear in their public statements.

This problem has been exacerbated by shortcomings in the way the voting chain operates. Shareholders say that they often have little time to make considered decisions before having to submit their votes, while companies say that they do not receive the bulk of votes until a day or two before the annual general meeting.

The lack of direct contact with their actual shareholders feeds the perception on the part of many companies that proxy advisors wield undue influence over voting outcomes. While there is no clear evidence that UK investors vote purely on the basis of a recommendation from a proxy advisor, this perception is exacerbated by the behaviour described above.

It would help companies to have a better understanding of how proxy advisors carry out their research and what they can expect in terms of communication. The draft Best Practice Principles developed by the industry with the encouragement of the European Securities Market Authority earlier this year is potentially a constructive development, although robust oversight arrangements will be needed if they are to be seen as credible by companies. In turn, investors are responsible for ensuring that activities they have delegated to others are carried out in a manner consistent with their own approach to stewardship.

The quality of reporting by Stewardship Code signatories remains variable. There are some very good examples, and some investors are now going beyond simply describing their policies and processes and have begun to report on the outcomes of specific cases of individual and collective engagement. This is to be welcomed as it helps to demonstrate that there is substance behind their public statements.

For the same reason, the FRC would encourage more signatories to consider obtaining an independent assurance on their engagement processes, as recommended by the Code. While the number of signatories doing so has increased, at 14 per cent it remains low.

The FRC is concerned that nearly half of the signatories to the Code have not yet updated their public statements over a year after a revised edition of the Code took effect in October 2012, and that a number of signatories do not report on all of the principles of the Code. While recognising that this does not necessarily indicate a lack of activity, such a high percentage suggests that at least some investors have signed up to the Code in name only. The FRC is considering mechanisms for ensuring that statements are complete and up to date, and possible sanctions if they are not.

Ultimately the key to increased stewardship activity by asset managers is greater client demand. There are some signs this is beginning to happen – more mandates and Requests for Proposal now refer to stewardship, and owners are reportedly less satisfied with the quality of information they receive from their managers – but there remain many real and perceived barriers.

The detailed assessment that follows in the remainder of this report draws on new and publicly available research, studies of annual reports and Stewardship Code statements and conversations with companies, investors and other interested parties. The FRC would like to thank everyone who has directly or indirectly contributed to the report.

The Operating Environment

This section summarises the main changes in the regulatory framework for corporate governance and stewardship during 2013, and indicates the further developments that are expected in the next twelve months. It also comments on some of the main developments in the operation and structure of the UK equity market in the period since the previous report.

A new edition of the UK Corporate Governance Code was published in September 2012, which applied to reporting years beginning on or after 1 October 2012. The main changes to the UK Corporate Governance Code included: that boards should confirm that the annual report and accounts taken as a whole are fair, balanced and understandable; that audit committees should report more fully on their activities; that FTSE 350 companies should put the external audit contract out to tender at least every ten years; and that companies should report on their boardroom diversity policies.

To assist companies with implementing the Code recommendations, the FRC issued in July 2013 a best practice note on audit tendering,[1] and a report from the Financial Reporting Lab on audit committee reporting in October 2013.[2]

The issues of audit tendering and audit committee reporting have been revisited by the Competition Commission, which published in October 2013 its report into the market for audit services in FTSE 350 companies.[3] The Commission intends to introduce Orders in 2014 that will make tendering at least every ten years mandatory for FTSE 350 companies (as opposed to being subject to "comply or explain" under the Code) with effect from October 2014.

It seems likely that further regulatory requirements making tendering and auditor rotation mandatory will be agreed at European level, where negotiations on the Audit Directive and Regulation appear to be reaching a conclusion. If those negotiations are successful, the Directive and Regulation will become law in the first quarter of 2014.

The Competition Commission has also made a number of recommendations proposing amendments to the UK Corporate Governance Code, primarily in relation to the content of audit committee reports but also proposing that shareholders should be offered an advisory vote on the committee's report. The FRC is currently considering these recommendations. If any changes to the Code are proposed they will be subject to consultation, and would apply to financial years beginning on or after 1 October 2014.

At the same time as implementing the latest edition of the Code, listed companies have had to adapt to significant legislative changes that affect reporting and voting.

The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, which took effect on 1 October 2013, require companies to produce a Strategic Report which will explain, amongst other things, the company's objectives, strategies, and performance. The FRC issued draft guidance on the Strategic Report for consultation in August 2013. Final guidance will be issued early in 2014; as well as reflecting responses to the consultation it will draw on the practical experience of those companies that have already adopted the new reporting requirements.

[1] Audit Tenders: Notes on Best Practice; Financial Reporting Council; July 2013
[2] Reporting of Audit Committees; Financial Reporting Lab; October 2013
[3] Statutory Audit Services for Large Companies Market Investigation; Competition Commission; October 2013

Prompted by the introduction of the Strategic Report, which will lead to some restructuring of the annual report and accounts for many companies, the FRC is considering whether the UK Corporate Governance Code should be amended to enable companies to place the full corporate governance statement on their website, with an edited version containing the disclosures most relevant to investors in the annual report and accounts. If this is proposed, it will form part of the broader consultation on Code changes in 2014.

As part of the Strategic Report, companies are required to disclose their principal risks and uncertainties. The FRC has been looking more broadly at standards of risk management and reporting in the listed sector, and in November 2013 issued for consultation draft guidance on risk management and internal control, which is intended to replace its 2005 guidance on the subject (known as the "Turnbull Guidance"). It also incorporates more specific guidance to listed companies on how to assess and report on their solvency and liquidity risks and determining whether to adopt the going concern basis of accounting, as required under accounting standards.

The FRC has also proposed some changes to the UK Corporate Governance Code to support the proposed guidance. If adopted, this would apply to financial years beginning on or after 1 October 2014.

As with auditing, there is a strong possibility of new European requirements on non-financial reporting being agreed early in 2014. If adopted, these would overlap to a certain extent with the requirements of the Strategic Report. The current draft of the proposed directive also contains requirements on companies to report on their boardroom diversity policies, which are largely consistent with the existing provisions of the UK Corporate Governance Code.

The other significant new legislative requirements affecting listed companies relate to reporting and voting on directors' remuneration. The Enterprise and Regulatory Reform Act 2013 introduced regular binding votes on companies' remuneration policies in addition to the existing annual advisory vote. Details of the information companies must disclose in their remuneration reports are set out in the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, which drew in part on reports by the Financial Reporting Lab.[4] Both the Act and the Regulations took effect from October 2013.

At the request of the Government, the FRC consulted in October 2013 on whether changes should be made to the sections of the UK Corporate Governance Code addressing remuneration.[5] The FRC is currently considering responses to that consultation. If the FRC decides to propose amendments to the Code there will be further consultation on the draft wording which, as with the other possible changes mentioned, would be included in a revised edition of the Code taking effect from October 2014.

There is also a possibility of European legislation that would require a shareholder vote on directors' remuneration. The European Commission has indicated that proposals for a "say on pay" will be included in a revised draft of the Shareholder Rights Directive, which the Commission is currently expected to publish in the first quarter of 2014.

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[4] A Single Figure for Remuneration; Financial Reporting Lab, June 2012 and Reporting of Pay and Performance; Financial Reporting Lab; March 2013

[5] Directors' Remuneration; Financial Reporting Council; October 2013

With European Parliamentary elections in May 2014, and a new Commission being appointed later in the year, there is unlikely to be any further significant progress on revisions to the Shareholder Rights Directive during the course of 2014. The same is likely to be true for other proposals in the European Commission's Company Law Action Plan – with the exception of the proposed non-binding Recommendation on the "comply or explain" mechanism, which does not need to be approved by the European Parliament or Member States – the separate Directive on gender balance among non-executive directors of listed companies, and any measures set out in the Commission's planned action plan to promote long-term investment.

Many of the other elements of the proposed revisions to the Shareholder Rights Directive seem likely to be directed at investors and their advisors. The European Commission has indicated that it will probably include some form of transparency requirements on proxy advisors. This follows a report by the European Securities Market Authority in February 2013 on the role of the proxy advisory industry,[6] which led the industry to issue draft Best Practice Principles for consultation in October 2013.[7]

The revised Directive is also expected to contain proposed measures that would require more transparency on the part of both asset managers and owners on their voting and engagement policies and activities, which seem likely to overlap at least in part with the disclosures made on a voluntary basis by signatories to the Stewardship Code.

As noted in last year's report, the edition of the Stewardship Code published in September 2012 contained extensive revisions intended to clarify what is expected of signatories and address some shortcomings in implementation or reporting that the FRC had identified. While not ruling out further fine-tuning in 2014, the FRC believes the main priority now is to focus on implementation, by encouraging and assisting signatories to the Code to deliver on the commitment they have given, and to monitor whether they are doing so.

The two objectives of the Stewardship Code are to increase the quality and quantity of engagement between company boards and investors, and to improve accountability and transparency down the investment chain to the real owners of those companies. These are not objectives that can be achieved through the Code alone, and the FRC will continue to work closely with market participants and other regulators to deliver them.

There has been considerable activity in recent months addressing these issues. Some of this has come from the investment industry itself, including the Stewardship Disclosure Framework developed by the National Association of Pension Funds launched in October 2013[8] and proposals from the Collective Engagement Working Group for a new investor forum published in December 2013.[9] In addition, the Institute of Chartered Secretaries and Administrators issued guidance for companies and investors on enhancing stewardship dialogue in March 2013.[10]

In response to concerns raised in the Kay Review[11] that uncertainties and misunderstandings on the part of pension trustees about their fiduciary duties had contributed to them taking a short-term approach to investment, the Law Commission is

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6 Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry; European Securities and Markets Authority; February 2013

7 Public Consultation on Best Practice Principles for Governance Research Providers; Charter Signatories Working Group; October 2013

8 Stewardship Disclosure Framework for Asset Managers; National Association of Pension Funds; October 2013

9 Report of the Collective Engagement Working Group; Collective Engagement Working Group; December 2013

10 Enhancing Stewardship Dialogue; Institute of Chartered Secretaries and Administrators; March 2013

11 The Kay Review of UK Equity Markets and Long-Term Decision Making; July 2012

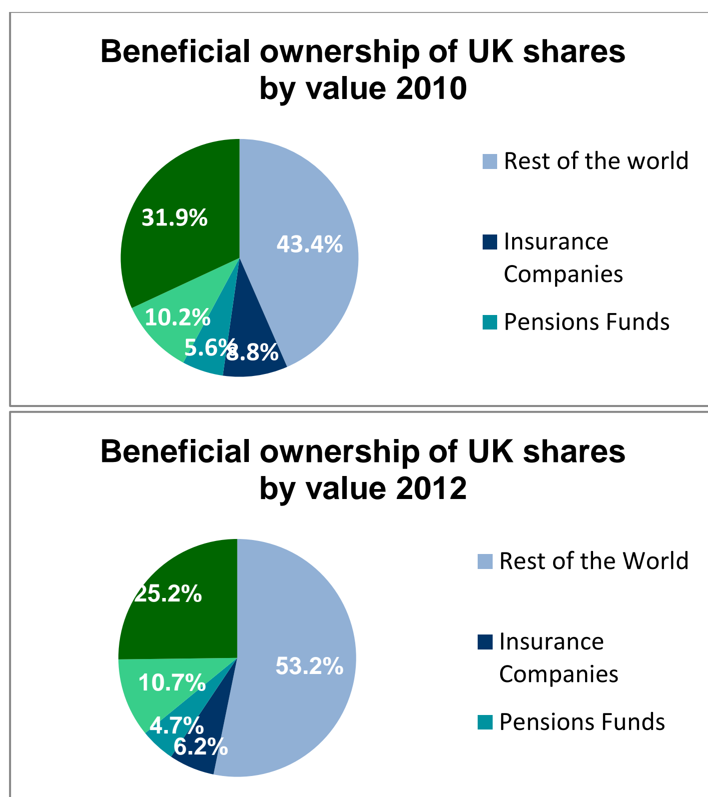
currently considering how the law of fiduciary duties applies to investment intermediaries,[12] and whether there is a need for it to be clarified or strengthened. It is expected to report its conclusions by June 2014.

In October 2013 the Financial Conduct Authority (FCA) announced that it was reviewing whether there is a need for reforms to the dealing commission regime to increase transparency and better align the interests of investment managers and their customers. As a first step, the FCA published for consultation in November proposed changes to the rules on investment managers' use of client commissions.[13]

The FCA also announced in November 2013 that it would be making changes to the Listing Rules to enhance protection for minority shareholders in listed companies with a controlling shareholder.[14] These include measures to give independent shareholders a veto over transactions between listed companies and a controlling shareholder and to require separate approval of independent directors by independent shareholders, in addition to gaining approval from shareholders as a whole. The changes to the Listing Rules are expected to take effect in mid-2014.

As noted in previous FRC reports, changes in the ownership of UK equities have created further challenges to the ability to improve engagement between company boards and investors. The trend of declining participation in UK equities of traditional UK-based long-term holders such as insurance companies and pension funds, matched by much greater foreign participation, has, if anything, accelerated in recent years.

Chart: Beneficial ownership of UK shares by value in 2010 and 2012



Source: 'Ownership of UK Quoted Shares 2012; Office for National Statistics; September 2013

[12] Fiduciary Duties of Investment Intermediaries; Law Commission; October 2013
[13] Consultation on the use of dealing commission rules; Financial Conduct Authority; November 2013
[14] Feedback on CP12/25: Enhancing the effectiveness of the Listing Regime and further consultation; Financial Conduct Authority; November 2013

The latest data from the Office for National Statistics (ONS) shows that foreign investors owned 53 per cent of UK equities at the end of 2012, with North American investors accounting for nearly half of that number. If these figures are accurate, this means that they alone own over twice as much of the market as UK insurance companies and pension funds combined.

Comparisons with previous years need to be treated with caution as the ONS has recently changed its methodology for calculating these figures, but the overall trend is undeniable and borne out by other data. UK pension funds' equity allocation fell to 35.1 per cent from 38.5 per cent in 2012, with the UK proportion falling from 33.9 per cent to 31 per cent.[15]

While the impact of these changes needs to be balanced against evidence of improvements in engagement and increasing owner demand for stewardship summarised later in this report, they do contribute to a challenging environment, and illustrate the importance of finding ways in which overseas investors and retail shareholders can be brought more effectively into the engagement process.

[15] The Purple Book; The Pension Protection Fund and the Pensions Regulator; November 2013

The Governance of Listed Companies

This section of the report looks at how the UK Corporate Governance Code has been implemented during 2013, with a particular focus on the new principles and provisions introduced in 2010 and 2012. Those provisions that introduced new reporting requirements are considered in the next section.

Overall compliance rates

The evidence shows that overall reported rates of compliance with the Code remain very high among companies of all sizes.

The annual survey of compliance by FTSE 350 companies carried out by Grant Thornton[16] showed that 57 per cent of those companies stated full compliance with the Code, an increase of 6 per cent over the previous reporting year, with 85 per cent of the remainder complying with all but one or two of the Code's 53 provisions.

As in previous years, the Code provision with the highest rate of non-compliance among FTSE 350 companies is Section B.1.2, which states that at least half the board of those companies, excluding the chairman, should be independent; although the rate of compliance has risen from 81 per cent to 87 per cent since the last report. The FRC's assessment of the quality of the explanations given for non-compliance with this provision is contained in the next section of this report.

Data compiled by Manifest[17] on behalf of the FRC shows that, in respect of board and committee composition, compliance levels among companies on the FTSE Small Cap and Fledgling indices are generally consistent with those of larger companies, as the examples in the table show, and all figures are generally consistent with the equivalent figures in 2012.

Table: Compliance with selected provisions of the UK Corporate Governance Code

Code requirement	FTSE 350 companies	Smaller companies
Separate Chairman and CEO	94%	97%
Met minimum standards for number of independent NEDs	87%	99%
Met minimum standards for audit committee composition	94%	96%
Met minimum standards for remuneration committee composition	92%	84%
Met minimum standards for nomination committee composition	96%	98%

Sources: Grant Thornton and Manifest – The Proxy Voting Agency

Note: There are different requirements for FTSE 350 and smaller companies regarding the minimum number of independent directors and the minimum requirements for board and committee composition (for example, for FTSE 350 companies independent directors should make up at least half the board, while smaller companies are only expected to have at least two independent directors).

[16] Governance steps up a gear; Grant Thornton; December 2013

[17] Manifest looked at a sample of 270 companies, 246 on the Small Cap Index and 24 on the Fledgling Index

Annual elections

In 2010, the FRC amended the Code to recommend that FTSE 350 companies put all directors forward for re-election annually. In 2013, all but two FTSE 350 companies did so.[18] In addition, 43 per cent of Small Cap and Fledgling companies put all directors forward for re-election even though the Code provision does not apply to them, up from 30 per cent in 2012.[19]

Board evaluation

The Code first recommended regular evaluation of the board's effectiveness in 2003. In the 2010 edition, the FRC recommended that the evaluation of the boards of FTSE 350 companies should be externally facilitated at least every three years.

According to the Grant Thornton research,[20] in the last three years 94 per cent of FTSE 350 companies reported that they had carried out an externally facilitated board review (34 per cent in 2013; 35 per cent in 2012 and 25 per cent in 2011). While this figure is probably inflated, as it will include a number of companies that have carried out more than one externally facilitated review in that period, it nonetheless represents a positive response.

A further change was made to the Code in 2012 recommending that companies should disclose the identity of the external facilitator and whether they had any other link to the company, as many companies were not doing so. 80 per cent of companies that undertook an externally facilitated review provided this information, compared to 70 per cent in 2012.[21] Practical Law reported that 51 different facilitators were appointed by FTSE 350 companies. By comparison, the same companies used 24 executive search consultants and 25 remuneration consultants.[22]

During 2013 the FRC held a series of meetings with directors, company secretaries, investors and independent reviewers to get their views on the impact of board evaluation on board effectiveness in the ten years since it was first recommended in the Code. In general, participants considered that the impact had been positive, and that it had contributed to boards operating more professionally over that period. The benefits had increased as directors became accustomed to regular reviews and assessment processes and techniques continued to improve.

Some companies raised concerns about what they felt was the variable quality of the service provided by external facilitators, and stated that they found it difficult to differentiate between them. The change made to the Code in 2010 has undoubtedly prompted more providers to enter the market, as the data from Practical Law shows, and it may be that market forces will resolve these concerns over time.

Succession planning and the appointment process

One of the issues most frequently highlighted as a result of board evaluations is the quality of succession planning. This appears to be borne out by the variable quality of reporting on this issue, as covered in the next section of this report.

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[18] Annual Reporting and AGMs 2013: What's Market Practice?; Practical Law; November 2013
[19] Data provided by Manifest
[20] Governance steps up a gear; Grant Thornton; December 2013
[21] Governance steps up a gear; Grant Thornton; December 2013
[22] Annual Reporting and AGMs 2013: What's Market Practice?; Practical Law; November 2013

Unless they are planning over the medium- to long-term, for both executive and non-executive positions, boards will struggle to ensure that they have the mix of skills and experience they need as the company evolves. The FRC intends to undertake a project during 2014 looking at succession planning specifically, and the activities of the nomination committee more generally, with the aim of identifying and spreading good practice. There is no presumption on its part that this will lead to changes to the Code or formal FRC guidance. The FRC will support whatever actions are most likely to achieve effective outcomes.

In June 2013, the Parliamentary Commission on Banking Standards asked the FRC to investigate "the widespread perception that some 'natural challengers' are sifted out by the nomination process", noting that "the nomination process greatly influences the behaviour of non-executive directors and their board careers".[23] The FRC has found no evidence to suggest that individuals that might provide constructive challenge are deliberately sifted out by the chairman or nomination committee, but it is possible that in some cases this is the unintended consequence of shortcomings in the appointment process.

The FRC will consider how this issue might be addressed, including the merits of the Parliamentary Commission's other suggestions on advertising board vacancies and the chairmanship of the nomination committee, as part of its planned review. The FRC will also consider the findings of the review of the voluntary code of conduct for executive search firms currently being undertaken by Charlotte Sweeney at the request of the Secretary of State for Business, Innovation and Skills.

Diversity

Better succession planning may also help to increase the number of female executive directors. The percentage of female executive directors in FTSE 100 companies has fallen slightly in the last twelve months (from 6.7 to 6 per cent), while in both FTSE 250 and smaller listed companies there has been a marginal increase from 5.2 to 5.4 per cent over that period.[24]

More encouraging progress has been made in respect of non-executive director positions. In FTSE 100 companies the percentage has risen from 21.6 to 23.9 in the last twelve months, and similar increases have been seen in FTSE 250 and Small Cap companies, where women now account for 18.6 and 12.3 per cent of non-executive directorships respectively.

In last year's report, the FRC quoted research by Cranfield that found that women accounted for 44 per cent of new director appointments in FTSE 100 companies in the six months to September 2012, and 36 per cent of those in FTSE 250 companies. In the equivalent period in 2013, these figures have fallen to 27 and 29 per cent respectively.

As noted by Cranfield, if these rates of appointment remain unchanged, the headline figure for female directorships in FTSE 100 companies (currently 18.9 per cent when combining executive and non-executive directorships) is unlikely to reach Lord Davies' target of 25 per cent female directorships by 2015.

Gender is, of course, only one aspect of diversity which boards should consider when determining the appropriate balance of skills, background and attributes that they need.

[23] Final Report – Changing Banking for Good – Volume I; Parliamentary Commission on Banking Standards; June 2013

[24] All data on gender diversity on the boards of FTSE 350 companies in this section is taken from Women on Boards: Benchmarking adoption of the 2012 Corporate Governance Code; Cranfield University School of Management; November 2013. Data on smaller listed companies was provided by Manifest

Research by Korn/Ferry[25] comparing first-time non-executive appointments in 2007 and 2012 suggests that companies are increasingly looking beyond the listed sector to find suitable candidates. In 2012, only 24 per cent of first-time non-executive directors had previously been an executive director on a quoted company board, compared to 46 per cent in 2007.

Separate research by Deloitte found that 22 per cent of directors on FTSE 350 companies in 2012 were non-UK nationals, compared to 15 per cent in 2005.[26] As might be expected, the figures are much higher in larger companies with global operations.

The extent to which companies are reporting on their boardroom diversity policies and targets, as recommended in the 2012 edition of the Code, is considered in the next section of this report.

Audit Tendering

In 2012, the FRC amended the Code to recommend that FTSE 350 companies should put the external audit contract out to tender at least every ten years. It also put forward proposed transitional arrangements, recognising that it was neither realistic nor desirable to expect all companies that had not undertaken a tendering exercise in the previous ten years to do so within the first year of applying the revised Code.

Thirteen FTSE 350 companies reported that they had carried out tenders during their 2012 or 2012-13 financial years, with eight of those companies changing auditors as a result.[27]

As only 22 per cent of FTSE 100 companies and 19 per cent of FTSE 350 companies specified a date for the prospective audit tender[28] it is difficult to give an accurate figure for future uptake. However, discussions with audit firms suggest that approximately 30 companies are tendering in their current financial years – some of which, most recently Unilever, have already announced that they intend to change auditors as a result – and up to 50 are preparing to do so during their 2014 or 2014-15 financial years. If these predictions are accurate, it would represent a positive response.

Since the amendment to the Code last October, the Competition Commission has announced that it will introduce an Order making it mandatory for all FTSE 350 companies to undertake a tender at least every ten years, with effect from October 2014. Separately, it seems likely that negotiations between the European Commission, the European Parliament and Member States will result in requirements on mandatory tendering and auditor rotation being included in the revised Audit Directive, which is expected to be agreed in early 2014. The FRC will review whether to retain the "comply or explain" tendering provision in the Code in light of these developments.

[25] The Class of 2012: New NEDs in the FTSE 350; Korn/Ferry Institute; July 2013
[26] At The Helm: Board structure and non-executive directors' fees; Deloitte; May 2013
[27] Governance steps up a gear; Grant Thornton; December 2013
[28] Annual Reporting and AGMs 2013: What's Market Practice?; Practical Law; November 2013

Reporting by Listed Companies

This section sets out the FRC's assessment of the quality of reporting on corporate governance. As noted in previous reports, while overall reporting is good and improving, there are still too many examples of generic and boiler-plate reporting. Improvements have been seen in some specific areas highlighted by the FRC, for example reporting on boardroom diversity policies, but there is still plenty of room for improvement.

This is particularly true for mid- and small-cap companies. While recognising the greater resources available to larger companies, the FRC does not believe that the size of a company should be a determining factor in the level of transparency investors can expect. All companies should be capable of explaining clearly how they are governed.

Explanations

As shown in the previous section, it is still relatively rare for companies to deviate from the Code. However, it is important that, where companies do not follow a Code provision, a clear explanation is provided so that their shareholders can assess whether they are content with the governance arrangements that the company has put in place.

The 2012 edition of the Code set out a number of features of what the FRC considers to be meaningful explanations, to provide a benchmark for companies when providing explanations and shareholders when assessing them. They are: that the explanation should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken; and that where deviation from a particular provision is intended to be limited in time, the explanation should indicate when the company expects to conform to the provision.

The FRC reviewed a selection of explanations in FTSE 350 annual reports published during 2013 to assess the extent to which companies are now providing this information. The review looked at two areas of non-compliance: where less than half the board of a company, excluding the chairman, comprises independent non-executive directors (Code Provision B.1.2) and where the roles of the chairman and chief executive have been combined (Code Provision A.2.1).

The standard of explanations was variable. While the majority of examples reviewed provided at least some of the information the FRC expects, in a number of cases the company simply asserted that the governance arrangements it had adopted were appropriate for its circumstances.

In general, companies appear to find it easier to explain what their actual governance arrangements are and, where relevant, the actions intended to make the company compliant again with the Code, than to explain why they consider those arrangements to be the most appropriate for the company.

The FRC will review the quality of explanations again in 2014. If there is not adequate improvement, it is willing to consider taking further steps to ensure the criteria set out in the introduction to the Code are consistently applied.

Explanations where less than half the board, excluding the chairman, comprises independent non-executive directors (B.1.2)

Explanations were usually clearer where companies deviated from the Code due to force of circumstances – such as directors leaving the board for one or other reason – rather than because of a conscious decision to do so. The high number of cases in the former category,

where companies returned to compliance during the course of the year or were taking action to do so, reinforces the impression that the underlying reason may be poor succession planning rather than a fundamental disagreement with the Code.

A review of the annual reports of those companies that remained non-compliant at the end of the reporting period found that the rationale was often little more than a general statement about the need to avoid the board becoming too large and unwieldy and/or to ensure a necessary balance of skills and experience on the board. The FRC believes it would be more helpful to investors if companies instead defined why they believe the composition of their board was appropriate. One such example, from a company with a relatively large number of executive directors, read:

> *"The Board believes that the diversity of skills and experience which the executive directors bring to the Board (particularly in relation to their own operating divisions) is more valuable than maintaining parity between the number of executive and non-executive directors. Furthermore, the Board considers its non-executive directors to be sufficiently independent and of such calibre and number that their views may be expected to be of sufficient weight that no individual or small group can dominate the Board's decision making processes."*

The Code asks that companies explain what mitigating actions the board has put in place to ensure a sufficient degree of independence is maintained. These are particularly important in cases where the deviation from the Code is intended to be permanent. A good example was the explanation provided by a company whose board included non-independent non-executive directors representing the founder shareholder, which set out in some detail the steps taken to address any conflicts of interest.

Explanations where companies have a combined chairman and chief executive (A.2.1)

As with explanations on independent directors, a number of the companies were non-compliant with the Code for only part of the year. In some cases this was because the roles were separated during the course of the year and in others because planned or unplanned board changes had resulted in companies becoming non-compliant. In these circumstances the background was usually clearly explained.

Where the combination of the two roles was not expressly time limited, a number of explanations referred to the qualities of the individual and/or the circumstances of the company; for example, where the combined role was considered appropriate during a period of transformation within the company or due to prevailing market conditions. Others provided no obvious rationale, simply noting the fact that the role was combined and explaining the mitigating arrangements that had been put in place.

The amount of information provided about the mitigating arrangements varied considerably. Some companies set out in detail the specific responsibilities that had been allocated to other board members in an effort to ensure that too much power was not concentrated in the executive chairman. For instance, one has a Deputy Chairman who "leads on governance issues, including the annual review of board effectiveness, and acts as an intermediary, if necessary, between non-executive directors and the Executive Chairman and between the company and shareholders."

A number of companies stated that large shareholders had been consulted. While dialogue with shareholders is obviously to be encouraged, the fact it occurred does not in itself constitute a rationale for non-compliance. Companies should be able to set out in the annual report the reasons given to shareholders when they were consulted.

Diversity

Under the latest edition of the UK Corporate Governance Code, which applies to financial years beginning on or after 1 October 2012, listed companies are expected to set out in their annual reports their policy on boardroom diversity – including, in particular, gender – and report on progress against any measurable objectives they have set themselves. The FRC announced in October 2011 that it intended to introduce these provisions and encouraged companies to adopt them on a voluntary basis rather than wait for the Code change. So, while many companies are not formally required to report on their policies until 2014, the FRC would expect a high rate of compliance by now.

Research carried out by Cranfield[29] on behalf of the FRC and the Government Equalities Office found that over 90 per cent of FTSE 100 companies make some reference to boardroom diversity, and that two-thirds of them had what Cranfield considered to be a clear policy on the subject. Other research on FTSE 350 companies found similar results.[30]

However, the results for a sample of 50 FTSE 250 companies reviewed by Cranfield were more disappointing. Although 82 per cent referred to diversity, only 18 per cent set out a clear policy. While this disparity in rates of early adoption is consistent with what the FRC has seen after other changes to the Code have been introduced, it shows there is more work to be done.

Table: Disclosure of diversity policies

	All FTSE 100 companies	**Sample of 50 FTSE 250 companies**
Does the company refer to the need for greater boardroom diversity and/or the new FRC Code?	91%	82%
Does the company have a clear policy on boardroom diversity?	65%	18%
Does the policy specifically mention gender?	61%	16%
Does the company set measurable objectives?	42%	14%
Does the company record progress against those objectives?	*37%*	*12%*

Source: Women on Boards: Benchmarking adoption of the 2012 Corporate Governance Code in FTSE 350; Cranfield University School of Management; November 2013. Data based on the annual reports of FTSE 350 companies issued between July 2012 and July 2013.

As regards other aspects of diversity, Grant Thornton found that less than 10 per cent of FTSE 350 companies referred to age or ethnicity when discussing board diversity, and only 13 per cent commented on the relevance of nationality or gave insights into the type of experience considered desirable.[31]

Succession Planning

As part of the same research project, Cranfield looked at what companies said about how they address succession planning more generally, to see if this supported the evidence from board effectiveness reviews that it was an area of weakness in many companies and to inform the FRC's further work on the topic.

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[29] Women on Boards: Benchmarking adoption of the 2012 Corporate Governance Code in FTSE 350; Cranfield University School of Management; November 2013

[30] Grant Thornton found that 91 per cent of FTSE 350 companies provided at least some description of the company's boardroom diversity policies (Governance steps up a gear; Grant Thornton; December 2013)

[31] Governance steps up a gear; Grant Thornton; December 2013

Cranfield found that there was little consistency in what was reported and that "many of the companies talked about non-executive succession planning when in fact they were referring retrospectively to the appointment process. Transparency around the appointment process forms part of good corporate governance reporting and there were a number of good detailed examples of this. However, it should not replace reporting on forward-thinking succession planning".[32]

Board evaluation

The UK Corporate Governance Code states that companies should describe how evaluation of the performance and effectiveness of the board has been carried out. It does not require companies to disclose the outcomes of those reviews, but it is becoming increasingly common for companies to provide at least some information on what actions will be taken as a result of the review.[33]

The FRC encourages other companies to disclose the main actions that were agreed following the board effectiveness review and, where relevant, how those actions identified in previous years had been implemented. While not wishing to be prescriptive, the FRC believes this approach potentially enables boards to demonstrate to shareholders how they are working to improve their effectiveness in a way that does not require them to disclose sensitive information, and would encourage companies to consider providing such information.

As noted in the previous section, there has been a notable increase in the number of companies disclosing the identity of the external facilitator they used following the change in the Code in 2012 that asked them to do so.

Election of directors

One of the purposes of regular evaluation of the effectiveness of the board as a whole and directors individually is to inform decisions on whether changes to the composition of the board are needed.

Provisions B.7.1 and B.7.2 of the UK Corporate Governance Code detail the information that should be set out in the papers accompanying resolutions for the election of directors. This includes biographical detail, confirmation from the chairman that the individual's performance continues to be effective and, in the case of non-executive directors, the reason why the company believes the individual should be elected.

The FRC reviewed a sample of 50 annual general meeting notice papers from a cross section of listed companies to assess the extent to which companies were following these recommendations. As with other aspects of reporting to shareholders, the results were mixed.

There were a number of companies that gave no detail other than the name of the directors, leaving shareholders to cross-check the biographies in the annual report. The majority of AGM notices referred to directors continuing to perform satisfactorily (where the director was being put forward for re-election) and gave some details of the individual, although this tended to be straightforward biographical information.

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[32] Women on Boards: Benchmarking adoption of the 2012 Corporate Governance Code in FTSE 350; Cranfield University School of Management; November 2013

[33] Grant Thornton found that 56 per cent of FTSE 100 companies and 32 per cent of FTSE 250 companies disclosed outcomes of their evaluation in 2013, up from 44 and 30 per cent respectively the previous year. (Governance steps up a gear; Grant Thornton; December 2013)

Very few companies, however, set out clearly the specific contribution that the individual brought to the board, in terms of their particular skills and strengths. Good examples included: “XX has a wealth of business, accounting and finance experience... has significant boardroom experience and has worked with a wide variety of companies throughout his career, including many in the consumer goods sector” and “Prior to joining the Group XX served as Chief Financial Officer of XX where he gained extensive experience of working with global brands… including strategic and day-to-day financial management, executive Board responsibilities and investor relations.”

The FRC considers that the majority of companies could do more to explain to investors in the AGM papers how individual directors contribute to the effectiveness of the board as a whole. As well as being helpful to investors, it may benefit companies if it means that voting decisions are better informed.

“Fair, Balanced and Understandable”

The UK Corporate Governance Code was amended in 2012 to require boards to confirm that the company’s annual report and accounts taken as a whole are fair, balanced and understandable. This ensures that the narrative sections of the report are consistent with the financial statements and accurately reflect the company’s performance.

Most companies are only formally expected to make such a disclosure in the reports that will be published in 2014. While only a limited number of companies did so this year, anecdotal evidence suggests that many companies have reviewed the process by which they produce the annual report and accounts to ensure they will be in a position to do so in 2014. For example, the FRC understands that some companies have formed project teams, rather than producing the different sections in isolation and bringing them all together at the end of the process.

Audit Committees

The 2012 UK Corporate Governance Code revisions introduced requirements for audit committees to describe in more detail the work that they do. The Code calls for descriptions of the significant issues considered by the audit committee in relation to the financial statements and how they were addressed, how the audit committee assessed the effectiveness of the external audit process and their approach to appointing the auditor and safeguarding objectivity and independence relative to the use of non-audit services.

As with the “fair, balanced and understandable” disclosure, most companies are only formally expected to make such a disclosure in the reports that will be published in 2014. Nonetheless, Grant Thornton reported encouraging signs of early adoption, with the number of FTSE 350 audit committees commenting on financial statements, including key judgements made, increasing from 9.5 per cent in 2012 to 24.8 per cent in 2013.[34]

The FRC will be monitoring reporting by audit committees closely in 2014. It would encourage companies to read the Financial Reporting Lab’s ‘Reporting of Audit Committees’ report,[35] published in October 2013, which provides insights from companies and investors on effective approaches to audit committee reporting including the content and the way information is presented.

[34] Governance steps up a gear; Grant Thornton; December 2013
[35] Reporting of Audit Committees; Financial Reporting Council; October 2013

Risk Management

In its annual report published in October 2013, the FRC's Corporate Reporting Review team[36] noted that there had been "improvements in the disclosure of companies' principal risks and uncertainties, following our earlier focus on this area of narrative reporting. We are pleased that an increasing number of companies now explain how they manage or mitigate the risks identified."

The FRC published in November 2013[37] a consultation on proposed changes to the UK Corporate Governance Code and draft guidance for boards of listed companies which covers reporting on risk, internal control and the company's status as a going concern. They propose a number of changes to the way companies report on these matters, including:

- an explicit expectation that companies will describe how their principal risks are being managed or mitigated, and identify their principal solvency and liquidity risks;
- clear cross-referencing between the description of the company's principal risks in the Strategic Report and the adoption of the going concern basis of accounting in the financial statements; and
- a recommendation that companies should disclose any material failures or weaknesses in the internal control system that they have identified, and what steps have been taken to address them.

If these proposed changes are implemented, they will apply to financial years beginning on or after 1 October 2014. The FRC will benchmark current reporting on these issues in next year's report, and the Financial Reporting Lab is likely to undertake a project on risk reporting during 2014.

[36] Corporate Reporting Review Annual Report 2013; Financial Reporting Council; October 2013
[37] Risk Management, Internal Control and the Going Concern Basis of Accounting; Financial Reporting Council; November 2013

Stewardship and Engagement

The objectives of the Stewardship Code are: to help to build a critical mass of investors with a long-term focus that are willing and able to monitor and engage with the companies in which they invest; to increase the quantity and quality of engagement; and to increase accountability down the investment chain to clients and beneficiaries. This section reports on progress against those objectives, and assesses to what extent signatories have adopted the revisions made to the Code in 2012.

While there are some encouraging signs, changes in behaviour take time and there are some real impediments to effective engagement. While not ruling out further fine-tuning of the Code in 2014, the FRC believes the main priority must be on encouraging and assisting signatories to the Code to deliver on the commitment they have given, and to monitor whether they are doing so.

Take-up of the Stewardship Code

As at the beginning of December 2013, the Stewardship Code had 290 signatories, a modest overall increase from 259 at the same point in 2012. 203 signatories are asset managers, 73 asset owners and 14 service providers.

The 73 asset managers that responded to the 2012 survey on the Code carried out by the Investment Management Association (IMA) collectively managed £702 billion of UK equities, a figure equivalent to 36 per cent of the UK equity market.[38] When adding in the equities managed by the other asset managers that have signed up to the Code but did not take part in the IMA survey, it is clear that the current signatories have the potential to provide the critical mass needed to monitor and engage with companies effectively.

It appears that managers and owners are increasingly also applying a stewardship approach to other asset classes. Of a sample of statements of compliance with the Stewardship Code analysed by the FRC, 30 per cent chose to apply their stewardship to their holdings in non-UK equities and 30 per cent to their holdings in fixed income.

Quality of engagement

Assessing the effectiveness and quality of engagement between companies and investors is inevitably a subjective exercise, as most engagement takes place away from the glare of publicity and the views of participants in individual engagements may be coloured by the outcome.

In making its assessment, the FRC takes informal soundings from investors and companies as well as relying on survey data from the IMA and the National Association of Pension Funds. In addition, this year, the GC100 and the Investor Relations Society kindly organised surveys of their members at the FRC's request to get a broader perspective from companies.

Investors report that many companies are engaging earlier when there are potentially contentious matters on which investor views are sought, and have in general been more proactive and flexible in their dealings with shareholders. One practice that appears to be becoming widespread, and which is encouraged in guidance on engagement issued by the Institute of Chartered Secretaries and Administrators[39] and the recent report by the

[38] Adherence to the FRC's Stewardship Code: As at 30 September 2012; Investment Management Association; June 2013

[39] Enhancing Stewardship Dialogue; Institute of Chartered Secretaries and Administrators; March 2013

Collective Engagement Working Group,[40] is for companies to hold a meeting with major shareholders outside the AGM season to discuss the company's strategy and governance arrangements.

The larger companies in the FTSE 100 reported generally positive engagement with their top investors. 60 per cent of GC100 members who responded to its survey considered that they were able to have discussions on strategy with all of the ten largest shareholders, with an additional 25 per cent able to engage in this way with 80 to 90 per cent of the top ten shareholders. The majority of Investor Relations Society members that responded to its survey felt investor engagement has improved at all levels over the last twelve months. However, companies considered that engagement is still being driven by the same, mostly larger, investors as previously.

This perception appears to be borne out by the results of the IMA survey, which highlight differences in the resources and practices of larger and smaller institutions. The IMA found that the average number of analysts and specialists engaged in stewardship in respondents owning or managing more than £1 billion of assets was 21, compared to nine in respondents with less than £1 billion; and that an increase in the number of smaller investors responding to the survey had corresponded with the number of respondents that vote shares but do not otherwise engage with companies increasing from 8 per cent to 14 per cent.[41]

There are also some signs that investors are willing to engage on a wider range of issues. While the IMA survey unsurprisingly found that investors were most likely to engage on remuneration – an issue on which there is an even greater focus this year as companies seek shareholder views in advance of the first binding votes in 2014 – it is encouraging that the next most frequently addressed issues were the company's strategy and objectives, board leadership and board and committee composition.[42]

These encouraging signs are primarily to be seen at the top end of the market. Some smaller companies with concentrated registers also reported positive engagement. However, there appears to be an emerging "engagement deficit" for medium-sized companies, starting from the lower end of the FTSE100 Index. Many companies in this group reported frustration that their requests for engagement with investors were sometimes rebuffed.

Where investors hold shares in a large number of companies and/or allocate a relatively small proportion of their overall investments to UK equities, their stewardship resources are stretched thinly and the pressure on those resources is as significant a constraint for them as it is for companies. In practice this means investors are able to engage only with those companies in which they have large holdings or about which they have concerns.

While recognising that there are capacity constraints, the FRC believes they cannot be used as an excuse not to exercise stewardship responsibilities. Rather, investors need to consider how they can best exercise those responsibilities with the resources they have available.

[40] Report of the Collective Engagement Working Group; Collective Engagement Working Group; December 2013

[41] Adherence to the FRC's Stewardship Code: As at 30 September 2012; Investment Management Association; June 2013

[42] Adherence to the FRC's Stewardship Code: As at 30 September 2012; Investment Management Association; June 2013

Barriers to engagement

The prime barriers to better engagement reported by both companies and investors in 2012 were resource constraints and the focus on remuneration in the run-up to the introduction of the binding vote.

One way to derive greater impact from limited resources is to make better use of collective engagement. In December the Collective Engagement Working Group published proposals for an investor forum, to be in operation from June 2014.[43] The Working Group has stated that the forum will need to facilitate collaboration between international as well as UK based investors. In parallel, the Association of British Insurers has established an "Investor Exchange"[44] which will enable any significant shareholder proactively to raise a concern about a UK-listed company with other shareholders. Both of these initiatives are to be encouraged.

One of the arguments sometimes given by investors for not participating in collective engagement is fear of falling foul of "acting in concert" rules. In November, the European Securities and Markets Authority (ESMA) issued a public statement[45] which helpfully identifies a "White List" of activities in respect of which there will be no presumption that they are acting in concert. These include "making representations to the company's board about company policies, practices or particular actions that the company might consider taking".

Another potential barrier to effective engagement is a perceived lack of appropriate skills and experience within investment management firms, particularly where greater responsibilities are being placed on analysts rather than corporate governance specialists.

One important group of investors with a natural long-term holding period is retail shareholders, who own at least 10 per cent of UK equities directly yet experience particular barriers to engaging with the companies in which they invest. While needing to be realistic about the ability to remove some of these barriers, the FRC will explore with private shareholders whether there are actions that could be taken to enable their voice to be better heard.

Client demand and accountability

Ultimately, greater client demand will be the key to increased monitoring and engagement by asset managers. There are some signs this is beginning to happen, and many owners have told the FRC that the biggest merit of the Stewardship Code was that it had normalised their right to ask for stewardship as a routine matter for consideration.

The NAPF Engagement Survey reported that over 90 per cent of respondents had an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting; 70 per cent took stewardship activities and policies into account when selecting managers; and just under 40 per cent incorporated Stewardship Code principles into contracts with their investment managers. This last figure is consistent with the finding in the IMA survey[46] that 35 per cent of respondents always referred to stewardship in their mandates.

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[43] Report of the Collective Engagement Working Group; Collective Engagement Working Group; December 2013

[44] Improving Corporate Governance and Shareholder Engagement; Association of British Insurers; August 2013

[45] Public Statement: Information on shareholder cooperation and acting in concert under the Takeover Bids Directive; European Securities and Markets Authority; November 2013

[46] Adherence to the FRC's Stewardship Code: As at 30 September 2012; Investment Management Association; June 2013

One of the reasons sometimes given by owners for not explicitly adopting a stewardship approach intended to deliver long-term returns is that their fiduciary duties require them to do otherwise. As noted, the Law Commission is currently considering how the law of fiduciary duties applies to investment intermediaries and is due to report by June 2014.

A practical difficulty faced by owners when selecting managers is judging the quality of the stewardship activities offered by individual asset managers. In October 2013, the NAPF launched the Stewardship Disclosure Framework,[47] under which asset managers are invited to self-certify against categories based around the principles of the Stewardship Code, and which may help address this problem.

Another means by which owners can distinguish between managers is by asking whether they have obtained an independent opinion on their engagement and voting process, as recommended in the Stewardship Code. The IMA survey reported that the proportion of respondents that have done so increased to 14 per cent in 2012 from 10 per cent in 2011.[48] While this is a move in the right direction, take up remains very low.

While incorporating stewardship policies in the manager selection process is important, owners also need to monitor the performance of their managers. The evidence of whether they are doing so is mixed. The NAPF survey found that only 46 per cent of respondents were satisfied with the level of stewardship reporting from asset managers,[49] which suggests that they are not only monitoring their managers but have become more demanding about the quality of information they receive. On the other hand, some asset managers report that, while Requests for Proposal regularly reference stewardship, there is rarely follow-up from clients after the mandate has been awarded.

To repeat what was said in respect of direct engagement with companies, while recognising that owners also face resource constraints, the FRC believes this cannot be used as an excuse not to exercise stewardship responsibilities. Asset owners need to consider how best they can do so, and what assistance they should expect from managers and advisers such as investment consultants.

Voting and Proxy Advisors

Compared to the so-called “Shareholder Spring” of 2012, the 2013 AGM season was relatively quiet. However, this does not mean that investors were less active than in 2012. There is not necessarily a correlation between the level of engagement activity and the level of votes against resolutions; indeed, it is often argued that a high level of votes against is an indicator of insufficient or ineffective engagement.

The annual survey of voting results in Europe carried out by ISS found that voter turnout at UK general meetings rose slightly from 73.1 per cent in 2012 to 73.5 per cent in 2013. Turnout in the UK is higher than in any of the other markets analysed by ISS, and compares favourably with the European-wide average of 65.5 per cent for 2013.[50]

Average levels of dissent in the UK – measured as the percentage of votes cast against the resolution – were 3.4 per cent in 2013. This was exactly the same percentage as in 2012, belying the perception that there had been less shareholder opposition, and it is also in line with the European average of 3.8 per cent votes against.

[47] Stewardship Disclosure Framework for Asset Managers; National Association of Pension Funds; October 2013

[48] Adherence to the FRC’s Stewardship Code: As at 30 September 2012; Investment Management Association; June 2013

[49] NAPF Engagement Survey: pension funds’ engagement with investee companies; National Association of Pension Funds; November 2013

[50] 2013 Voting Results Report: Europe; ISS; September 2013

However, there were fewer cases of companies experiencing high levels of opposition. In 2013, only 2.7 per cent experienced a vote against of 20 per cent or higher, compared to 8.3 per cent in 2012.[51]

A particular frustration expressed by many companies this year was what they perceive to be an increased tendency on the part of shareholders not to notify them in advance of the AGM of any concerns, with the result that votes against or withheld come as a surprise; a frustration exacerbated by the fact that the majority of votes are only received shortly before the meeting, leaving little time for engagement. This perception appears to be borne out by the IMA Survey, which found that the proportion of respondents that inform management in advance when voting against or abstaining on a resolution decreased slightly to 35 per cent from 39 per cent in the previous year's survey.[52]

The FRC reminds signatories to the Stewardship Code that it states that if investors intend to abstain or vote against the resolution and have been unable to reach a satisfactory outcome through active dialogue, it is good practice to inform the company in advance and explain why. If signatories do not follow this practice, the FRC would expect this to be made clear in the statement on how the Code has been applied.

The lack of direct contact with their actual shareholders throughout the year and the behaviour described above contributes to the perception on the part of many companies that proxy advisors wield undue influence over voting outcomes.

It is difficult to find compelling evidence to support this perception. The TUC's annual survey of fund manager voting found a wide variation in voting practice amongst respondents, with support for management proposals ranging from less than 20 per cent to 85 per cent for the votes on which information was requested.[53] This variation does not appear consistent with unthinking support for the recommendations of proxy advisors, although it should be acknowledged that those completing the survey were primarily large investors.

Notwithstanding this, it would be helpful if companies had a better understanding of how proxy advisors carry out their research and what can be expected in terms of communication. The draft Best Practice Principles developed by the industry in response to the report issued by the European Securities Market Authority earlier this year is a helpful development, although robust oversight arrangements will be needed if they are to be seen as credible by companies. In turn, investors are responsible for ensuring that activities they have delegated to others are carried out in a manner consistent with their own approach to stewardship.

Both companies and investors have expressed concerns to the FRC about the way the voting chain operates. Shareholders say that they often have little time to make considered decisions before having to submit their votes, while companies say that they do not receive the bulk of votes until a day or two before the annual general meeting.

While some of these problems can be alleviated by earlier engagement, if both shareholders and companies feel they are being squeezed then it is difficult to argue that the voting chain as a whole is working effectively. The FRC is pleased to note that the Shareholder Voting Working Group will be reviewing its operation to see if there are further steps that can be taken to address these issues and so assist the engagement between companies and shareholders.

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[51] UK AGM Season 2013; Computershare; October 2013

[52] Adherence to the FRC's Stewardship Code: As at 30 September 2012; Investment Management Association; June 2013

[53] TUC Fund Manager Voting Survey 2013; Trades Union Congress; November 2013

Directed voting in pooled funds

In the feedback statement published alongside the 2012 edition of the Stewardship Code, the FRC committed to convening roundtable meetings for market participants to consider whether the Code should be amended to facilitate pro rata voting within pooled funds, as requested by some asset owners. These meetings were held during 2013.

While no regulatory or legal impediments were identified that prevent managers providing such a facility in response to client demand, a number of concerns were noted: the process is highly manual and could not easily be scaled-up in its current form; splitting the vote attributed to asset managers' control may make it harder for managers to engage credibly with companies; and companies reported concern that it would lead to increased fragmentation of their register and make engagement more difficult. It was noted that owners that wish to direct their own votes already have the option of using a segregated fund.

On balance the FRC considers that this issue should not be addressed in the Stewardship Code. The FRC encourages asset owners that wish to explore the option of directed voting to discuss this with their managers and/or investment consultants at an early stage when letting a new mandate and choosing the type of account they hold, and would encourage those managers that offer this facility to indicate the fact when reporting on their stewardship policies under the Code. In addition, the NAPF's Stewardship Disclosure Framework explicitly invites managers to disclose whether they offer this facility.

Quality of Stewardship Code statements

There are some very good examples of clear and specific reporting by Stewardship Code signatories. But the extent to which signatories have responded to the changes made to the Code in 2012 is disappointing, particularly compared to the response of companies to the changes made to the UK Corporate Governance Code at the same time. The clients and beneficiaries of asset managers and owners that have committed to the Stewardship Code are entitled to expect the same transparency and accountability that shareholders rightly demand of the companies in which they invest.

More than one year on from the 2012 Code coming in to force, nearly half of the signatories have not yet updated their policy statements. While recognising that failure to update the statement does not necessarily indicate a lack of activity, especially where the signatory has limited resources, such a high percentage suggests that at least some investors have signed up to the Code in name only.

In addition, a small minority of signatories are still not disclosing against all seven principles of the Code. In 2014, the FRC will be considering how to encourage complete and up to date reporting against the Code, including possible actions against those signatories that fail to do so. The FRC will also be considering whether it should take action to improve the quality of explanations provided where signatories do not follow one of the principles, as it has done with explanations provided by companies when deviating from the UK Corporate Governance Code.

Even when policy statements have been updated in line with the 2012 Code, the levels of disclosure against the different Code principles vary. The FRC's analysis of a sample of statements found that disclosures on conflicts of interest and collective engagement remain weak. Descriptions on the processes for monitoring and escalation were stronger, with the best examples showing a genuine desire to communicate the signatory's actual practices.

One area where there has been significant improvement since the Code was first introduced in 2010 is disclosure on voting. Most of the larger institutions now disclose at least a summary of their key voting statistics for the season.

Another welcome development is the number of asset managers publishing stewardship reports which present a mix of voting statistics and case studies of successful engagement. The FRC would encourage signatories to provide examples of individual or collective engagement, where possible, in order to show how stewardship works in reality.

As noted earlier in this report, the revised Shareholder Rights Directive due to be published in early 2014 is expected to contain proposed measures for more transparency on the part of both asset managers and owners on their voting and engagement policies and activities, which seem likely to overlap at least in part with the disclosures made on a voluntary basis by signatories to the Stewardship Code. The FRC will engage with the parties responsible for negotiating the directive with the aim of ensuring that the final requirements are proportionate and informed by the UK experience.

If the experience of the last two years is repeated, the FRC would expect to see further stewardship codes being developed in other countries and regions. There are now seven such codes already in effect, and a number of others are being developed.

The greater the number of codes, the more pressing the need for some common principles underpinning them so that global investors are not asked to comply with conflicting sets of requirements. The FRC does not underestimate the level of complexity disclosing against multiple codes introduces, and remains committed to finding ways to manage this in the best interests of the signatories and their broader stakeholders. The OECD's review of its principles of corporate governance, scheduled to take place during 2014, might provide a suitable opportunity for doing so.

Next Steps

The FRC is currently considering whether to make further changes to the UK Corporate Governance Code that would:

- Revise the recommendations on assessing and reporting on risks and going concern;
- Update the sections of the Code dealing with remuneration in the light of the new legislative requirements on reporting and voting on directors' remuneration; and
- Implement recommendations by the Competition Commission relating to reporting and voting on the activities of the audit committee.

If the FRC decides to make these changes, it will consult on proposed wording in the first half of 2014, with the revised Code taking effect from 1 October 2014, at the same time as Orders introduced by the Competition Commission that would make it mandatory for FTSE 350 companies to put the external audit contract out to tender at least every ten years.

The FRC is also considering whether the Code should be amended to enable companies to place the full corporate governance statement on their website, with an edited version containing the disclosures most relevant to investors in the annual report and accounts. If this is proposed, it will form part of the same consultation.

As well as possible changes to the UK Corporate Governance Code, the FRC will publish new guidance helping companies to meet the legal requirement to publish a Strategic Report, and updated guidance on risk management, internal control and going concern for listed companies. Once the latter guidance has been published, the Financial Reporting Lab is likely to undertake a project bringing together companies and investors to consider risk reporting, in the light of the requirements in the Strategic Report and the proposed Code changes.

Depending on the outcome of consultation, changes to the FRC's Guidance on Audit Committees may also be needed to bring it into line with a revised version of the Code and the Competition Commission's Orders. A follow-up project by the Financial Reporting Lab may also be needed.

The FRC will undertake a project during 2014 looking at succession planning specifically, and the activities of the nomination committee more generally, with the aim of identifying and spreading good practice. There is no presumption on its part that this will lead to changes to the Code or formal FRC guidance.

When monitoring how the UK Corporate Governance Code has been applied, the FRC will pay particular attention to reporting by FTSE 250 and smaller listed companies. Evidence from this year's monitoring activities suggests that, while compliance with the Code by these companies is broadly comparable with FTSE 100 companies, they compare less well when it comes to describing their actual governance policies and activities. The FRC will also continue to monitor whether companies of all sizes are providing clear explanations where they deviate from the Code.

While not ruling out the possibility of some limited changes to the Stewardship Code in 2014, which would be subject to consultation, the FRC does not envisage proposing changes as extensive as those made in 2012. Rather, the main priority will be on encouraging and assisting signatories to the Code to deliver on the commitment they have given, and to monitor whether they are doing so.

The objectives of the Stewardship Code – developing a critical mass of investors committed to stewardship, increasing the quality and quantity of engagement between company boards and investors, and improving accountability and transparency down the investment chain – are not ones that can be achieved through the Code alone, and the FRC will continue to work closely with the market and other regulators to deliver them.

There is also a need for investors to improve how they report against the Stewardship Code. Nearly half of the signatories have not yet updated their public statements over a year after a revised edition of the Code took effect in October 2012, and a number do not report on all of its principles. The FRC is considering mechanisms for ensuring that statements are complete and up to date, and possible sanctions where they are not.

It is not entirely clear what impact developments at European level will have during 2014. There seems to be a strong possibility that legislation on auditing (including mandatory tendering and rotation) and non-financial reporting (including reporting on risk and diversity) will be finalised before the European Parliament breaks up in April.

Progress is less likely to be made in the short term on other legislative proposals such as the revised Shareholder Rights Directive, and in the longer term it will depend at least in part on what priority they are given by the new European Commission after it has been appointed in late 2014. In any event, the FRC will continue to work with partners in the UK and other countries – including the European Corporate Governance Codes Network – to ensure that the debate at European level is well-informed and evidence-based.

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