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Dear Chris

Re FRC Review of the effectiveness of the Combined Code – second consultation

This is Aviva Investors' response to the second consultation of the review of the effectiveness of the Combined Code. Please read this response in conjunction with our first response and also the ABI's response which, in the main, we support. This paper reflects areas that are not covered by the ABI's response or where we have somewhat differing views. We also address areas we consider could benefit from additional emphasis and clarification.

In view of the 3 related consultations happening together (Walker, Institutional Shareholders Committee and the review of the Combined Code) we will be referring to all three and how they fit together in order to generate better governance at companies and a better relationship between shareholders and their companies.

Walker: We welcome and support most of the 39 Walker review proposals. A copy of our submission on the review is attached for information. Most of what Walker proposes is already best practice as contained in the Combined Code and, as such, should not be a problem for most well governed larger companies to comply with or explain against. In fact, some would question whether Walker has gone far enough in that he is not adding anything new to "corporate" governance. There are areas in Walker that we consider overly prescriptive but on the whole most proposals would be easily transferable to non BOFI companies and therefore also into the Combined Code (except where the recommendations are specifically aimed at FSA regulated firms).

A significant part of Walker's recommendations affects fund managers and institutional investors. We are supportive of a Code for Institutional Investors but we are very concerned about proposed FRC involvement in monitoring engagement and question the possible effectiveness of the proposed Memorandum of Understanding (Recommendation 21). We believe that both could in reality act as barriers to engagement rather than the intended facilitation/encouragement. The nature of the FRC's role will need further consideration as will the proposals on the Memorandum of Understanding.

ISC Code: Regarding the Investors Code (based on the ISC's newly revised principles), we agree it would be logical for Section 2 to be removed from the Combined Code (which will then relate only to companies) and for the Combined Code's principles for investors to be transferred to and form part of the new ISC Code (that will then relate only to investors).

FRC and Memorandum of Understanding: We are not convinced this is workable. If too bureaucratic or if it's easier for investors to sit on the sidelines rather than engage, it will further discourage effective engagement. Many investors can and do readily engage and collaborate already without formalities and are likely to continue doing so. There needs to be much better articulation about the advantages and objectives of the Memorandum and how this will be used. The FRC role in monitoring engagement has to be more clearly identified.

Shareholder engagement and collaboration: A critical mass of engaged shareholders is vital to the proper functioning of comply-or-explain and we believe a wider spectrum of investors should be more actively interested in the companies they own. However, this in itself is not a panacea. Shareholders do not all think alike and may therefore present very mixed messages to companies; they have an information disadvantage compared to directors and may therefore be forming opinions that are not fully informed; there are resource issues with some fund managers who will feel they now have to engage (as a result of these consultations) and this may lead to less than satisfactory assessments of companies. Therefore, shareholders are a useful sounding board for directors and they make their investment decisions based on their view of management and strategy, but shareholders have to be careful not to micro-manage companies. Companies also need to be realistic about the practical constraints shareholders are under in their engagement activities, especially given the number of companies that most institutional investors own.

Culture and ethics: We agree with Walker that the critical issue is about behaviour rather than legislation or procedures. This is why we are surprised there is so little in the document about the need for ethical and cultural change on boards and in company management generally. At the end of the day, with all the rules and processes in the world, it boils down to companies "doing the right thing" for long term shareholders and stakeholders.

The Combined Code consultation paper acknowledges this on page 4 where it says that "….the continuing credibility of this approach depends on there being consensus that the contents of the Code are conducive to best practice and on companies and investors *acting in the spirit*, not just the letter, of the Code and "comply and explain". Whilst culture is mentioned in A.1, "…The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met", we believe there is scope for greater emphasis on this area and is a gap that the Combined Code can and should fill. For example:

- This could be done in articulating more forcefully the role of the Chairman and the Board in promoting the right culture and the need to act with integrity and respect for all shareholders and stakeholders. We have seen how inappropriate behaviour has contributed to the current financial crisis and the furore over bank pay.

- Boards should ensure they are reassured that Audit and risk committees are not focused just on the most expedient considerations for the short term e.g. doubtful accounting approaches but focused on the long term interests of the company.

- The remuneration of executive board members and throughout the organisation should in part be determined by how well they live the culture and standards of the company. Individuals should suffer the consequences of not meeting the company's expectations by having their remuneration scaled back. In some situations, it may be appropriate for employees to be dismissed.

- Proper, externally managed whistle-blowing processes should be available to staff.

- A company should put a summary of its Corporate Responsibility Report to a vote at the AGM. The main purpose of such a provision would be to create the right kind of discussions within boardrooms, throughout the business, and between the company and its shareholders. It will also help to ensure that shareholders understand the company's values and standards, and provide them with the opportunity to feed back to the company their views on its broader behaviour.

The approach to culture and ethics and the processes around facilitating this culture should be disclosed and transparent. Aviva plc, our parent company is a good example to start with.

Succession: The importance of succession planning needs to be further emphasised. As large shareholders we repeatedly encounter problems generated by companies failing to have effective succession plans in place. There should be succession arrangements in place as a matter of course, not just when key executives and employees are expected to step down or retire. When we ask companies about succession planning, a very common answer is that they will address this closer to the time when the director is expected to retire! This approach does not address unexpected departures or crises and can put remuneration committees in an extremely difficult position when negotiating CEO and executive pay. Chairmen should ensure that proper arrangements are in place at all times and succession arrangements should be more fully disclosed in Annual Accounts. Please see below the Aviva Investors' view on succession planning that is in our Corporate Governance and Voting Policy.

Aviva Investors Approach

Succession related issues and problems have been a frequent source of concern for Aviva Investors.

Companies should disclose to shareholders that the necessary arrangements to manage succession effectively are in place. This should be done in context, recognising that the potential value and recognition associated with this will not be achieved through boilerplate disclosures.

Companies with effective succession planning and management are seen to perform better during periods of transition. Companies, therefore, should adopt a proactive approach that shows that the foundations are in place to deliver effective succession management. Linking this to, and evidencing, a substantive approach to reviewing individual and board performance and effectiveness is a good starting point (see section A.6 of the Combined Code).

Companies should also be sensitive to the need to cultivate leadership talent within the business. Overall, companies that nurture their future top level talent internally are generally perceived to have out-performed those that don't over the longer term. That is not to say that selective external recruitment of executives can't deliver benefits, but rather that it should not ideally be the automatic choice of preference.

This clearly emphasises the need for a link between the approach at board level and the development of executive talent within the business. Again boards should see this as integral to ensuring that the company has the right people and talent in place to meet its long-term objectives (see first supporting principle in section A.1).

Research[1] on 'visionary' businesses that had been successful over extended periods found that one of the reasons for their success was a strong focus on succession planning and leadership development. They had continually sought to develop and promote internal managerial talent, in a way that their counterparts had failed to.

Companies that are integrating this type of approach clearly within their strategic goals, their business philosophy and are beginning to communicate that to shareholders, stand out from the crowd.

Following on from this, we also believe it would be helpful if the Combined Code focused more on the benefits of diversity (including of experience, gender and nationality). With regard to gender, while the world has undergone transformational changes during the past 10 years, UK's record of women in boardrooms has improved only slightly by 5%.to 11.7%. Meanwhile women's representation as leaders of Norwegian business has risen from 6% to 44%.

This will widen the perspective of the average board in a society that is increasingly cosmopolitan, and will bring views, experiences and attitudes that are much more relevant in today's environment.

Pool of directors: Just as importantly, this will also help increase the pool of non-executive talent available to boards. We are disappointed that the pool of acceptable talent does not appear to be expanding.

As an idea for further discussion, there may be scope for boards to have an "ex-officio" attendee. Our initial thinking is that these "attendees" would be senior executives who have board potential but not the opportunity to gain the experience. For example, they may be able to participate in board discussions but not vote because they are not elected by shareholders. Perhaps they could have a NED mentor to help them develop. Regulatory and legal considerations may need to be taken into account to enable this.   Individuals with potential within the same organisation may be asked to attend strategy away days or executive meetings and attend board lunches. Once the requisite experience and training is gained, the individual would have had some experience and become more attractive candidates for board membership for that or any other appropriate board.

Independence of directors: There has been an over-emphasis on independence at the expense of getting the "right person" for an effective and balanced board. Whilst we do not under-estimate the importance of independence, and in particular, independence of mind, we think that companies should give better explanations when they appoint non independent directors, and that these should be convincing enough to allow shareholders to accept the appointments of non-executive directors who would technically not be considered independent. Explanations would include meaningful information on the value the director will bring, how he or she will improve the balance and dynamics of the board, how they will fill a need on the board and how they are expected to improve decision making.

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[1] :   'Built to Last: Successful Habits of Visionary Companies', (1999) J.Porras and J.Collins, Stanford University

Frequency of director elections: We are of the view that, should reforms be pursued in this area, all directors should stand for re-election each year. Such an approach would support the unitary board concept and avoid creating overly engineered and potentially cumbersome requirements. (Please note that this is a development of our thinking since our submission to the first consultation)

Board information, development and support: It is imperative that board members receive correct and accurate information. Amongst other things, NEDs should satisfy themselves that management information and accounting information has used appropriate accounting treatments that do not, for example, inflate earnings or post profits inappropriately. Boards cannot make proper decisions unless they are provided with the right information in the first place. Following on from Walker, non financial companies too should review their arrangements for monitoring and addressing risks. There is a general need in corporate governance for more focus on risk oversight. Recognising that a distinction needs to be made between strategic and operational risks, disclosure to shareholders should focus on Boards' collective responsibility for decisions about strategic risk and for assessing the business model in terms of the risk that the Group should take. Whereas, in terms of operational risks the focus of Boards' responsibility should be more on ensuring that the risks are being managed effectively.

Remuneration: Remuneration is one of the most vexing issues to manage. We believe that, for accountability reasons, the annual vote on pay is on balance a good thing. However, we believe that the UK is going about the “assessment” of pay in the wrong way.

Remuneration has got far too complicated and, to be honest, its an overly time consuming exercise second-guessing on forward looking issues where no one really knows which is the right or wrong approach. The future is unpredictable as we are all too well aware, and hours are spent negotiating on remuneration plans that, over time, prove to be de-motivating because targets are no longer achievable or pay out undeserved windfalls as a result of markets that managements have not influenced. We believe that a whole new approach to assessing pay needs to be developed, focused on much fairer pay for performance.

Whilst we do not have a conclusive answer to this problem and more discussions need to take place, we would like to see the vote on pay focused much more on assessments of (1) how well forward looking pay arrangements are linked to strategy and disclosed targets. There should be little separate discussion on specific performance targets as these should be the KPIs expressed in strategy statements to the investing community; (2) how appropriate were the amounts paid out in the year measured against performance achieved both for the short term payments and the longer term; (3) In terms of disclosure, we need effective disclosure of pay outcomes in each year, including meaningful performance graphs in Annual Accounts that reflect payments made against performance and explanations as to why the board believes that what was paid is fair and appropriate and in the long term interests of the company.

This approach would lead to far fewer prescriptive guidelines and less technical “box ticking”. There would be much more flexibility for remuneration committees to use their discretion and much more flexibility for shareholders to vote according to fewer but broader guidelines. Currently, not enough research is done, post the implementation of share plans, on the actual pay outcomes compared to performance and too much time is spent unnecessarily trying to guess what may or may not be sufficiently good performance to warrant a theoretical reward.

Where shareholders are concerned about pay arrangements, they can vote against the remuneration report. If they are very concerned, they can vote against the directors. The pressure for remuneration committees to “do the right thing” would be enhanced via this approach because they could be penalised for not using their discretion appropriately. This may also help remuneration committees resist pressure from their executive directors. We also believe that those directors who receive inappropriate pay should be held responsible for receiving this – it is not just the remuneration committee members’ responsibility. Too often CEOs say they have nothing to do with the rewards they receive because the “independent” remuneration committee makes the decisions. Each individual executive board director has a responsibility to “do the right thing” by not accepting what may be considered egregious amounts or payment for failure.

Disclosure: The complexity of disclosure rules means that a substantial amount of information needs to be disclosed. In addition to better use of the Business Review (see our previous submission on the Combined Code) we believe more can be made of executive summaries to each section of the report e.g. Corporate Governance report, remuneration and risks reports. This should be free-form, rules-free reporting of the company’s approach to good stewardship. As shareholders, we do not look to see if companies have complied with every single regulatory requirement but we use the disclosures as an assessment of whether managements have merely reported in order to tick the boxes or whether they truly invest in good governance and its benefits. We would be supportive of companies who make the effort to “tell it as it is” rather than take the easy way out, by ticking the boxes.

In conclusion: Comply or explain works well but could work better. We have highlighted some of the problem areas above and made some suggestions. If there is a theme to our response, it is about encouraging boards to develop a culture of “doing the right thing”. Post the financial crisis, it is all about companies re-establishing trust and credibility and shareholders stepping up to the mark.