Report

FRC Financial Reporting Council

December 2012

Developments in Corporate Governance 2012

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

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Introduction

Promoting long-term growth is an objective which underpins many of the FRC's activities and many of the recent changes to the UK Corporate Governance and Stewardship Codes. Our mission is to foster investment through high quality corporate governance and reporting. Providers of risk capital want to be assured that their interests will be promoted by a good board and that they will receive clear and honest reports on the company's performance; the absence of either deters long-term investment in the company.

The need for boards and investors to take a longer term view in order to benefit companies and savers and strengthen capital markets is a message that has been repeated frequently in 2012. It comes through strongly in the recommendations of the Kay review, and in Lord Sharman's review of how companies assess their going concern status. The European Commission has also identified its importance in promoting growth and will shortly set out its views on the issue in a Green Paper.

A long-term perspective is also necessary when assessing the impact of governance codes and regulation. Changes in process or practice can be brought about relatively quickly; for example, just two years after the UK Corporate Governance Code first recommended that FTSE 350 companies put all directors up for re-election annually, nearly all of those companies and a good many smaller ones now do so. Changes in culture and behaviour, which are ultimately what determine good governance, take longer. Instilling those changes is one of the primary responsibilities of a company's board.

This report focuses on corporate governance and stewardship over the last twelve months, and there are encouraging developments to report. Our feedback sessions with company chairmen and senior investors indicate that both sides have been trying to raise their game, and that communication between them has increased at senior level. Companies and investors have responded positively to the changes the FRC made in 2010, of which the most significant was the establishment of the Stewardship Code. Aggregate compliance with the UK Corporate Governance Code across FTSE 350 companies stands at 97 per cent, and we now have over 250 signatories to the Stewardship Code. The more recent changes to both codes, introduced in October, build on solid foundations.

But it is important also to look further back to where we have come from, and ahead to the challenges we face.

The UK Corporate Governance Code celebrated its twentieth anniversary this year. Over that period it has made a big difference to corporate governance standards and practice in the UK. It has a history of success in pushing out the boundaries of best practice, such as the separation of the chairman and chief executive, the independence of audit committees and the practice of regularly reviewing the board's effectiveness. It is the flexibility inherent in the "comply or explain" approach that has enabled those boundaries to be pushed, and the FRC believes it is important that flexibility is retained if the Code is to continue to do so. We are pleased that the European Commission has recognised the important role that national "comply or explain" codes have to play in raising governance standards across the EU.

Not all governance problems have been solved by any means. Two that have been highlighted this year are the perennial question of how to set executive remuneration in a way that is seen as fair reward for good performance, and wider concerns about governance in the banking sector. In both instances the UK Corporate Governance Code operates alongside regulation which the Government is in the process of reforming.

The FRC will consider during 2013 whether changes are needed to how the Code addresses remuneration, and will consult on this question once the Government's legislation has been finalised. The FRC is also contributing to the debate on the governance of banks. We believe that the Code itself should continue to be applicable to all companies and that, as a general rule, any governance issues specific to the financial sector are best addressed through the existing framework for regulating that sector.

There have also been significant changes in ownership structure since 1992 that have created some challenges that might not have been anticipated when the "comply or explain" approach was first devised.

One of these is the increase in recent years in the number of Premium listed companies with controlling shareholders. The pure "comply or explain" approach can be less effective in these cases, where the majority shareholder is in effect reporting to themselves, and for this reason the Financial Services Authority is currently consulting on proposals to give greater protection to the minority shareholders of such companies.

While this is a relatively recent development, underlying changes in the ownership of listed companies in the UK - and in particular the declining share held by UK-based long-term investors - go back much further.

The impact of these changes has been significant in many respects, as Professor Kay has identified in his report. In terms of corporate governance, it means that the critical mass of investors with a long-term perspective who are willing and able to engage with boards has to be established internationally, not just within the UK. Establishing a critical mass that enables the chain of accountability from companies through to savers to work as it should, in a difficult economic environment, is possibly the greatest challenge, and is the over-arching objective of the Stewardship Code.

The events of the so-called "Shareholder Spring" indicated a greater willingness on the part of investors to challenge boards. This is welcome in many ways, but will not in itself create a stewardship culture where all parties work together to deliver sustainable returns to savers. Indeed, genuine stewardship may suffer if public confrontation becomes the default mode of engagement. As well as the implications for the relationship between individual boards and their shareholders, it may deter exactly those sorts of investors - particularly international investors - that should be encouraged to engage more.

The development of a stewardship culture among investors is not something that happens overnight. It requires cultural and behavioural change rather than prescription. Looking back over the first two years of the Stewardship Code it is clear that much has changed, and the recent changes to that Code will hopefully moves things on another stage. Stewardship is firmly on the investment agenda and the evidence suggests that leading investors are taking their responsibilities seriously, and looking to engage more effectively both individually and collectively.

Stewardship needs to develop further, however, if we are to reach the critical mass needed. As emphasised in the revised Stewardship Code, it is not something that can be delegated to proxy advisors or other third parties; and just as the quality of governance within companies is determined by the board, it needs senior management within institutions to provide leadership and commitment.

Baroness Hogg
Chairman, Financial Reporting Council
December 2012

Overview

2012 has seen considerable change in the regulatory framework, including changes to the UK Corporate Governance and Stewardship Codes which took effect in October. This will continue into 2013 when Government legislation on directors' remuneration and narrative reporting comes into effect, the FRC will publish updated guidance on risk and internal control and the going concern assessment, and the European Commission begins to implement its Action Plan on company law and corporate governance and its Directive on gender diversity.

These changes are summarised in the next section of the report. It is too early to assess what the cumulative effect will be on the standard of corporate governance and stewardship in the UK; the FRC will monitor and report on the impact in future years.

The remainder of the report focuses primarily on the implementation of the 2010 editions of the two codes, first assessed in last year's report. It also considers the impact of market developments such as changes in ownership and the series of high profile votes on remuneration reports, and looks ahead to the priority issues for 2013.

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

Compliance by listed companies with individual provisions of the UK Corporate Governance Code remains high, with half of all FTSE 350 companies complying fully with the Code, and an aggregate compliance rate of 97 per cent among those companies. There has been a positive response by companies to the changes introduced in 2010, with 96 per cent of FTSE 350 companies putting all directors up for annual re-election and indications that a large majority of those companies will also have at least one externally facilitated board review in the period 2011 to 2013. Companies' response to the new Code provision on reporting on the board's diversity policy, which was announced in October 2011 but did not take effect until October 2012, has also been encouraging, with 60 per cent of FTSE 100 companies already reporting on their policies to some extent.

While explanations for non-compliance are very much in the minority, is it important that they are clear so that shareholders can understand the reasons why the board has taken the actions it has, and consider whether they are content that their interests are being properly looked after. The FRC has found the standard of explanations to be variable.

Companies are generally better at setting out the background and actions taken to mitigate any governance concerns than they are at explaining the rationale for their decisions. In a few cases they do little more than assert that the actions taken are the most appropriate for the company, which is not acceptable. The FRC hopes that, by setting out the features of what it considers to be a clear explanation in the introduction to the 2012 edition of the Code, it will be able to report on an improvement in standards in 2013. If not, it will need to consider whether further action is needed.

The FRC has noted further improvement in the overall quality of reporting on principal risks and uncertainties, and the majority of companies are now attempting to explain their business model. There are also more examples of companies reporting some of the outcomes of, or follow up to, their board evaluations. Reporting by audit committees on their activities, on the other hand, remains generally uninformative. For this reason, the FRC has introduced new provisions in the 2012 edition of the Code to encourage more fulsome reporting on the significant matters considered by the committee, including the effectiveness of the audit process.

The number of signatories to the Stewardship Code has increased, although more slowly than in the first twelve months. There are now nearly 260 signatories, including most of the largest investors in UK equities, the most notable exceptions being sovereign wealth funds.

While there has been an increase in the number of asset owners signing up to the Stewardship Code, the numbers remain small in comparison with asset managers. The FRC hopes that the clarification of the respective responsibilities of managers and owners in the 2012 edition will encourage more owners to commit to the Code. Regardless of whether they are signatories or not, the direction given by owners to their investment managers will be of crucial importance. There is some evidence that more owners are discussing stewardship with their managers, although it is less clear to what extent it is then reflected in mandates.

The quality of reporting by investors on how they have applied the Stewardship Code is variable, and the FRC has strengthened the wording in some parts of the 2012 Code to make it clearer what information it considers should be disclosed. The statements made by signatories are important, as they enable companies to understand the approach to stewardship taken by their major shareholders and - in the case of statements made by asset managers - assist potential clients in identifying managers whose approach is compatible with their own.

Overall voting levels at annual general meetings continue to increase, with an average turnout of over 73 per cent in the first six months of 2012, and more asset managers now disclose at least some details of their voting records.

Voting on remuneration reports attracted considerable attention during the course of the annual general meeting season. While these were significant events, this was more as a result of the size rather than frequency of the vote against. The number of FTSE 350 companies that received twenty per cent or more votes against the remuneration report was actually lower than in 2011.

It remains to be seen what impact the Government's changes to legislation to introduce a binding vote on the remuneration policy, intended to take effect from October 2013, will have on voting patterns and on engagement in advance of the annual general meeting. Some have predicted that pressure on investor resources could become acute towards the end of 2013 as companies start consulting on their remuneration policy ahead of the new vote, squeezing out engagement on broader issues of strategy and governance. It would be unfortunate it that was to be the case, and companies and investors are encouraged to plan ahead.

Some companies reported more regular contact with shareholders on a broader range of issues, although many considered that this was because those investors that already engaged were doing more, rather than because more investors were becoming involved. Despite restructuring in some institutions there was reportedly a modest increase in investor resources dedicated to stewardship, although some feared this would not be maintained.

Familiar concerns were heard from companies about the perceived lack of joining up within institutions and the alleged influence that proxy advisors had on the outcome of votes at the annual general meeting. It is not clear from the available evidence that larger investors routinely follow advisors' recommendations, although they may not be representative of all investors. The FRC emphasised in the 2012 edition of the Stewardship Code that outsourcing to external service providers does not absolve investors from exercising their stewardship responsibilities. Separately, the European authorities are considering actions to address the transparency of proxy advisors' activities.

The European Commission has recently announced that it will develop guidance to increase legal certainty on the relationship between investor cooperation on governance issues and the rules on acting in concert. This is potentially an important development. The FRC considers that more effective collective engagement can maximise investors' resources and provide a basis for higher quality engagement with companies, and welcomes the market's efforts to develop an investor forum as recommended by Professor John Kay.

The Operating Environment

This section summarises the main changes in the regulatory framework for corporate governance since the last report on the impact and implementation of the UK Corporate Governance and Stewardship Codes was published in December 2011, and further developments that are expected in the next twelve months. It also comments on some of the main developments in the operation and structure of the UK market in that period.

The regulatory framework

In September 2012 the FRC published revised editions of both codes following consultation earlier in the year. The new codes apply to reporting periods beginning on or after 1 October 2012.

The main changes to the UK Corporate Governance Code included that boards should confirm that the annual report and accounts taken as a whole are fair, balanced and understandable, that audit committees should report more fully on their activities, and that FTSE 350 companies should put the external audit contract out to tender at least every ten years. The requirement for companies to report on their boardroom diversity policies, first announced in 2011, also came into effect. As with all existing provisions of the Code, these additions are subject to “comply or explain”.

The introductory section to the new Code identifies the sort of information that the FRC believes should be disclosed when companies choose to explain, in order to help investors assess the appropriateness of the company’s governance arrangements. This report contains case studies assessing the information provided where companies have chosen not to follow the Code’s recommendations.

The FRC will consult during 2013 on whether the sections of the Code dealing with the framework for making decisions on directors’ remuneration need to be updated, and will separately consult on revisions to its guidance on the issues to be considered when assessing whether the company is a going concern, and its guidance to directors on their responsibilities for risk and internal control.

The consultation on remuneration issues will not take place until after the Government’s revised legislation on reporting and voting on remuneration has been finalised. In the meantime, the Financial Reporting Lab has facilitated two projects with companies and investors at the request of the Department of Business, Skills and Innovation (BIS) to provide advice on how some of the proposals on reporting might be implemented.

The Financial Reporting Lab will also be facilitating a separate project on audit committee reporting. This follows an updated edition of the FRC’s Guidance on Audit Committees which reflected the changes to the UK Corporate Governance Code, and which was also published in September.

The new Stewardship Code, also published in September 2012, has been more extensively revised than the UK Corporate Governance Code, although the seven principles of the Code are unchanged. The extent of the revisions partly reflect the fact that the Code is still in its infancy, and the experience of implementing it had identified a number of respects in which it was insufficiently clear what was

expected of signatories. Other changes are intended to address some of the shortcomings in implementation or reporting highlighted in the FRC's December 2011 report.

The main changes to the Stewardship Code include: clarification of the respective responsibilities of asset managers and asset owners for stewardship, and for stewardship activities that they have chosen to outsource; and clearer reporting requirements, including on the policy on stock lending. Asset managers are also encouraged to have the processes that support their stewardship activities independently verified, to provide greater assurance to their clients. The Institute of Chartered Accountants in England and Wales published in November 2012 a revised edition of the Stewardship Supplement to its guidance on assurance reporting (AAF 01/06) to enable assurance to be carried out against the revised Code.

The Codes are not the only part of the framework for corporate governance to have been reviewed and revised during 2012. As well as the legislation on remuneration referred to above, BIS has also consulted on proposals to change the structure and content of non-financial reporting, and draft regulations were published in October 2012. The FRC will review its guidance on narrative reporting in the light of the final regulations.

Looking further ahead, Professor John Kay's report on UK equity markets and long-term decision making, published in July 2012, identifies some major challenges for regulators and standard-setters, including the FRC. Generally speaking, his recommendations go with the grain of what the FRC has been seeking to do to promote long-termism and a healthy equity market. Professor Kay has urged the FRC to develop the Stewardship Code in a way that takes a more holistic approach going beyond narrowly based discussion on remuneration, and this is reflected in the recent revisions to the Code. The Government announced its response to the report's recommendations in November and the FRC looks forward to working with it in the implementation phase.

In addition to the legislation on remuneration and reporting being introduced by BIS, which applies to all listed companies, 2012 has seen a number of proposals for regulation that are targeted on specific sectors or types of company.

The FRC noted in its December 2011 report the challenges involved in applying a pure "comply or explain" approach, designed for a market where dispersed ownership is the predominant model, to the increasing number of closely controlled companies listing in the UK. In October 2012, the Financial Services Authority (FSA) began consultation on a number of proposed rules relating to the governance of such companies intended to give additional protection to their minority shareholders. The market continues to have concerns about the governance of closely controlled companies, and the FRC welcomes the FSA's decision to consult on these issues.

While the regulation of the banking sector is a matter for the Government and the FSA rather than the FRC, the FRC does have an interest in the governance aspects of banking reform. In November 2012, the Chairman of the FRC gave evidence to the Parliamentary Commission on Banking Standards and argued that the investability of banks must be an important consideration when designing the regulatory framework within which they operate. While it is important to ensure that

regulators and supervisors have the necessary powers to enable them to act in the public interest, if the net effect of regulatory change is that ability of shareholders to exercise their control rights is reduced it could be a significant disincentive to investors to provide capital.

Many of the issues that are being addressed through changes to the Codes and regulation in the UK have also been debated in Europe. Recent weeks have seen the European Commission issue a number of proposals for EU action.

In November, the Commission published a draft Directive on the gender balance among non-executive directors of listed companies. In December, the Commission published an Action Plan setting out a series of legislative and other initiatives on company law and corporate governance that the Commission proposes to commence during 2013 and 2014. It includes proposals to: improve the quality of corporate governance reporting; give shareholders more oversight of directors' remuneration; improve the transparency and conflict of interest frameworks applicable to proxy advisors; require institutional investors to disclose their voting and engagement policies; and develop guidance on collective engagement and the rules on acting in concert.

Many of the initiatives in the Action Plan are intended to address issues that have already been the subject of Code or other changes in the UK. While the FRC supports many of them in principle, it will be important to study the detailed proposals when available.

Finally, the Commission has stated that it intends to publish in the near future a Green Paper on long-term finance. The Commission's intention is to launch a debate on the ability of the financial system to channel savings towards the financing of projects and businesses with long planning horizons, which may involve re-examining some of the issues raised in the Kay report.

The structure and functioning of the market

The 2012 reporting season will be remembered for a series of protest votes at annual general meetings. Shareholder discontent made itself felt not just in the UK but also overseas, for example through the remuneration votes at UBS and Citibank. A striking and unusual feature of the UK season was the series of high profile protest votes on remuneration, and the departure of leading executives from companies as diverse as Aviva, Astra Zeneca and Trinity Mirror.

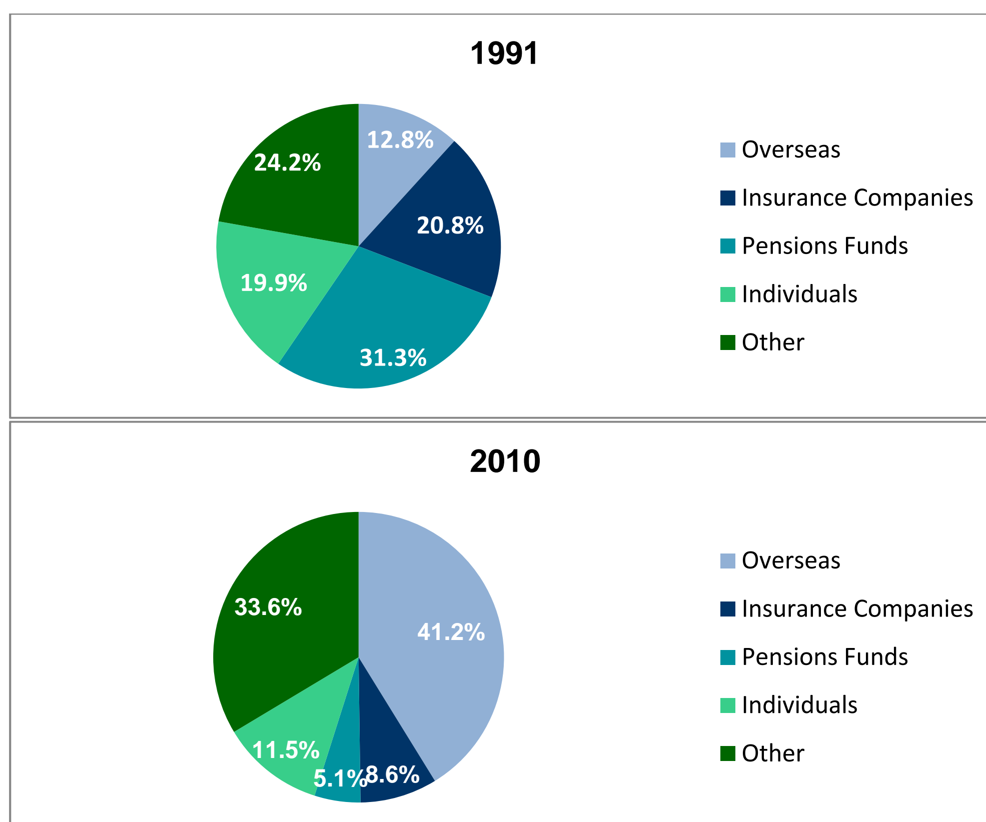
For some commentators these developments were an indication of a sea change in investor attitudes, arguing that the lessons of the banking crisis had been learned and investors were moving away from what their critics continue to describe as their apathy. A look at what actually happened does not suggest a widespread revolt against excessive remuneration. Rather it appears that investors are selective in the issues they take on, but harder on those cases where they do have specific concerns that may well go beyond remuneration. Since the annual meeting season there has also been further evidence of shareholder pressure on companies with some shareholders expressing strong views, for example, in the debates over the proposed mergers of BAe Systems with EADS, and of Glencore with Xstrata.

However, the overall level of protest does not appear to have increased. Average dissent across all AGM resolutions has remained at around three per cent for the last four years[1]. While some companies met fierce resistance on remuneration, the number of FTSE 350 companies whose remuneration report received twenty per cent or more votes against was actually lower than in 2011 (25 as opposed to 40)[2].

The FRC's view is that the dialogue between companies and shareholders on remuneration needs to be integrated with broader engagement on strategy, risk management, business culture, the quality of the board and succession planning. While remuneration is a legitimate subject for debate and a greater willingness to challenge is welcome, more effort will be required to embed the culture and practice envisaged by the Stewardship Code. There needs to be level of engagement that looks more like ownership than confrontation. A "no" vote is not necessarily evidence of success if it means a failure to engage constructively on the part of the company or its shareholders.

Structurally, the market trends of recent years persist. Latest figures from the Office for National Statistics show a further decline in the participation of insurance companies and pension funds, which are traditional long term holders of equities, while foreign participation remains very high.

Beneficial share ownership by type



Source: Ownership of UK Quoted Shares, 2010; Office for National Statistics; February 2012

[1] 2012 Voting Results Report: Europe; ISS; September 2012
[2] Guide to Directors' Remuneration 2012; KPMG; October 2012

It should be noted that the figures for 2010 are constructed on a different methodology and are not directly comparable with those of previous years, and that the high level of overseas holdings may not account for investments ultimately held abroad but managed within the UK. The governance rights of major UK-based institutional investors, including those of foreign parentage, are likely be higher than the figures suggest.

Nonetheless there is little escaping the declining interest of the traditional long term UK holders. Data published by the Pensions Regulator and Pension Protection Fund shows a reduced allocation to equities amongst Defined Benefit pension schemes and, within equities, a falling UK share[3]. Looking across both Defined Benefit and Defined Contribution pension schemes, the asset allocation of the average pension fund to UK equities stood at 18 per cent in 2011, down from 46 per cent a decade earlier[4].

2012 was the year of auto-enrolment, and it remains to be seen what impact this boost for Defined Contributions pensions will have. The FRC is pleased to note that NEST is a signatory to the Stewardship Code, and would encourage other providers of auto-enrolment services also to commit to the Code.

There are some signs of a shift in market preferences. Asset managers are facing pressure on fee income, and there appears to be less demand for active equity investment with the result that a number of asset managers have been looking at their product mix. For example, in early 2012, Aviva Investors announced a series of changes which reduced its focus on active equity management and involved a corresponding cut in the resources it applies directly to governance and stewardship. A number of other asset managers have made or have been considering similar changes, although, like Aviva, they have generally continued to affirm their commitment to stewardship.

Taken together, however, these market developments create a challenging environment for stewardship. Against that must be set the evidence of shareholder activism seen this year as well as the continuing relatively high turnout at UK general meetings, as discussed in the stewardship section of this report.

[3] The Purple Book: DB Pensions Universe Risk Profile 2012; Pension Protection Fund and The Pensions Regulator; November 2012
[4] Pension Fund Indicators 2012; UBS Global Asset Management; July 2012

Compliance with the UK Corporate Governance Code

This section of the report looks at how the 2010 UK Corporate Governance Code has been implemented, with a particular focus on the new principles and provisions introduced in 2010, and the new provisions on diversity which were first announced in 2011. Data shows that rates of compliance with the Code remain very high among companies of all sizes.

In its 2013 report the FRC will also assess compliance with the new provisions introduced this year. This will include the provision stating that FTSE 350 companies should put the external audit contract out to tender at least every ten years, although it will not be possible to draw any firm conclusions on that particular addition to the Code after only twelve months.

Overall compliance rates

The annual survey of compliance by FTSE 350 companies carried out by Grant Thornton[5] showed that 51 per cent of those companies claim full compliance with the Code. A further 29 per cent complied with all but one of the Code's 48 provisions. Aggregate compliance with individual Code provisions across all FTSE 350 companies was 97 per cent. These figures are not significantly different from 2011.

As in previous years, the Code provision with the highest rate of non-compliance among FTSE 350 companies is Section B.1.2, which states that at least half the board of those companies, excluding the chairman, should be independent. Nearly one in five companies chose to explain rather than comply with this provision. The FRC's assessment of the quality of these explanations is contained in the next section of this report.

Data compiled by Manifest[6] on behalf of the FRC shows that compliance levels among companies on the FTSE Small Cap and Fledgling indices are generally consistent with those of larger companies, as these examples show. There is no significant variation between any of these figures and the equivalent figures in 2011.

Code requirement	FTSE 350 companies	Smaller companies
Separate Chairman and CEO	**97%**	**98%**
Meets minimum standards for number of independent	**81%**	**94%**
Meets minimum standards for audit committee	**90%**	**89%**
Meets minimum standards for remuneration committee	**89%**	**83%**
Meets minimum standards for nomination committee	**95%**	**99%**

Sources: Grant Thornton and Manifest - The Proxy Voting Agency

[5] The Chemistry of Governance: A catalyst for change; Grant Thornton; December 2012
[6] Manifest looked at a sample of 354 companies, 256 on the Small Cap Index and 98 on the Fledgling Index

Diversity

The issue of boardroom diversity, and in particular gender diversity, continues to be high on the agenda in the UK and in Europe. The FRC believes strongly in an approach based on transparency and the promotion of best practice aimed at improving the quality of board decision-making, as proposed by Lord Davies in his "Women on Boards" report in 2011. The Code was amended in 2010 to state that boards should explicitly address diversity when considering the balance of the board, and further recommendations were added in October 2012.

The latest data on female directorships is in most respects encouraging[7]. Research carried out by the Cranfield School of Management on behalf of the FRC and the Government Equalities Office found that the percentage of female directors in FTSE 100 companies had risen from 15.6 per cent in March 2012 to 17.4 per cent in November 2012, and in FTSE 250 companies from 9.6 per cent to 12 per cent over the same period. Women accounted for 44 per cent of new director appointments in the FTSE 100 in the six months to September 2012, and 36 per cent of those in the FTSE 250. Both figures were a significant increase over the previous six months.

Separate data from Manifest showed that the percentage of female directors in Small Cap and Fledgling companies has increased from just over eight per cent in 2011 to just under ten per cent in 2012.

While the increase in female representation at board level is welcome, it is almost entirely accounted for by an increased number of female non-executive directors. The percentage of female executive directors has remained static. As at November 2012 there are 6.7 per cent female executive directors in the FTSE 100, in contrast to 21.6 per cent non-executive directors, and only between five and six per cent of executive directors in the FTSE 250 and below are female.

There are, of course, many less executive than non-executive directorships, so change may take longer to become visible, but it will not happen at all unless companies take steps to develop a diverse pool of talent within the company on which they can draw. The FRC would encourage companies to consider, as part of their diversity policy, what actions they can take in this regard.

The extent to which companies are reporting on their diversity policies and targets is considered in the next section of this report.

Board evaluation

In the 2010 edition of the Code, the FRC recommended for the first time that the evaluation of the boards of FTSE 350 companies should be externally facilitated at least every three years.

According to the Grant Thornton research, 35 per cent of FTSE 350 companies reported that they had carried out an externally facilitated board review during 2011/12. Separate research by Practical

[7] Data on FTSE 350 companies is from: Women on Boards: Benchmarking early adopters of the Corporate Governance Code 2012; Cranfield School of Management; November 2012. Data on smaller companies was compiled by Manifest on behalf of the FRC

Law's What's Market[8], which excludes investment trusts, found that 53 per cent of FTSE 350 companies disclosed in their 2011/12 annual reports that they had done so at some point in the last two reporting periods. Both figures suggest that there will be a high rate of compliance with this provision over the three year cycle.

Practical Law's What's Market also reports that one-third of those companies that carried out an externally facilitated review during the last two reporting periods did not disclose the identity of the reviewer. This practice has led some investors to be sceptical about how "independent" the review has been in these cases. The 2012 edition of the Code states that, in future, the reviewer should be identified and any other connection with the company disclosed.

Annual elections

The FRC reported in its 2011 report that, within twelve months of the Code being amended to recommend that FTSE 350 companies put all directors forward for re-election annually, over 80 per cent of those companies had complied. In 2012 that figure has risen to 96 per cent[9]. In addition, research by Manifest on behalf of the FRC found that nearly 30 per cent of Small Cap and Fledgling companies had put all directors forward for re-election even though the Code provision does not apply to them.

The FRC believes it is to the credit of companies that they have responded so quickly to the introduction of this provision, and that this is a good example of how the code-based approach can deliver rapid improvements in market practice.

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[8] Annual Reporting and AGMs 2012: FTSE 350: What's Market Practice?; Practical Law Company; November 2012
[9] Grant Thornton. Practical Law's What's Market reported that this rises to 98 per cent if investment trusts are excluded.

Reporting by Listed Companies

The FRC reviewed a sample of 60 corporate governance statements taken from annual reports and accounts published in the first six months of 2012. This section of the report summarises some of the findings of this research and other reviews of the quality of reporting.

In its report on developments in corporate governance published in December 2011 the FRC noted that while, overall, corporate reporting was good and improving, there were still many examples of generic and boiler-plate reporting and that a continued effort was needed to bring the general standard up to the level of the best.

The same can be said of reporting on corporate governance in 2012. In some areas, such as reporting on companies' principal risks and uncertainties, standards have continued to improve. In others, the FRC has felt it necessary to strengthen the UK Corporate Governance Code to provide an impetus for progress, include by setting out what information the FRC expects to be provided when a company deviates from the Code.

The revised Code also seeks more informative reporting by audit committees on how they have carried out their responsibilities and the significant matters they have considered. To quote from a report from BDO[10], who surveyed a selection of annual report and accounts issued during 2012: "By and large annual reports are quite adequate at telling investors what audit committees do but don't give an indication of how they do it. A little more granularity in disclosure might go a long way in reassuring investors that audit committees are discharging their obligations to investors in a comprehensive and effective manner".

The FRC's Financial Reporting Lab provides a facility for companies and investors to come together to develop pragmatic solutions to reporting issues. In November 2012 the Lab issued a call for companies and investors to participate in a project to identify ways of improving audit committee reporting in the light of the changes to the Code. The FRC will report on the outcome of that project, and the general standard of reporting by audit committees, in its 2013 report.

Explanations

As the data on compliance with the Code in the previous section shows, it is relatively rare for companies to deviate from the Code. Nonetheless, it is important for the continuing credibility of the "comply or explain" approach that, when companies do not follow a provision of the Code, they provide a clear explanation so that their shareholders can assess whether they are content with the governance arrangements that the company has put in place.

For that reason, the 2012 edition of the Code sets out a number of features of what the FRC considers to be a meaningful explanation, to provide a benchmark for companies when providing explanations and shareholders when assessing them. These features are: that the explanation should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating

[10] Good Strong Words – That Mean Something: An Analysis of Audit Committee Reporting; BDO; December 2012

actions taken; and that where deviation from a particular provision is intended to be limited in time, the explanation should indicate when the company expects to conform to the provision.

The FRC has reviewed a selection of explanations in annual reports published during 2012 to assess the extent to which companies were already providing this information. The review looked at two areas of non-compliance: where less than half the board of a FTSE 350 company, excluding the chairman, comprises independent non-executive directors (the most common area of non-compliance in the FTSE 350); and where companies have a combined chairman and chief executive.

The standard of explanations was variable. While the majority of those that were reviewed provided at least some of the information the FRC would expect to see, it was unusual for an explanation to provide clear information on all the aspects identified in the Code. In a few cases, companies simply asserted that the governance arrangements they had adopted were appropriate for their circumstances without any further elaboration, which is not satisfactory. These findings are consistent with those of the Association of British Insurers in its separate study of the quality of explanations[11].

In the examples reviewed by the FRC, companies were generally better at explaining the background and, where relevant, the mitigating actions that they had taken - including in some cases actions intended to make the company compliant with the Code - than they were at explaining the rationale. Explanations were usually clearer where companies deviated from the Code due to force of circumstances – such as directors leaving the board for one or other reason – rather than because of a conscious decision to do so. The FRC considers that many companies could do more to explain why they consider their actions and governance arrangements to be in the best interests of shareholders.

The FRC will monitor the quality of explanations again during 2013. Depending on its findings, it will also consider whether further steps are needed to ensure the criteria set out in the Code are consistently applied.

Explanations where less than half the board, excluding the chairman, comprise independent non-executive directors

A number of the companies sampled were non-compliant with the Code for only part of the year. In the majority of these cases, it was because there had been changes in board composition during the year that meant they were now compliant, although one company had appointed an additional executive director which had caused it to become non-compliant.

In addition, a few other companies indicated that they intended to make changes to the board and would become compliant in the future, with one company noting that "providing some continuity of leadership is important and therefore [it] has taken a measured approach to transforming the board to one that is compliant with the independence requirements of the Code".

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[11] Comply or Explain: Investor expectations and current practices; Association of British Insurers; December 2012

In cases where the company had been non-compliant throughout the year, it was not always explained how this situation had arisen (although it is possible that such an explanation may have been given in a previous report when the board composition last changed). One exception was a company that had completed a merger during the year, which explained that the board and management structure had been specified in the terms of agreement.

The rationale provided by those companies that were not compliant and did not state that they intend to become compliant in the future varied in both content and detail. A number of them referred to the need to avoid the board becoming too large and unwieldy and/or to need to ensure a necessary balance of skills and experience on the board.

Some companies were specific about what they saw as the optimal size and balance – for example, one company noted that "with thirteen members the board is already larger than the boards of most comparable companies" – while a few companies highlighted in their explanation the attributes of a particular board member, usually a non-executive director who was not classified as independent, whose value they considered justified retaining them even though the consequence was that the company did not comply.

Other companies made a more general statement, for example: "The directors consider that the board is of sufficient size and diversity that the balance of skills and experience is considered to be appropriate for the requirements of the group at the current time." This explanation on its own is not very illuminating, and companies should consider how they can demonstrate the basis on which they have made that judgement (for example, by cross-referring to information elsewhere in the report such as the director's biographies or the report given on the evaluation of the board's effectiveness).

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

As with explanations on independent directors, a number of the companies sampled were non-compliant with the Code for only part of the year. In some cases this was because the roles were separated during the course of the year, making companies compliant, and in others because planned or unplanned board changes had resulted in companies becoming non-compliant. In these circumstances the background was generally clearly explained and, where relevant, it was normally stated whether the deviation was intended to be temporary. For example, in one case where the chief executive had resigned due to ill health, the company explained that "the Board is recruiting a new Chief Executive and once appointed [the executive chairman] will relinquish his executive responsibilities and revert to his role as non-executive Chairman".

Where the combination of the two roles was not intended to be a temporary arrangement, different rationales were provided. A number of explanations referred to the qualities of the individual and/or the circumstances of the company – for example, "the board considered that the combined role is in the interests of shareholders in order to utilize [his] proven leadership qualities and significant experience through a challenging period for the company" – but some others provided no obvious rationale, simply noting the fact that the role was combined and explaining the mitigating arrangements that had been put in place.

The amount of information provided about the mitigating arrangements varied considerably. Some companies set out in detail the specific responsibilities that had been allocated to other board members in order to ensure that too much power was not concentrated in the executive chairman. Others addressed the issue more succinctly, for example: “The Board considers that its predominantly non-executive composition combined with the delegation of significant responsibility for operational management to a divisional level achieves an appropriate balance and prevents a concentration of power in its Executive Chairman.”

Diversity

Under the latest edition of the UK Corporate Governance Code, which took effect at the beginning of October 2012, listed companies are expected to set out in their annual reports their policy on boardroom diversity – including, in particular, gender - and report on progress against any measurable objectives they have set themselves. The FRC announced in October 2011 that it intended to introduce these provisions into the Code twelve months later, and encouraged companies to adopt them on voluntary basis rather than wait for the Code change.

Research carried out by Cranfield on behalf of the FRC and the Government Equalities Office found that a significant percentage of FTSE 100 companies already disclose their boardroom diversity policies. Other research on FTSE 350 companies found similar results[12].

Table: Disclosure of diversity policies by FTSE 100 companies

	Percentage of sample
Clear policy on boardroom diversity	60%
Specific reference to gender diversity as part of the policy	60%
Measurable objectives disclosed	42%
Progress against those objectives disclosed	7.5%
Diversity mentioned as part of the board evaluation process	26%
Disclosure of policies aimed at increasing women in senior	47%
Measurable objectives for the number of women in senior	18%

Source: Women on Boards: Benchmarking early adopters of the Corporate Governance Code 2012; Cranfield School of Management; November 2012. Data based on a sample of 93 FTSE 100 companies that produced annual reports between January and October 2012.

[12] Grant Thornton found that 78 per cent of FTSE 350 companies provided at least some description of the company's boardroom diversity policies (The Chemistry of Governance: A catalyst for change; December 2012). Practical Law Company found that 29 per cent of FTSE 350 companies, excluding investment trusts, disclosed a target for the number of women they aimed to have on the board by 2015 (Annual Reporting and AGMs: What's Market Practice?; November 2012).

The FRC considers this is an encouraging response to its request for early adoption of the new Code provisions, and hopes to be able to make a similarly positive assessment of progress in its review of developments in corporate governance in 2013.

Board evaluation

The UK Corporate Governance Code states that companies should describe how evaluation of the performance and effectiveness of the board has been carried out, but does not require companies to disclose the outcomes of those reviews. Some investors have called for such a requirement to be added to the Code, but some companies have expressed concern that such a requirement might oblige them to report on sensitive issues that are better resolved privately. Despite those reservations, it is becoming increasing common for companies to provide at least some information on the outcomes of the evaluation[13].

Among the annual reports surveyed by the FRC there were some good examples of companies disclosing the main actions that were agreed following the board effectiveness review and, where relevant, how those actions identified following reviews in previous years had been implemented. While the FRC does not wish to prescribe how companies report on their board evaluation, it considers this approach potentially enables boards to demonstrate to shareholders how they are working to improve their effectiveness in a way that does not require them to disclose sensitive information, and would encourage companies to consider providing such information.

The 2012 edition of the Code states that "evaluation of the board should consider the balance of skills, experience and independence and knowledge of the company on the board, its diversity, including gender, how the board works together as a unit, and other factors relevant to its effectiveness". As part of its monitoring of reporting in 2013, the FRC will look at the extent to which boards describe how they consider these issues. The fact that succession planning is the area most frequently identified as in need of improvement following board evaluations perhaps indicates an increased awareness of the importance of these issues[14].

Business model, strategy and risk

Business model

In 2010 the FRC amended the UK Corporate Governance Code to state that companies should explain their business model, which the Code defines as "the basis on which the company generates or preserves value over the longer term". The draft narrative reporting regulations published by the Department of Business, Innovation and Skills in October 2012 will also, if implemented, include a requirement for companies to explain their business model. Disclosure of this information would therefore become a mandatory rather than a "comply or explain" requirement.

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[13] Report on Board Effectiveness; Association of British Insurers; December 2012. The ABI reported that 48 per cent of FTSE 100 companies and 34 per cent of FTSE 250 companies disclosed outcomes of their evaluation in 2011/12, up from 31 per cent and ten per cent respectively the previous year.
[14] The ABI reported that 50 per cent of FTSE 100 companies and 60 per cent of FTSE 250 companies that disclosed evaluation outcomes identified succession planning as an area needing improvement.

Other than suggesting in the footnotes to the Code that the explanation of the business model should be linked to the disclosures companies make on their strategy and principal risks and uncertainties, the FRC has consciously decided not to prescribe the format or content of this disclosure, as it believes companies should have the flexibility to communicate their business model to shareholders in a way that is meaningful to them.

The annual reports surveyed by the FRC revealed considerable differences both in how companies provided this information, and the clarity with which they did so. This impression was confirmed by a survey of the annual reports of 100 listed companies of all sizes carried out by Deloitte[15], which found that "85 per cent of companies were judged to have provided some consideration of the basis on which the businesses generates or preserves value, although the extent of such explanations varied significantly and most did not go so far as to provide a specific section discussing the business model".

These findings are perhaps unsurprising given the nature of the information companies are being asked to provide and the fact that it is still a relatively new reporting requirement. Once the BIS regulations have been finalised, the FRC will be reviewing its current guidance on narrative reporting and will consider whether a Financial Reporting Lab project might add value. Irrespective of the outcome of those reviews, the FRC will continue to monitor this area of reporting and hopes that it will be able to report an improvement in the overall standard of disclosure in its next report.

Risk

The Financial Reporting Lab also intends to facilitate a project on risk reporting during 2013, and the FRC will separately consult on revisions to its guidance to directors on their responsibilities for risk and internal control.

In its annual report published in September 2012, the FRC's Financial Reporting Review Panel[16] noted that there had been "a significant improvement this year in the overall quality of reporting in relation to all aspects of principal risks and uncertainties", and that while the Panel continued to challenge companies that did not explain how they mitigated these risks "such cases were relatively infrequent and the reporting of mitigating actions is generally being done well." The FRC also welcomes the fact that an increasing number of companies are now integrating reporting on risk with the description of their strategy.

However the September 2012 report also noted that there scope for further improvement. In particular, some companies continue to provide a list of bullet point headings rather than a clear description of the principal risks they faced, while others did not clearly separate the company's principal risks and uncertainties, providing instead a long list of potential risks. Grant Thornton reports that the average number of principal risks disclosed by FTSE 350 companies is eleven, although

[15] Joined Up Writing: Surveying Annual Reports; Deloitte; October 2012
[16] Financial Reporting Review Panel Annual Report 2012; Financial Reporting Council; September 2012

there is significant variation between sectors[17]. The Deloitte survey of one hundred companies found similar results.

The one element of risk reporting that has not improved significantly in recent years is the internal control statement. While some companies have made efforts to describe clearly their key controls and the overall operation of the risk management and internal control system, the majority of statements are largely boiler-plate.

[17] Grant Thornton reported that the sectors with the highest and lowest average number of principal risks were health care (16.5) and technology (7.8).

Stewardship and Engagement

When the FRC first issued in the Stewardship Code in July 2010 investors were being criticised in some quarters for having contributed to the banking crisis. They were perceived as having failed to hold the boards of banks properly to account, and perhaps even to have encouraged them to pursue risky strategies in pursuit of short-term gains.

The FRC identified three objectives for the Stewardship Code: to help to build a critical mass of investors with a long-term focus that are willing and able to monitor and engage with the companies in which they invest; to increase the quantity and quality of engagement; and to increase accountability back down the investment chain to clients and beneficiaries. This section reports on progress against those objectives.

Take-up of the Stewardship Code

As at the beginning of December 2012, the Stewardship Code had 259 signatories. These comprise 187 asset managers, 58 asset owners and 14 service providers. Of the owners, 40 are pension schemes. All but six signatories are based in the UK or have UK operations.

The disparity in the number of asset managers and asset owners may be partly explained by the fact that asset managers are required under the Financial Services Authority's Conduct of Business Rules to disclose whether or not they apply the Code, but there is no equivalent obligation on owners; and partly because there was a perception among some owners that the Code was not addressed to them as they did not directly engage with companies. The revised edition of the Code makes it explicit that both asset managers and owners have responsibilities for the stewardship of their clients and beneficiaries' assets.

A total of 83 signatories responded to this year's survey of adherence to the Code carried out by the Investment Management Association[18]. Of these, 58 were asset managers that manage £774 billion of UK equities, which the IMA estimates represents 40 per cent of the UK market.

While the number of signatories is encouraging, it is now important that the commitment to the Code translates into action.

Quality of Stewardship Code statements

When reporting on take-up of the Stewardship Code in 2011, the FRC observed that the levels of disclosure against the different Code principles varied. Some of the 2012 Code revisions were designed to encourage more transparency on issues observed in that report, for example the signatory's willingness to engage collectively and the use made of proxy voting agencies and other service providers. In addition, the 2012 Code explicitly states that the policy statement should describe how the signatory has applied each of the seven principles of the Code and disclose the specific information requested in the guidance to each principle.

[18] Adherence to the FRC's Stewardship Code at 30 September 2011; Investment Management Association; June 2012

The updated Code also encourages more disclosure on how conflicts of interest are managed. In November the FSA published a review on this subject which concluded that “many [asset management] firms had failed to establish an adequate framework for identifying and managing conflicts of interest”[19]. In the light of this finding the FRC believes it would be in asset managers’ own interest to be more transparent about how they deal with these matters

Some asset owners have reported that, while the level of disclosure in policy statements is a useful start, more detail is needed to help them differentiate fully between managers. The 2012 edition of the Code now encourages signatories to explain which of their funds or products are covered by the approach described in their statements. Where institutions apply a stewardship approach to other asset classes, they are encouraged to disclose this as well.

Separately, a number of initiatives are underway aimed at helping asset owners judge the quality of stewardship offered by individual asset managers. While welcoming the growing interest in these issues, the FRC believes that such judgements must be a matter for the market. The role of the FRC is to set the standard against which managers can be benchmarked, not to do the benchmarking itself.

It is important that signatories keep their statements up to date. The 2012 edition of the Code recommends that signatories review, and if necessary update, their statements at least annually. In its December 2011 report the FRC noted that around 50 per cent of signatories did not provide an up to date point of contact. There has been little improvement since and the FRC would encourage signatories to address this as part of their reviews.

Client demand and accountability

The National Association of Pension Funds (NAPF) noted that over half of respondents to its survey of members[20] with more than £1 billion in assets under management incorporate stewardship principles into their contracts with investment managers or their Statement of Investment Principles (up from 40 per cent in 2011). Over 70 per cent of respondents indicated that they take the stewardship activities and policies of managers into account during selections, while over 60 per cent indicated that they had increased the amount of time spent reviewing reports from managers. The FRC welcomes the NAPF’s new stewardship policy, published in November 2012, which encourages those funds that have not yet adopted these policies and practices to do so.

The IMA survey reported that, “since 2010, there has been an increase in the number of mandates that refer to stewardship”, although some institutions have told the FRC that, while stewardship may be raised at the request for proposal stage, it is less frequently referred to in the final mandate.

The FRC considers that if asset owners want managers to pursue a stewardship approach on their behalf – and 70 per cent of the respondents to the NAPF survey considered that the most effective

[19] Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks; Financial Services Authority; November 2012
[20] NAPF Engagement Survey: Pension Funds’ Engagement with Investee Companies; National Association of Pension Funds; December 2012

form of engagement was through their investment manager – then the best way of achieving this is to make the manager accountable by making explicit reference to stewardship in the mandate.

One of the changes made in the 2012 edition of the Code was to strengthen the references to independent assurance of how asset managers carry out their stewardship activities. The Code now states that managers should obtain such assurance – although they can, of course, choose to explain rather than comply - and make the reports available to clients on request. In November 2012 the Institute of Chartered Accountants in England and Wales published an updated version of its AAF 01/06 Stewardship Supplement, one of the frameworks available for asset managers to use, to reflect changes in the Code.

According to the IMA Survey, only 20 per cent of respondents had obtained an independent opinion covering their voting process, with fewer than 10 per cent covering stewardship as well. However, as the Stewardship Supplement to the AAF 01/06 was only published in March 2011, respondents would not have necessarily had the time to obtain such an opinion. The FRC would hope to be able to report greater uptake of the Supplement and other assurance frameworks in its next monitoring report.

Quality of engagement

Publicity around the so-called "Shareholder Spring" focused on the voting figures for controversial resolutions at annual meetings, but this does not provide insight into the quality of the on-going dialogue between companies and their shareholders which is critical to the impact of the Stewardship Code. Following the annual general meeting season the FRC undertook a series of meetings with companies and investors to discuss the extent to which the quality of engagement had improved.

A number of company chairmen said they were having more regular contact with shareholders and that the interest of the latter in discussing strategy had increased. However, the interest varied from institution to institution, and the consensus view was that, while those who had traditionally been involved in engagement had raised the standard of their engagement, there was little sign of greater numbers being involved. Some companies said they also found the views of investors varied even within individual asset management firms. Where this happens it is difficult for the companies to respond as the message they are receiving is unclear. This perception is also shared by some asset owners. Respondents to the NAPF survey "perceive[d] that there has been a decrease in the integration at the asset manager level of responsibility for engagement with investee companies".

Investors meanwhile continue to consult each other informally about concerns with companies. There is some anecdotal evidence that this is leading to a more strategic approach to engagement. For example, investor bodies held collective meetings with banks ahead of the 2012 bonus round, and there have been examples through the year of boardroom changes which follow shareholder engagement.

Here again, investors do not always agree on the desired outcome and companies complain they are sometimes confused about what to do. Nonetheless, it is important in these circumstances that they recognise there is a level of shareholder concern which, one way or another, needs to be addressed.

While investors report an active exchange of information between some shareholders, there also appear to have been some disagreements, particularly around the decision of some investors to publicise their positions and/or criticise the views of other investors. Collaboration depends on trust and it would be a matter of regret if the market were unable to address these differences.

Voting

Overall voting levels at annual general meetings continue to increase. In the first six months of 2012 the average turnout was 73.1 per cent, up from 70.9 per cent in the same period in 2011, and from 65.8 per cent in 2008. Average turnout in the UK is above the average of 65.9 per cent across seventeen European markets, although turnout also increased in the majority of those markets this year[21].

One of the concerns raised when annual re-elections were introduced by the UK Corporate Governance Code in 2010 was that it would create the potential for boards to be destabilised if it led to significant votes against directors becoming widespread. Research carried out by PIRC on behalf of the FRC, which analysed all voting results in FTSE 350 companies for the period 1 July 2011 to 30 June 2012, suggests that this risk has not materialised.

While the number of directors of FTSE 350 companies whose re-election was opposed by ten per cent or more of those shareholders that voted increased from 56 in 2011 to 93 in 2012, all directors received sufficient support to be re-elected and the average vote against all directors was under two per cent and was not significantly different to previous years.

The increase in the number of directors receiving ten per cent or more of votes against their re-election in part reflects the fact that a greater number of directors were put forward for re-election in 2012; they accounted for three per cent of all directors standing for election, as opposed to two per cent in 2011. There were a few cases where there appears to be some correlation between voting on the remuneration report and one or more directors, but not enough to infer that there was a discernible trend.

Since 2011 there has been an increase in the number of asset managers who disclose their voting records on their websites. The TUC has noted that the large majority of respondents to its Fund Manager Voting Survey now disclose some level of voting data publicly, but considers that there continues to be significant variations in the quality of disclosure[22].

The FRC's observation is that voting disclosure is generally restricted to larger institutions at present. The European Commission has stated in its Action Plan for company law and corporate governance that during 2013 it will bring forward proposals to improve disclosure of voting policies and records by

[21] All data in this paragraph from: 2012 Voting Results Report: Europe; ISS; September 2012.
[22] TUC Fund Manager Voting Survey 2012; TUC; November 2012

institutional investors. The FRC considers that it will be important to ensure that any requirements are framed in a way that avoids imposing disproportionate costs on investors.

Proxy advisors

Companies continue to report concerns about the role of proxy advisors in the voting process. At the European level this has led to a consultation about possible regulation or other action by the European Securities and Markets Authority (ESMA), and the European Commission has stated that it will consider an initiative to improve the transparency of the activities of proxy advisors in 2013 as part of its Action Plan.

The suggestion that shareholders blindly follow recommendations does not appear to be borne out by academic work[23], while the TUC survey indicates a wide variation in voting practice[24] which does not appear consistent with block voting by institutions in accordance with advice from proxy advisors. Only two respondents to the IMA survey stated that they automatically followed an advisor's recommendations, while 70 per cent of those that said they would sometimes do so used more than one service provider for research. This data appears to suggest that the majority of respondents are making conscious choices of their own when it comes to voting decisions.

However, these surveys may not be representative of the investor community as a whole. While larger UK investors may be making independent decisions, others may be more naturally inclined to rely on advice, especially those based overseas who may be less familiar than domestic shareholders with the governance of companies in which they invest.

Indeed, the internationalisation of the UK equity market, coupled possibly with resource constraints within institutions, may lead to proxy advisors acquiring a larger influence. This puts a particular onus on them to be seen to pursue high standards, including the application of sufficient resource and analytic capability. Equally some investors have told us of their belief that the advisors have been subject to excessive pressure from some companies seeking to influence their judgements. In its response to the ESMA consultation, the FRC suggested the advisors should establish a voluntary industry code to help address these concerns.

The prospect of growing proxy advisor influence raises a number of issues. First is the argument that the advisors have no "skin in the game", as their recommendations carry no direct financial consequences for them, in contrast to the clients who use their advice. There are also concerns that proxy advisors might stand in the way of a direct relationship between companies and their shareholders. This is especially relevant in the context of the Kay Review conclusions about the role of intermediaries in the investment chain.

[23] For example: Do Institutional Investors Follow Proxy Advice Blindly?; Michael Schouten; Faculty of Law, University of Amsterdam; January 2012
[24] The TUC analysed voting data by institutional investors on a sample of resolutions which attracted high oppose votes in 2011 and found that the percentage supported by each investor ranged from under 20 per cent to over 90 per cent.

In the FRC's view, unless they have a direct mandate to the contrary, proxy advisors should be clear that they do not wish to be seen as representatives of shareholders but merely as providers of advice. In addition, companies should not treat them as if they were shareholder representatives but should continue to seek direct contact with their shareholders.

Shareholders have a clear obligation, too, not to fall back on delegation. The new edition of the Stewardship Code makes this clear when it says that "institutional investors may choose to outsource to external service providers some of the activities associated with stewardship. However, they cannot delegate their responsibility for stewardship. They remain responsible for ensuring those activities are carried out in a manner consistent with their own approach to stewardship." The FRC will be monitoring statements by signatories closely over the course of the coming year and liaising further with the European authorities on their initiative.

Barriers to engagement

The IMA survey highlighted cost and a shortage of resources and time as the principal barriers to stewardship and engagement, especially where the size of holding limits the investor's ability to engage and challenge. Other barriers identified by respondents included lack of client demand and regulatory constraints, including fears of infringing acting in concert rules. The lack of receptiveness on the part of some companies was also seen as a barrier, with some respondents considering this could particularly be an issue when companies have controlling shareholders.

There was a mixed message around the level of investor resources. The IMA survey reported a modest increase in headcount involved in stewardship of four per cent over the year, and more respondents had specialists dedicated to stewardship in the UK than was the case a year previously. However, the mood in the market was cautious, particularly in the light of the high profile restructuring of two in-house teams, and speculation that other institutions may be facing similar decisions.

While the FRC recognises that institutions have limited resources, it does not believe that it is sufficient for them simply to say that lack of resources prevents them from acting as stewards. If senior management within institutions consider stewardship important they should reflect this in how they prioritise their available resources, and consider whether they can use them more efficiently. In particular, the FRC believes portfolio managers could take on some work commonly left to corporate governance specialists, especially where this leads to a better integration of governance considerations and investment decision-making. Relevant subjects might include strategy, succession-planning, the quality of management and the board, and risk oversight.

A large part of the engagement effort still seems to be directed towards remuneration, especially the detailed analysis of complex performance share and option schemes. Concerns have been raised that pressure on resources could become acute towards the end of 2013 as companies start consulting on their remuneration policies ahead of the introduction of the new binding vote. Companies and shareholders should plan for this.

Asset owners can have an important impact on the extent to which resources are employed in stewardship. The NAPF survey reports that the primary barrier to pension funds becoming more actively involved in stewardship is that other issues take precedence.

While the NAPF has consistently commended the Stewardship Code to its members, the advice that pension funds receive from investment consultants appears to be mixed. The NAPF survey found that in only 38 per cent of cases had investment consultants raised the issue of stewardship with funds. That said, a few investment consultancies report that they are trying to raise the profile of stewardship, for example by integrating governance metrics into their standard reporting templates for trustees or producing briefing notes for clients on corporate governance topics.

The European Commission has announced that it is to work with member states and ESMA to develop guidance that will increase the legal certainty with regard to collaboration between shareholders on corporate governance matters and acting in concert. This will hopefully provide reassurance to those institutions that remain concerned and help ease this particular barrier to engagement.

Equally, however, some investors also report concerns that engaging with companies may put them at risk of becoming insiders when they wish to continue to trade. In its discussions with the European Commission and other authorities, the FRC has stressed the importance of ensuring that the market abuse rules are not couched in a way that inhibits dialogue on corporate governance matters. Conversations that are designed to inform companies of the views of their shareholders are valuable to both sides and should not involve the exchange of price sensitive information.

Meanwhile, the revised Stewardship Code contains new wording to the effect that investors may or may not wish to be insiders. Those that are willing to be made an insider should indicate in their stewardship statement their willingness to do so and the mechanism by which this could be done. There is no suggestion here that investors should be willing to be made insiders, but the new language reflects awareness from our conversations with the market that some investors may be willing and equipped to do so, perhaps even for longer than hitherto assumed. If this is the case, this may help towards more considered consultation around corporate actions such as acquisitions and capital raisings where companies are often left with little time to present their case.

Next Steps

Having recently revised both the UK Corporate Governance and Stewardship Codes, the FRC does not envisage making further changes to either Code during 2013. Both companies and investors need time to consider what implications the changes to the codes have for the way they operate and report, and to take what steps they think appropriate to implement them. They will also have to come to terms with changes to the legislation on remuneration and narrative reporting, which the Government intends should apply from October 2013.

That said, in addition to monitoring implementation of the new Codes, the FRC will be take action on a number of aspects of the UK Corporate Governance Code and its related guidance. These include consulting on whether changes might be needed in the future to those sections of the Code that address the procedures for setting executive directors' remuneration. This consultation will not take place until after the Government's legislation has been finalised. The FRC will consult separately on revisions to its guidance on the issues to be considered when assessing whether the company is a going concern, and its guidance to directors on their responsibilities for risk and internal control

As well as monitoring implementation of the Code revisions, the FRC will take action where appropriate to help companies apply them. For example, the FRC believe companies and audit committees need to have the right information to enable them to conduct tenders efficiently and with due regard to audit quality, and to that end it is holding a series of meetings with market participants. These will focus primarily on how to assess the quality of current and prospective auditors, and may result in the publication of guidance aimed at assisting companies with future tender processes

The Financial Reporting Lab will facilitate a project on audit committee reporting, following the changes made to the UK Corporate Governance Code in 2012. This project will hopefully enable companies to provide the information that shareholders need in order to have a properly informed discussion about the work of the committee and how it is promoting their interests. The Lab will also be bringing together companies and investors to consider risk reporting and, potentially, reporting on the business model.

The FRC will monitor the impact of the changes made to the Stewardship Code on the quality of engagement between companies and investors and the effectiveness of the investment chain. In addition, the FRC believes that further action to develop stewardship can help in four different areas.

First, it has become increasingly clear that the role of asset owners is important. By setting out some clear benchmarks for long-term shareholder expectations the Stewardship Code has given asset owners a greater ability to define the services they want and expect from their asset managers. The FRC hopes that stewardship statements will become more informative and help asset owners make a choice on mandates.

More rigour in the way mandates are awarded might help. The Kay Review's Good Practice Statement for Asset Holders calls on them to "be proactive in setting mandates for asset managers based on open dialogue about agreed investment directives." The Myners Principles on investment

decision-making by pension funds have for some time called for “clear written mandates covering scheme expectations, which include clear time horizons for performance measurement and evaluation.”

Asset owners ought to be able to demonstrate that they have made a considered decision when awarding mandates. The progress report on the Kay Review recommendations due in 2014 will provide a useful opportunity for assessing developments in this area, and the FRC will meanwhile continue to focus on mandates in its monitoring of stewardship.

Second, it is clear that the concept of stewardship needs further internationalisation. When companies have a widely dispersed ownership and a large overseas shareholder base, UK institutions acting on their own may not be able to muster a sufficient critical mass for engagement. For this reason, the FRC is broadly supportive of the Kay Review proposal for an investor forum that would, for the first time, open the door to involvement by overseas long-term holders of UK shares. It is critical, however, that any forum should be investor led, independent of political influence, command widespread support in the investor community, be strategic in its approach and seek to add value rather than replace existing arrangements where they continue to work satisfactorily. This means it should not seek to do everything. Instead it should focus high quality resource on those situations where existing arrangements may not suffice.

Third, in the light of the resource constraints discussed in the previous chapter and the need for better integration within institutions between investment decision-making and consideration of governance, the FRC continues to believe that investors should have opportunities for developing their engagement skills.The FRC is encouraged by the initiative from the CFA Society of the UK to develop training materials on governance analysis and will be watching with interest the take-up of these materials in the market

Finally, more work is needed to ensure the voting chain is reliable. One particular aspect of the voting chain which the FRC will be exploring in more depth is the ability of investors in pooled investment funds to exercise their voting rights. Pro rata voting within pooled funds was highlighted in responses from asset owners’ representative bodies and a number of individual owners to the 2012 consultation on revisions to the Stewardship Code. The FRC will hold a meeting with market participants in the first quarter of 2013 to debate this issue, and will consider whether it would be appropriate to address it in a future edition of the Code.

The issues around the voting chain are much broader, however. Because of the way in which the custody system operates, formal legal title to a share may not reside with the beneficial owner. The European Commission has been considering modifications to its Securities Law Directive, and the FRC hopes that any proposals protect the rights of both institutional and individual shareholders. The Commission’s initiative, and its proposal to revisit the issue of shareholder identification as part of the Action Plan announced in December, has the potential to improve the operation of the voting chain and the ability of companies to identify who controls them at any one time.

The Commission's Action Plan, and any actions resulting from its planned Green Paper on long-term finance, will set the agenda at European level in 2013 and beyond. The FRC will engage with the Commission, the UK Government and other stakeholders - including its opposite numbers in the European Corporate Governance Codes Network - with the aim of ensuring that this programme of activity preserves and builds on the strengths of the various different approaches at national level across the EU.