

Armstrong Bonham Carter's additional comments on the Financial Reporting Council's
Progress Report and Second Consultation October 2009

Armstrong Bonham Carter (ABC) is delighted to comment on the Financial Reporting Council's (FRC) Progress Report and Second Consultation on the review of the effectiveness of the Combined Code.

ABC is a specialist consultancy which advises chairmen on how to improve the effectiveness of their Boards.

The FRC has asked for comments or other evidence on the issues identified in its Progress Report. ABC has as requested commented on whether any recommendations of the Walker Review should be extended to all non financial listed companies.

Summary of feedback to date

ABC would concur with the comments made but would note that whilst the Combined Code has indeed contributed to clear improvements in governance standards and, in particular, to making accountability clearer, ABC believes there is still much to do to improve the transparency of Boards.

Furthermore, whilst the Walker review claimed the behaviour on BOFI boards were the source of those Boards' corporate governance failures; ABC believes this is too opaque explanation. ABC believes Boards can still make strategic errors despite being effective and BOFI Board failed to properly appreciate the evolution of the strategic risk facing their companies. But as this is fundamentally a subjective issue, ABC would agree that this cannot be limited by a regulatory framework.

1. The Content of the Combined Code

1.1. Guiding Principles

ABC would agree with the FRC's principles.

1.2 The responsibilities of the chairman and the non-executive directors

ABC believes there is no need to further clarify the role, key responsibilities, expected behaviours and time commitment of the chairman, the senior independent director, and non-executive directors for non-financial companies with the exception of recommendation 8.

With respect to BOFI, ABC would comment as follows:

Recommendation 3

NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. A minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere.

Response: ABC would agree that it is hard to be prescriptive on the right amount of time spent by NEDs and our experience would suggest that NEDs have spent more time than originally outlined in their letters of appointment. ABC would suggest that via the board review process, individual NEDs time commitment should be evaluated in terms of the extra amount given in their own assessment of the current state of the business and its capabilities to achieve the corporate aim within the approved risk appetite in the context of the changing business and risk environment. ABC would suggest this would preclude the appointment of the NED with a full time executive position at another company.

Recommendation 6

As part of their role as members of the unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.

Response: ABC's experience would suggest this is done. But if it is felt that this area needs tightening, ABC would suggest that CEO's should be tasked to win the hearts and minds of the board to the chosen strategy and the members should be required to vote openly on whether or not they support the strategy. The result of this vote should be disclosed in the corporate governance statement.

Recommendation 7

The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the BOFI chairmanship role would have priority over any other business time commitment.

Response: ABC would agree and believe that in practice this has been accepted with some BOFI boards appointing an executive chairman. Indeed ABC would suggest that any BOFI chairman should certainly not be entitled to chair another FTSE 350 company.

Recommendation 8

The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice.

Response: ABC would accept whilst leadership is key, the chairman must hold or be capable of developing suitably profound knowledge of banking to be able to develop a relationship of mutual respect with the CEO. ABC has observed that where a Chairman does not have a suitably comprehensive understanding of the industry in which his company operates that he is at a disadvantage in his relationship with his CEO. This may be offset if his CEO is a relatively inexperienced leader but the chairman's ability to challenge his CEO will be reduced.

Recommendation 9

The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.

Response: ABC believes there is a lack of consensus over what constitutes an effective board and exactly what the products of an effective board are to enable all stakeholders to assess whether there is one despite the existence of the Combined Code. The recommendation outlined above is largely similar to the respective contents of the Combined Code.

Recommendation 11

The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.

Response: ABC believes this is best practice or even current practice amongst listed companies but would not object to reiterating this point once more.

1.3 Board Balance and Composition

ABC is firmly of the view that the most effective NED is one with pertinent skills and experience of the industry in which the company operates or at least one with experience of the company's customers. NEDs effectiveness is undermined if they don't know the answers to their 'tricky questions' or will erode over time if the company is not viewed as being successful during the period of their appointment.

But the real test of Board composition is a forward looking one, namely whether the NEDs have the appropriate skills and experience to achieve the company's aim over the next three to five years.

All Boards require NEDs as the EDs will be incentivised to grow the company and therefore take risk. NEDs are there to ensure shareholders funds create value for shareholders and not as the means of transferring value to executive directors. Thus Boards need to be able to control executive directors and a balance of NEDs and EDs is a transparent means of doing so.

The Combined Code independence tests do remain relevant but they will remain inevitable contentious as some prescription is involved.

With respect for the Walker review recommendations 4 and 5, ABC notes the involvement of the FSA would preclude them applying to non financial listed companies and comments as follows:

Recommendation 4

The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business and take into account not only the relevant experience and other qualities of individual directors but also their access to an induction and development programme to provide an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberation, above all on risk strategy.

Response: ABC agrees with the recommendation but would comment that BOFI boards must be entirely transparent with the FSA as to the organisation's aim, its appreciation of the future business environment, the selection of the preferred strategy, including the assumptions underlying it and the annual plans to successfully implement the strategy including the risk management process. As a result of this, it would be evident to the FSA and the board the type of skills and experience required on the board to achieve the aim whilst managing the risks inherent in the execution of strategy and those that emerge due to the state of the business environment. The FSA could then assess the Board development plan either through recruitment and/or training to meet the required set of skills and experience.

Recommendation 5

The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.

Response: ABC would agree with the recommendation and stress the importance of the assessment of a potential NED on their understanding of leadership as well as the business of banking and economics.

For non financial companies, ABC believes there needs to be sufficient relevant experience amongst the NEDs to be able to attest the veracity of what the executive directors inform them about their strategies, plans, risk management and implementation of approved strategies and plans.

ABC does not believe that the independence criteria and the way this has been applied by boards of companies and investors have impacted on the effectiveness of Boards.

ABC would agree that the Code could be more explicit on board composition being aligned with the present and future needs of the business.

1.4 Frequency of director re-election

With respect to Walker Review recommendations, ABC would comment as follows:

Recommendation 10

The chairman of a BOFI board should be proposed for election on an annual basis.

Response: ABC would strongly disagree with this recommendation as this would leave the chairman vulnerable to his performance being assessed over a short term time frame. The Chairman's performance should be evaluated over whether he or she has created and maintained an effective board that has led and is continuing to result in the design and successful implementation of approved strategies and programmes of annual business plans which have achieved and are achieving the agreed aim and following which shareholders have confirmed that value for them has, and is, being created.

Recommendation 36

If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

Response: ABC recommends the resolution does become binding. Clearly all remuneration contracts that would be influenced by the vote would need to include a caveat to that effect. But remuneration policy and targets cannot be agreed in isolation. This needs to be matched by sufficient information covering the aim, strategy, plans, targets and risks inherent to appreciate the suitability of the remuneration arrangements.

ABC believes that there should be no move to annual re-election for the chairman, chairs of the main board committees or all of the directors for the risk that they all are judged inappropriately over too short a time frame.

As laid out in ABC's last submission to the FRC, ABC believes more should be done on binding votes. Indeed there is an opportunity to raise the standards of democracy, in terms of accountability and transparency, in listed companies. Listed companies should be required to state clearly what they intend to do over the next three or five years, detailing the measures of success and the strategy and plans to achieve this and the rewards for the employees and the executive team for achieving success. This does not have to compromise commercial sensitivity, but investors would be able to determine the 'what' and sufficiency of the 'how' to understand the risks and the suitability of the team and resources.

In return, investors should be required to vote either in support or against. This would allow the Boards to focus on achieving an aim over a medium or even longer term, which is currently only available to private companies. This would improve accountability, transparency and objectivity over Boards' performance and switch focus to the longer term.

1.5 Board information, development and support

ABC would concur that Board balance and composition are the first means of ensuring the non-executives have sufficient knowledge of the business to ensure the Board is effective. They will then need to ensure that the information they receive is accurate to assess that the continued validity of the aim, strategy, and plans, that the strategy and plans are being implemented in the approved manner and that risk is being managed according to the risk appetite and controls. If NEDs have to source this independently of the executive directors by commissioning independent advice, their own research into the company or industry, or other training and development, then they should be encouraged to do so.

ABC would agree that the company secretariat should serve all members of the Board and not simply non executive directors.

With respect to the Walker Review recommendation, ABC would comment:

Recommendation 1

To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman.

Response: ABC would agree with the recommendation but from our experience, we believe most BOFI and even listed companies believe they have this in place already. But to make this recommendation effective and ensure the FRC original recommendation is better implemented, then some measure of success is needed. Clearly having such a measure as an amount of time spent by directors in training would be arbitrary. Yet otherwise the risk remains if Boards continue to decide on the amount of training, with even a requirement to report it, that without such a measure in place, the variation amongst such programmes will remain.

Recommendation 2

A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separate from or additional to that available in the normal board process.

Response: From our experience and more especially according to ABC's research findings into the effectiveness of listed company boards, the FRC's Combined Code requirement for all members of boards to have access to independent advice has been universally adopted along with support from a company secretary and team. The board review process should include an evaluation of the support provided to the board.

Recommendation 9

The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.

Response: ABC believes there is a lack of consensus over what constitutes an effective board and exactly what the products of an effective board are to enable all stakeholders to assess whether there is one despite the existence of the Combined Code. The recommendation outlined above is largely similar to the respective contents of the Combined Code.

1.6 Board evaluation

With respect to the Walker Reviews recommendations, ABC comments were as follows:

Recommendation 12

The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report describing the work of the board, the nomination or corporate governance committee as appropriate. Where an external facilitator is used, this should be indicated in the statement, together with an indication whether there is any other business relationship with the company.

Response: ABC notes that currently only 47% of FTSE 100 companies have tried using a third party to manage the annual board review. Yet as this review has noted accurately a board is inherently rich in actual or potential conflicts, many of which are suppressed by the pressure to be part of the team. A board review recognises this, deals with this in a controlled and constructive way and provides evidence to all stakeholders that all members of the board are fully committed to maximise the performance of the board.

ABC would therefore agree with the recommendation of using a third party to fully and independently evaluate a board every two years with an internally led follow up process in intervening years. ABC would also suggest that boards should be encouraged to alternate their choice of consultant after a two year period to ensure their independence and objectivity of the review was preserved.

Recommendation 13

The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the

key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.

Response: In ABC's view all of this information is currently provided in most if not all corporate governance statements of the annual reports.

ABC notes with respect that both suggested exercises would be undermined if the lack of a clear and universally accepted definition of an effective board continues.

ABC believes the Walker review recommendation 12 should be applied to all listed companies for the reasons shown above.

ABC is of the view that the requirement for effectiveness of all the main board committees should be evaluated every year and should not be relaxed. ABC would simply point out the failures of Marks and Spencer's and ITV's nomination committees to have an effective succession plan, the increasing level of investor dissatisfaction with remuneration reports and the importance of Audit Committees in attesting the suitability of internal controls would all suggest the importance of these annual reviews.

ABC would also agree that more information should be provided by all listed companies on the evaluation process used, who managed it, any issues identified and the actions being taken to resolve them.

ABC does not believe an assurance statement is needed over and above the corporate governance statement.

1.7 Risk management and internal control

With respect to the Walker Review's recommendations, ABC would comment as follows:

Recommendation 23

The board of a BOFI should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy. In preparing advice to the board on its overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments such as those published by the Bank of England and other authoritative sources that may be relevant for the risk policies of the firm.

Response: It is hard to argue with the concept that if boards' poor governance of risk led to the credit crunch then more dedicated resources should be provided and thus managed by a dedicated board risk committee. But the effectiveness of the risk management systems is dependent on the quality of internal controls, and the active participation of the executive management team throughout the organisation. Will the new committee with its own dedicated resources in fact create barriers to effective management of risk throughout the organisation?

Second and in ABC's view, there has been no convincing explanation to date from the BOFI boards and the regulator as to why they did not anticipate more effectively the change in stock, risk and economic cycles. Having decided on the long term aim of a

company, the board should regularly, and where necessary reappraise the environment in which the BOFI operate to understand whether the approved strategy with its consequential risk is still achievable. Along with the proper resourcing of the company and its control, this is one of three prime tasks of the board. Hence ABC would be concerned if boards were being encouraged to delegate any aspect of the development of strategy to a board committee.

Recommendation 24

In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.

Response: ABC would not have an issue with the allocation of more resources to the management of risk. But the CRO should be instructed to manage risk in accordance with the approved business strategy and its attendant level of risk and not to be an independent assessor of how much risk was suitable for the organisation.

Recommendation 25

The board risk committee should have access to and, in the normal course, expect to draw on external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

Response: If such a committee is created, then this committee like all other board committees should be tasked to evaluate its own performance. Taking independent advice would evidence how the Committee was able to maximise its own performance, for example, by benchmarking its own performance or the effectiveness of the risk management systems.

Recommendation 26

In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee to oversee a due diligence appraisal of the proposition, drawing on external advice where appropriate and available, before the board takes a decision whether to proceed.

Response: If such a Committee exists then it should participate in the overall due diligence the board should instruct the BOFI to conduct covering every aspect of the transaction.

Recommendation 27

The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and outcome of the stress-testing

programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.

Response: Whether the board risk committee is formed or not, ABC would recommend that boards do report the reasons why the current business strategy and its inherent risks are still appropriate. Currently most comments on the outlook for a company tend to be rather brief. Secondly in addition to the voluminous information provided on risk registers and describing the risk management systems, the board should be required to evidence over the reporting period why they work and whether the 'risk appetite' was fulfilled.

ABC believes all of the above recommendations with the exception of 27 should not be applied to non financial companies, as ABC is sceptical that they should be applied to financial ones. But ABC would recommend its response to recommendation 27 be applied to all listed companies. Consequentially, ABC would agree that the Code could be more explicit on the Board's responsibilities for strategic risks and setting risk appetite and thus it would be worthwhile reviewing the Turnbull Guidance.

1.8 Remuneration

With respect to the Walker Review's recommendations, ABC would comment as follows:

Recommendation 28

The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.

Response: The remuneration committee should ensure that all incentives in the organisation are aligned with achieving the approved corporate aim, strategy and annual plans designed to achieved that aim within the approved risk appetite. Furthermore it should attest that the total compensation at Board level and across the organisation is no more than necessary.

Recently, it has been hard to reconcile corporate aims, strategies and plans in the banking sector with incentives and these incentives have been focused purely on growth (such as relative TSR, eps growth and ROE).

Recommendation 29

The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median compensation of executive board members on the same basis.

Response: As per response 28, for the entire organisation.

Recommendation 30

In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.

Response: As per 28, though some individuals may only have incentives linked to their business areas.

Recommendation 31

The remuneration committee report should disclose for “high end” executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.

Response: If the remuneration committee is mandated to do as recommended in the response to 28, it is not clear what benefit is further achieved by this recommendation.

Recommendation 33

Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

Response: ABC would suggest the threshold for deferring an element of bonus should be defined as being when a bonus can exceed 100% of salary and is in line with a higher tax band e.g. £150k and not just those suggested above. Clawback should also be considered where there is clearly a case of poor performance.

Recommendation 34

Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

Response: It is clear that executives should have ‘skin in the game’ but it needs to be material in terms of the individual’s wealth. As proposed, unless the executive never sells his shareholding, then the system favours the long serving successful executive and yet can prove a considerable burden to the newly appointed executive.

Recommendation 35

The remuneration committee should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.

Response: ABC believes performance targets have not been well-designed with most being a mixture of relative share price performance and profitability. This means that they do not fully reconcile to the business strategy and plan (especially LTIPs). In future, incentive targets should reconcile with the aim, strategy, plans and risk appetite.

Recommendation 37

The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.

Response: ABC would agree with this recommendation.

Recommendation 38

The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.

Response: In ABC's view and experience, remuneration committees have universally set their policies to attract, motivate and retain staff. The Combined Code also suggested that such committees should ensure that the remuneration paid was no more than necessary. This test has largely been met by ensuring basic salaries at least meet the median and the potential for total compensation (multiples of salary paid via short term bonus and LTIPS). Some remuneration committees then monitored staff turnover and regretted leavers to test the effectiveness of the policy. But this was not universal. Hence, in our view the remuneration consultants simply provided the means to prove relatively the remuneration packages were attractive and whether these were absolutely excessive was left to the advisory shareholder vote. Maybe this vacuum will be filled by politicians limiting the total compensation of staff at BOFI or again left up to the shareholders to decide. Either way, there is still an entirely subjective decision to be made and one which cannot be provided by remuneration consultants.

Recommendation 39

The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.

Response: ABC would agree with this recommendation if such a code were adopted by the remuneration consultants.

ABC would suggest that all of the recommendations and ABC's responses would be worthwhile considering and applying to all listed companies. ABC would also suggest it would be worthwhile considering the consequences of being consistent with the European Commission's recommendations and where appropriate the FSA's code of remuneration practice for financial institutions and the final recommendations of the Walker Review.

ABC would also like to see a full debate as to whether shareholders should have a binding vote on remuneration.

2. The Implementation of the Combined Code

2.1 The quality of disclosure by companies

ABC is concerned about the inadequacy of some of the explanations given for non-compliance with the Combined Code. But ABC would also note that overall these appear to be in the minority. ABC still believes it would be of value and recommends that these are monitored as inappropriate explanations for non-compliance which undermines the validity of the Code. For example, one FTSE Media company provides the following explanation for not appointing a senior independent director:

'The Board has not, as required by the Code, identified a senior independent non-executive Director since it believes that to identify such an individual is potentially divisive to a unitary body, as this Board is, and disruptive to the role of the Chairman.'

ABC believes the FRC should sponsor a balanced survey of compliance to the Combined Code highlighting good levels of compliance or good explanations for non-compliance to the Code.

ABC believes the current reporting on the corporate governance arrangements are still of value as directors will be required to assure themselves of the veracity of that report prior to its inclusion in the annual report. This ensures that the minimum standard of corporate governance procedures is complied with or that any explanations (of varying quality) will be provided.

2.2 Engagement between Boards and Shareholders

ABC commented in the following way to the recommendations of the Walker review:

A few observations on the comments about institutional behaviour:

- Portfolio management is driven by the client's investment return requirements, risk parameters and cash flows. Transactions will primarily be made on valuation grounds be they absolute and relative criteria or to meet cash flow requirements.

- Whilst active fund management has shown that the average fund manager underperforms an index, this has promoted the merits of passive fund management techniques and searches for other ways of consistently generating alpha. However the case for shareholder activism as a source of alpha to ABC's knowledge has not been proven and this is underlined by the relatively small amount of asset managed according to this style. However the performance of these funds can be clearly measured.
- Investment managers' primary duty is to their clients for whom they manage their assets and according to the investment mandate awarded. ABC would question the duty to society unless the client demands it e.g. an ethical fund.
- The board's role is to look after shareholders interests and is required to have the requisite skills and experience to do this. The Fund managers' duty is to have the appropriate skills, experience and time to manage clients' assets and not the knowledge of how to run a bank.
- ABC notes that our entire society of politicians, bankers, industrialists etc were collectively keen to pursue growth whilst confidence was high and to take credit for success.
- Fund managers have relied on boards to look after their interests throughout the economic cycle, empowering them as they recognised they had neither the skills, experience nor time to do so. So, if investors are to engage more, what is the point of a board? And is this really going to add any value if the wrong people with inappropriate skills, experience and insufficient time are involved?
- There is a real risk in this engagement process that the active shareholder will receive more useful and possible inside information. In fact true engagement must demand it. This may prevent the fund manager from meeting the needs of his client unless he has been instructed to pursue this investment style. Also after decades of efforts by past and present regulators to ensure the elimination of insider dealing and the equal distribution of information, smaller equity investors will be disadvantaged.
- Whilst boards may find it frustratingly hard to find a consensus amongst shareholders as to what they want done or how they want it done, it is a challenge facing all other leaders as, for example, politicians are required to win people's hearts and minds to their manifestos so why should board not be required to win a mandate to execute a strategy from their shareholders?

Recommendation 14

Boards should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for changes to the register and satisfy themselves that they have taken steps, if any are required, to respond.

Response: In ABC's experience, boards spend considerable time and funds in internal or external investor relations and consultation with their corporate brokers trying to understand their shareholder base and the changes to it. Many reasons for change may be due to grounds that have little to do with the company itself.

Recommendation 16

The remit of the FRC should be explicitly extended to cover the development and Encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as Principles for Stewardship.

Response: Fund managers as a whole must act in the interests of their clients. In ABC's view evidence that holding shares for the longer term and actively engaging creates alpha or superior returns is unproven. Thus ABC would be cautious on this initiative and look to see more quantification and evidence of both cost and benefits of it.

Recommendation 17

The present best practice "Statement of Principles – the Responsibilities of Institutional Shareholders and Agents" should be ratified by the FRC and become the core of the Principles for Stewardship. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.

Response: As per response 16 and ABC would suggest that there must be some means of judging how effective the fund managers are in engaging this initiative to work when box ticking and voting records have already been judged to be insufficient.

Recommendation 18

The ISC, in close consultation with the FRC as sponsor of the Principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.

Response: If they are to be applied then a review process is necessary but possibly an annual review would be excessive.

Recommendation 19

Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship. Such reporting should confirm that their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and should describe their policies on engagement and how they seek to discharge the responsibilities that commitment to the Principles entails. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for the position it is taking.

Response: As per response 16.

Recommendation 20

The FSA should encourage commitment to the Principles of Stewardship as a matter of best practice on the part of all institutions that are authorised to manage assets for others and, as part of the authorisation process, and in the context of feasibility of effective monitoring to require clear disclosure of such commitment on a "comply or explain" basis.

Response: As per response 16.

Recommendation 21

To facilitate effective collective engagement, a Memorandum of Understanding should be prepared, initially amongst major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific

initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate to the Memorandum of Understanding on collective engagement.

Response: To ensure effective collective engagement, it is our experience that institutional investors will generally become aware of price sensitive information which may then restrict their ability to look after their clients' interests in an optimum manner. Generally this has limited the willingness of investors to be taken inside but this process of greater engagement may have a profound implication for the fund managers' ability to manage their equity portfolio.

Recommendation 22

Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.

Response: ABC believes this is current best practice.

ABC is concerned about the framework proposed by Sir David Walker and would therefore not see an appropriate role for the FRC. ABC is concerned that collective engagement may disenfranchise smaller investors and as previously mentioned in ABC's May submission; improvements in transparency and a change to the AGM could ensure better engagement between companies and all their shareholders.

ABC believes any initiatives by the FRC to promote an improvement in transparency is essential to ensure better engagement between Boards and Shareholders and would have the most profound effect upon Board and shareholder relationships since the Combined Code went live in 2003.