F&C Management Limited
Exchange House
Primrose Street
London EC2A 2NY

Telephone +44 (0)20 7628 8000
Facsimile +44 (0)20 7628 8188
www.fandc.com

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

By email to: codereview@frc.org.uk

8 October 2009

Dear Chris,

Please find attached the response by F&C Investments to the Financial Reporting Council's Progress Report and Second Consultation on the Review of the Effectiveness of the Combined Code.

We are pleased to contribute to this important review, and hope that our comments are useful in your deliberations.

Please feel free to contact me if you have further questions or comments. We would be happy to meet with you, as required, to discuss our views in further detail.

With best wishes,

George Dallas

George S. Dallas
Director, Corporate Governance
george.dallas@fandc.com
020 7011 4246

cc. Marrack Tonkin, Company Secretary, F&C
Richard Wilson, Head of Equities, F&C
Karina Litvack, Head of Governance & Sustainable Investment, F&C
Kirsty Jenkinson, Governance & Sustainable Investment, F&C
Mirza Baig, Governance & Sustainable Investment, F&C

October 2009

Review of the Effectiveness of the Combined Code
Progress Report and Second Consultation

Response by F&C Investments

Background

F&C Management Ltd (F&C) is a London-based global asset management firm whose institutional and retail clients collectively represent over £128 billion of assets[1]. F&C has long been an active voice in support of robust corporate governance standards for UK companies and for companies in all jurisdictions where F&C invests. In this context we welcome the opportunity to comment on the Financial Reporting Council's (FRC) Progress Report and Second Consultation with regard to the Combined Code on Corporate Governance.

As an active member of the Association of British Insurers' (ABI) Investment Committee, F&C has also provided input to the ABI's response to this FRC consultation, and is broadly supportive of the ABI submission. But we also want to provide direct input to the FRC to reflect our own views on particular aspects of the Code.

Our response below proceeds along the structure of the Progress Report and Second Consultation published by the FRC in 2009. F&C does not comment on all the issues raised in this consultation document. Rather our comments reflect particular issues where we have views that we would like to convey to the FRC.

General Overview

F&C is supportive of the Combined Code, and believes that it has served UK companies and its investors well since its inception in 1992. This relates both to the specific content of the Code, as well as to the soft law "comply or explain" framework with which the Code is applied in practice. In particular we support the notion that the Code's flexibility in application enables the promotion of a higher standard of governance practices than might be possible through black letter law or regulation. However a code of this nature calls for periodic revision to ensure that it stays fresh with regard to current thinking about best practice in corporate governance. We believe this is particularly true for the 2009 review, given the lessons that need to be learned from the recent financial crisis, the Walker Review of governance in the financial sector, as well as other recent reviews of remuneration and governance practices that have been undertaken by regulatory authorities in the UK and other jurisdictions. While we identify in our submission those aspects of the Walker Review that may have relevance for Combined Code, we do not believe that all the specificities outlined in the Walker Review are all relevant for the broader corporate sector[2].

It is also the case that Section 2 of the Code, relating to investor engagement under the "comply or explain" framework, warrants further reflection given the shifts in ownership structure of UK companies. Since the Code's inception in 1992, UK institutional shareholders currently account for a notably lower percentage of UK market capitalization. Hence questions need to be raised not only about how UK investment institutions engage with UK companies under the Code, but also about the role of new shareholders, including foreign shareholders and sovereign wealth funds, in terms of company monitoring and engagement.

---

[1] As at 30 June 2009, F&C Management directly managed £88.3 billion in assets. In addition, F&C has been mandated to vote and/or engage in dialogue on behalf of over additional 20 investment institutions whose assets total £40 billion. These institutions are identified in our quarterly **reo®** reports: www.fandc.com/reopublicreport.
[2] F&C has also provided detailed feedback on the Walker Review.

Section 1

The responsibilities of the chairman and the non-executive directors

Role of the SID: We do not believe there is a need to elaborate in greater detail on the role of the chairman, however there is scope for guidance on the relationship between the chairman and the senior independent director (SID). In this context we believe that Recommendation 11 of the Walker Review is helpful. In particular, it emphasizes the role of the SID as a point of contact for shareholders in circumstances when direct access to the chairman is difficult, or when shareholders have particular concerns about the company chairman that they would like to express to an independent director.

Time commitment: We do not believe it necessary for the Code to adopt the Walker recommendations relating to expected time commitments for the chairman or non-executive directors (NEDs). We recognise that the size and complexity of large banks in particular will likely call for more claims on the directors as compared with smaller or less complex financial institutions or industrial companies. However it is worth noting that if increased time commitments on the order of 30 or more days a year become the norm in the financial sector or other sectors, then this will have the practical effect of precluding sitting executives on the boards of other companies. This, in turn, might raise issues about the trade-off between the quality of directors and the amount of time directors might have free to devote to serving on other boards.

Board balance and composition

Expertise v. Independence: With regard to the issues raised in the consultation document, we do not believe there needs to be a tradeoff between director experience and independence. Both are required for an effective board. We believe that boards need directors with solid company/sector experience, even if they do not meet independence criteria. However we also believe that many key board committees (audit, remuneration, nomination) call for independent directors, and that company boards should have a sufficient core of independent directors to carry out these functions effectively, without creating too great a workload on an individual independent director.

We strongly support the view that in aggregate FTSE 350 boards should be comprised of at least 50% independent directors. We think this is particularly important for companies with dispersed ownership. But even when companies have controlling or majority shareholders, we believe that 50% board independence helps to ensure proper alignment between controlling and minority shareholders.

Tenure: At F&C we do not employ a “nine year rule” in our own governance criteria. Moreover we do not encourage longstanding directors to leave the board after a defined period of time. However once an independent director has been on the board for twelve years, we will question whether such directors should be regarded as independent, particularly with regard to their involvement in key committee functions.

Succession planning: We believe that succession planning is critical for an effective board, and that there is scope for greater guidance in this area. This is particularly with regard to planning for the replacement of senior board members and executive officers and the extent to which key shareholders should be consulted as part of this process.

Frequency of director re-election

Committee chairs and company chairman: F&C supports the annual election both of committee chairs and the company chairman. We believe this should be standard practice, rather than a practice triggered by a prior year’s vote of less than 75% support. Enabling investors to vote annually on committee chairs, would allow for more focused investor feedback on specific activities of the board, enhance the quality of board communication with shareholders and improve director accountability. In the case of the company chairman, an annual vote would provide investors the opportunity to focus on how the chairman has led board as a whole.

All directors: We believe there is an argument justifying the annual re-election of all directors to underscore accountability of the entire board to shareholders. However, should an annual election of committee chairs be implemented, there would be less need for all directors to stand annually. Annual election of the entire board, as we have seen in recent cases in the UK, might best be held in reserve by investors as a tactic to be employed when a company has clear and extreme financial or operational problems.

Use of voting rights: If annual committee chairman elections were introduced, shareholders would be required to use these additional voting rights responsibly and in a considered way. More regular director elections should not be regarded as a punitive initiative by investors -- or by companies. Investors ultimately are looking for investee companies to succeed, grow and build in value. Apart from extreme situations where the need to replace management and the board is clear from an investment perspective, investors do not have a financial incentive to vote in ways that would destabilise the company. Experience in other markets (the USA, for example) suggests that investors have not responded radically when classified boards stand for re-election. Indeed, board continuity can be a critical dimension of shareholder protection.

Corporate governance statement vote: We believe that annual committee chair/board chair elections would have more impact than an annual vote on the corporate governance statement in promoting individual director accountability. However if annual committee chair/board chair elections are not introduced into the revised Code, we believe an annual vote on the corporate governance statement would be useful, as a second best option. Should such a vote be introduced, there would be the need for both investors and companies to have a common understanding of how these votes should be interpreted. Some guidance would be required here.

Board information, development and support

Board support: We support the views outlined in the FRC July 2009 submission that board effectiveness can be improved by directors gaining an enhanced understanding of the company and its operations, receiving training in relevant and specific board skills, and accessing independent advice and general administrative support. We believe that having a direct reporting line from the company secretary to the board – and not to management— can help to promote this effectiveness.

The three Walker Review recommendations (Recommendations 1, 2 & 9) regarding board support are pragmatic and relevant to all companies, not just financial institutions.

Board evaluation

Evaluation process: We believe that board evaluations are useful in enhancing board effectiveness, and support the Code advocating periodic board evaluations. If this is to be a genuine self-evaluation process, and not a compliance exercise, companies must have some flexibility about the timing and structure of such evaluations. We believe that external facilitation can enhance the quality and objectivity of board evaluations. We support the two Walker Review recommendations relating to board evaluations (Recommendations 12 & 13), and believe these are applicable to all companies. Recommendation 13 is particularly important in that it speaks to how the company communicates to investors with regard to key aspects of the evaluation process.

Assurance statement: The notion of an “assurance statement” relating to board evaluations could be a useful communications mechanism. To avoid this becoming a boxticking exercise, an overly prescriptive format for such a statement should be avoided. Instead, the Code should emphasise that the board evaluation ultimately should focus on board culture rather than process.

F&C Investments

Risk management and internal control

While the current Code makes clear reference to the Turnbull Guidance as a framework for risk management, the Code itself includes relatively little commentary about risk management at the board level. As a contrast, the Code contains considerably more detail on the audit committee and process.

Risk oversight: F&C believes that the board's awareness and understanding of risk management is an area that requires greater attention and focus in many companies, both with regard to financial and "extra-financial" risks (including environmental, social and ethical risks). In this context we believe the Code should provide more guidance and emphasis. We do not believe it is necessary to replicate the detail of the Turnbull Guidance in the Code, but would encourage the FRC to consider adding risk oversight as a main principle in the Code.

The role of the board should be to work with management to both understand and define the firm's risk appetite in relation to financial, operational and reputational risks. The board's further role is to monitor the output of the company's risk management reporting to provide ongoing oversight with regard to those risks that might deviate from established targets and norms and which have the potential to impact company performance and valuation. It is not an operational role.

Linking risk and remuneration: As noted below in the discussion on remuneration, we believe there should be a greater linkage between remuneration structures and risk management to ensure that company executives are not incentivized to undertake undue risks for the company as a whole to achieve personal financial rewards.

Risk committees: In many cases it may make sense for companies to have a formal risk committee. This is particularly true for large and complex firms, such as banks, where risk management issues come under the purview of an already busy audit committee and where risk management might not be the top committee priority. Given the clear importance of risk management in the financial sector, we support the Walker Review's recommendations relating to the establishment of risk committees as a standard board feature in large complex financial institutions.

However for less complex financial institutions and for the corporate sector as a whole, the Code need not be prescriptive in this area. As long as the board can demonstrate that it is aware of and effectively overseeing risks, either through the audit committee or other mechanisms, we do not believe a risk committee need be mandated in all cases. In this context it is important that the board has regular access to risk and internal control reports produced by the company's executive management. A specific suggestion in this regard, whether or not a formal risk committee is in place, is that risk management be a standing item on the agenda of the board as a whole.

Environmental, social and ethical risk management: F&C strongly recommends to the FRC that the revised Code makes specific mention to environmental, social and ethical risks for board consideration. These can be meaningful drivers of corporate performance and valuation, and should be factored into risk management systems and into company disclosure to investors in its risk reporting. The FRC would be missing an important opportunity if it does not make explicit reference to these risk factors in the revised Code. Environmental and social factors are now referenced in the International Corporate Governance Network's revised corporate governance principles, and are also explicitly referenced in the Institutional Shareholders Committee's draft code on the responsibilities of investors.

Remuneration

Links to strategy: F&C supports the Code's enhanced focus on how remuneration links with corporate strategy and risk management. Certainly in the financial sector, the recent financial crisis has shown that short-term incentives, with little or no consideration of underlying business risks, contributed to value destruction by both executive directors and by company employees below the senior executive level.

Extended performance periods: F&C has long supported extended vesting and holding periods for both short-term and long-term awards. We have also promoted clawback mechanisms in cases where incentive awards may have been granted for fraudulent or grossly negligent performance. While these features have a clear relevance to financial institutions, we believe these mechanisms are relevant for the entire corporate sector.

Remuneration beyond board level: We caution against the board becoming overly involved with compensation of employees below the top executive level. However it may be useful for the Code to encourage board understanding of compensation levels of those staff members whose remuneration is at or above the level of executive management. Even in cases where the remuneration of non-board executives is below the level of executive management, the board may wish to have an understanding of remuneration of those non-board executives that have a major impact on the business. In the banking sector this could be senior traders, or, more generally, employees with general management responsibilities for major assets or business units.

Section 2

The quality of disclosure by companies

Reporting standards: We note that compliance to the Code alone does not ensure good corporate governance or good corporate performance. Indeed, the five UK listed companies with the greatest loss in shareholder value in 2008[3] all received “Blue Tops” from the ABI’s IVIS service, indicating their conformity with the Code. Nevertheless, we believe it is important for investors to understand how a company conforms to the Code, and also to understand why a company may not choose to do so. Corporate governance reporting therefore remains relevant, as long as it is conducted to communicate true strengths and weaknesses and not as a compliance exercise. It is difficult to mandate substance over form in terms of disclosure, and it should be in part the role of investors to call companies to task when reporting standards trend towards boilerplating.

Links to strategy and risk: Disclosure standards by UK companies are strong on a global basis of comparison, though there is scope for improvement. In addition to meaningful reporting on corporate governance, investors would benefit from reporting that links governance to strategic and risk factors. As noted earlier, we believe that disclosure on operational and reputation risks should extend to how the company is managing—and how the board is overseeing-- environmental, social and ethical issues.

Engagement between boards and shareholders

F&C strongly believes that high-quality investor engagement with company executives and directors is important and can have a positive cumulative effect in protecting value to investors and enhancing company performance. Active investor input is critical to the healthy functioning of the “comply or explain” regime, upon which the Combined Code is based.

Institutional Shareholders’ Committee (ISC) code of practice: F&C recognises that there is scope for UK based investors to improve the quality of engagement with UK companies. We believe that the ISC document on Responsibilities of Institutional Shareholders and their Agents is a good foundation for developing a code of practice for investors to guide this improvement. We are open to the discipline of reporting F&C’s own approach to engagement against such a code on a “comply or explain” basis, and it is our view that F&C’s current engagement activities already conform to the standards outlined in this document. We also expect that several other leading UK fund managers are already active in company engagement in a way that would conform to proposed code.

---

[3] HBOS, RBS, Kazakhmys, Xstrata and London Stock Exchange. Source: Bloomberg.

Extending the scope: It is important that smaller UK investors and foreign investors – including sovereign wealth funds-- also become more active in company engagement and considered voting. This is particularly relevant given the declining share of ownership represented by the major UK based institutional investors in the UK market. While this does not relate to the Combined Code per se, the FRC may wish to consider formal outreach to similar regulatory bodies in other jurisdictions, such as the US or Continental Europe, where non-UK investors are active in investing in UK companies.

FRC endorsement/role: We would support the FRC's endorsement of an investor code of practice, and would encourage the FRC to encourage investment institutions that traditionally have been less active in UK engagement to live up to the standards of such a code. However just as the FRC is not monitoring companies' performance under the Combined Code, we do not believe it should be mandated to monitor compliance to an investor code of practice.

Collective engagement: We believe investors can effectively work together in company engagement and that the FRC should encourage such collaboration. However we would strongly caution against the FRC, or any other regulatory body, establishing a formal mechanism to guide such collective engagement. To be effective, collective engagement must be led by investors with scope for flexibility, both relating to company and issue selection. Any attempt to centralise or formalise this activity could easily result in a bureaucratic process that is both inefficient and ineffective.