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Date 29<sup>th</sup> May 2009



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Dear Chris

#### **REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE**

I would like to give a response to this review on behalf of Legal & General Investment Management (LGIM) and to support the response by the Association of British Insurers of which LGIM is a member.

LGIM is the investment management subsidiary of Legal & General Group Plc, a FTSE 100 company. We are one of the UK's top fund management companies by assets under management (£264 billion as at 31 December 2008) and have a long standing commitment to raise corporate governance standards.

LGIM has £60 billion invested in UK shares which represents around 4.5% of companies in the FTSE All Share index. We therefore have very extensive experience of dealing with corporate governance issues at both large and small companies.

We believe that the Combined Code has provided an excellent framework for corporate governance practice in the UK. It provides worthwhile long term benefits to investors and we consider the Code to be superior to a rigid form of regulation.

The unprecedented events of the past two years have tested all governance models within companies on a global level and have received much focused attention worldwide. In particular, the international banking industry has come under much scrutiny, which has led to a number of coordinated efforts by governments to resolve the global economic crisis and prevent the situation from deteriorating further.

At this moment in the UK, we have seen a number of publications from various institutional bodies that have taken an interest in the role of corporate governance and the part it has played in these events e.g. the Turner Report, the FSA's code on remuneration practices, the Treasury Committee's report on the Banking Crisis and Sir David Walker's current review on corporate governance in the UK Banking Industry.

Following on from these consultations, we feel that it is important for the FRC to adopt a consistent approach in order for the corporate community to efficiently be able to put it into practice these recommendations.

There are a number of areas that LGIM would like to highlight as important points for consideration. These are listed below:

1. The role of Non-Executive Directors (NEDs)

LGIM feels that the role of NEDs needs to be strengthened in companies. NEDs play a crucial role in the dynamics of the Board and the oversight of management actions. LGIM believes that on a number of occasions, NEDs have failed in their duty to properly assess and challenge executive management, which has led to poor decision making, too much risk being adopted and the destruction of shareholder value.

LGIM would like to see NEDs probing deeper in to a company's affairs and spend more time working with companies in order to properly take in to account the risks to a business model. The amount of time an NED should spend in the business should be determined by the size of the corporation, the complexity of the business and its product, the risks involved and its impact on the wider sector (e.g. whether the company is too big to fail and adversely effect the rest of society).

From our experience, we have often found that NEDs appear to be passive and fail to challenge both the Chairman and CEO of their Company. LGIM would like NEDs to question both of these individuals and regularly meet with Executives below Board level to gain a better perspective of the Company. NEDs should also receive independent support from the Company Secretary. As a result of the increased demand placed on NEDs, their remuneration should be increased to reflect this.

In addition, LGIM believes that special attention should be given to the Board Chairman, the Senior Independent Director and the Chairman of the Board Committees. LGIM would prefer these individuals to stand up for re-election annually in order for shareholders to express their views on any decisions taken by the Board and their Committees. In the longer term, LGIM would like to see all members of the Board standing for re-election annually. Consideration should also be given to the SID becoming Chairman of the Nominations Committee.

2. Remuneration

It is clear that discontent over Directors remuneration has been a main focal point for investors during these difficult times. LGIM would like to see more consideration taken in to the size of remuneration packages and how this correlates with the size of the companies given the significant drop in their market capitalisation values over recent years.

In addition, LGIM would like to see targets being set more clearly and more transparency being given to the use of Remuneration Committee discretion as this provision has been used controversially on a number of occasions.

3. External formal appraisals on Board performance

In order for investors to gain a clearer view on whether a Board operates efficiently, LGIM would like to see external formal appraisals being conducted, especially for large companies, and for the results to be independently assessed, signed-off and disclosed in the Annual Report & Accounts – much like an audit report.

This will enable shareholders to judge and consider any potential risks relating to the operational performance of Boards and their Directors.

The responses to the questions you raised in March 2009 are shown on the appendix in the next page. I look forward to receiving the report on this review and would like to be included in consultation on any rule changes. Please do not hesitate to contact me directly if you have any questions.

Yours sincerely,



Andy Banks  
**Head of Corporate Governance**

## **APPENDIX**

### **1. Which parts of the Code have worked well? Do any of them need further reinforcement?**

In overall terms, LGIM believes that the Combined Code has worked well. The 'comply or explain' principle is an essential catalyst for discussions between companies and investors.

Nevertheless, due to the evolving nature of risk, we feel that a number of issues need clarifying.

- (a) The independence of directors is difficult to judge because there is no direct way of demonstrating independence. There has also been some 'boiler-plate' language used by some companies in order to provide an explanation that a NED who has served on the Board for more than nine years should still be considered as independent. Whilst we do not dispute this fact, we would welcome an explanation on how the Board reached this decision as tenure becomes a compounding factor over time.
- (b) The importance of the Audit and Risk Committees needs to be reinforced.
- (c) Remuneration criteria needs to be updated and amended in line with best practice (FSA and ABI guidelines) due to the cultural change and perception from the wider public. In addition, due to the significant drop in the market capitalisation of firms, companies need to consider scaling back awards and bonuses to bring them in line with appropriate market levels.
- (d) The Combined Code currently does not give any guidance on how companies should deal with significant shareholders (over 20%) wielding undue influence.

### **2. Have any parts of the Code inadvertently reduced the effectiveness of the board?**

Whilst LGIM believes that the Combined Code contains essential principles and provisions that generate long term value, we feel that, in general, there may be too much of a 'box ticking' approach used by companies. This does not provide any benefits because it is essentially stepping away from good quality disclosure and explaining the way companies operate.

### **3. Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?**

LGIM has found that the circumstances where a CEO is appointed as Chairman, it is useful for the SID to formalise regular dialogue with each of these individuals.

Furthermore, for the Audit and Remuneration Committee meetings, LGIM prefers non-independent NEDs to attend meetings by invitation only. As a result, these individuals can contribute and take part in discussions formally. However, the independent Committees are held accountable for any final decision made.

### **4. Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved? Views are invited on the usefulness of company disclosures and the quantity and quality of engagement by investors.**

As mentioned earlier, LGIM believes that the Combined Code has worked well and the 'comply or explain' principle is an essential catalyst for discussions between companies and investors.

However, this can be improved further. Companies need to avoid boiler-plate language and give investors sufficient information in order to come to an informed decision. For example, in relation to the remuneration report, companies could disclose the retrospective targets used to award annual bonuses for the year. Investors can then decide whether the amount was justified and is not a "reward for failure".

## **Content of the Code: FRC welcomes views on -**

### **1. The composition and effectiveness of the board as a whole;**

Overall, LGIM has seen improvements with the effectiveness of Boards. However, this has not been apparent in some of the banks.

LGIM feels that more accountability needs to be placed on certain positions on the Board in order to emphasise the importance of their role and their authority. Therefore, LGIM would prefer if the Board Chairman, Senior Independent Director and Chairman of the Board Committees stood for re-election annually in order for shareholders to express their views on any decisions taken by the Board and their Committees. In the longer term, LGIM would like to see all Board Directors standing for re-election annually.

In addition, in order for Non-Executive Directors to be effective, LGIM would expect all the EDs and the majority of NEDs to have a formal recognised qualification in highly regulated industries. This is to ensure that the directors can demonstrate the correct competency level to understand the business of which they are a director.

### **2. The respective roles of the chairman, the executive leadership of the company and non-executive directors;**

LGIM believes that the role of the Board Chairman should be to:

- Lead the Board and Company strategy
- Adopt a hands-off style of management
- Act as a focal point between investors and the company
- Facilitate and encourage the participation of NEDs (including to scrutinise management and strategy)
- Ensure that new Board members undergo an induction course
- Manage the succession process of the CEO and other Directors

With regards to the role of the CEO:

- The Board should consider the timing of an appropriate successor

In relation to Non-Executive Directors, LGIM encourages them:

- To be more probing in to the Company's affairs
- To speak regularly to Executives below Board level to gain an overview of the Company.
- To be ready to question the Chairman and CEO
- To participate in challenging management decision making and strategy
- To engage with shareholders if there are any concerns
- Not to be passive

### **3. The board's role in relation to risk management;**

The Turner Report has highlighted some essential areas of risk management that needs expanding. LGIM believes that a Risk Management Committee should be of the correct size that reflects the business and be able to independently assess risks to a Company free from the influence of management.

The Risk Committee should consider internal and external measures and have a close relationship with the independent Audit Committee.

### **4. The role of the remuneration committee;**

One area that LGIM feel needs more clarification from the Combined Code and for the Remuneration Committee is the use of discretion. On a number of occasions, we have seen the use of discretion appearing as a 'reward for failure'.

Furthermore, LGIM would also welcome from the Remuneration Committee; (a) more transparency with regards to retrospectively setting targets and making awards under the annual bonus plan; (b) a more consistent approach of using the same comparator groups to set performance targets as well as to judge the companies overall performance against them; and (c) to improve disclosure with benchmarking salary levels.

LGIM also feels that remuneration consultants have an influential part in the determination of remuneration packages for executive management and we would recommend that the fees paid be disclosed in the Annual Report & Accounts.

#### **5. The quality of support and information available to the board and its committees;**

During meetings with companies, we have found that the Board mostly received sufficient and timely information before meetings. However, the way in which this information is put to constructive use is very much dependent on the individual directors themselves and their experience.

LGIM also expects NEDs to receive independent support from the Company Secretary of the firm for information and training requirements.

#### **6. The content and effectiveness of Section 2 of the Code, which is addressed to institutional shareholders and encourages them to enter into a dialogue with companies based on a mutual understanding of objectives and make considered use of their votes.**

LGIM has always welcomed dialogue with companies to discuss corporate governance issues.

However, in terms of remuneration consultations (which is often driven by remuneration consultants), it is unclear of the purpose of the consultations as on some occasions the alignment with shareholders' interests is questionable.

Although at general meetings, remuneration votes are advisory and not binding on the Company, LGIM still expects anything above 15% that is adversely voted upon to be reconsidered by the Company and amended appropriately. Due to the fragmentation of the shareholder register in companies, a 15% opposition should be enough of a signal to demonstrate that a number of investors are unhappy with their proposals. Therefore, LGIM would like to see the remuneration report as having binding consequences.

LGIM also believes that it is good practice to tell companies in advance on how voting instructions will be sent in order for companies to gain a better understanding of investors view on issues and both sides are clear on their stance on the matter.

#### **Application of the Code: FRC welcomes views on -**

##### **1. Concerns on whether application is working. Long term investors engaging constructively with companies in which they invest through dialogue and use of their voting and other rights – whether it has worked?**

LGIM takes the view that the UK corporate governance structure is much preferred over our international peers and as mentioned earlier, anything above a 15% adverse vote on a resolution should be reconsidered by the Company.

One area where LGIM is concerned with the application of the Combined Code is the role of the advisors/consultants. On some occasions, LGIM has seen disconnect between what companies are told by their advisors and what investors regard as good practice. This leads to misunderstandings by both parties and problems in the longer term.

LGIM takes the view that a "Code of Practice for Advisors" should be introduced so that the market understands clearly their role and the conflicts of interest that may arise. These best

practice guidelines should not form part of the Combined Code but be a complementary set of recommendations – similar to the Guidance on Audit Committees published by Sir Robert Smith.

## **2. What can be done to increase the usefulness of disclosures and the effectiveness of engagement?**

LGIM believes that detailed transparency and early engagement are key factors in the effective communication between companies and their shareholders.

The key to transparency is not the quantity but the quality of reporting. In order for shareholders to make an informed decision, it is vital that key details (whether they are advantageous or disadvantageous) are made available for examination. Explanations of how decisions are made and the options considered should be disclosed.

In addition, any areas of contention should be discussed with major institutional shareholders in advance to gain a candid view on how investors in the market feel about the Company's actions.

Our experience has found, at times, that direct engagement has been ineffective and not worked to our expectations. LGIM believes a "divide and rule" has occurred. There needs to be a mechanism to ensure Boards listen to their shareholders. LGIM feels an annual vote on the re-election of Board members is vital in order to hold Directors accountable for their actions.

In addition, LGIM has often found collective action (i.e. Investors getting together) can be more effective than one-on-one meetings with a Company. This is an argument for more united action between investors, in order to deal with high profile contentious issues. In saying this, however, LGIM feels that relationship with companies is built on trust and understanding. Therefore, individual meetings between shareholders and the companies in which they invest should always be welcomed.

LGIM would like to highlight that we have not seen any benefits from publicly disclosing votes on the company's website. There has been a low number of hits and has hardly been accessed by the public. Therefore, we conclude that there is no great demand for this service and the benefits have not materialised.