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Email: codereview@frc.org.uk

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
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Dear Chris

Financial Reporting Council –
Review of the Effectiveness of the Combined Code – Call for Evidence

IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey showed that at the end of 2007 IMA members managed holdings amounting to 44% of the domestic equity market.

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the Combined Code from the perspective of our members as institutional investors.

IMA supports good governance and the existing "comply or explain" framework in the Combined Code. It is widely accepted that the UK operates high standards and that successive codes and the operation of the "comply or explain" regime have led to a steady improvement in the stewardship of UK companies.

Thus whilst the "comply or explain" framework remains sound, it is now apparent that there were failings in banks' corporate governance and investors' scrutiny and challenge to banks' strategy. These failings did not cause the crisis nor would changes to governance have prevented it in that there are limitations as to what engagement can achieve.

Investors' main objective is to secure value for the beneficiaries/clients whose money they invest. They do this in two broad ways: by selling shares or engaging with management and boards of their investee companies and seeking, where necessary,

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to effect change. Both were used in relation to the banks in the period leading up to the crisis. But neither was effective in preventing it. In particular, a number of managers engaged with certain bank boards and began to express concerns about the bank's strategic direction, and stepped up their dialogue. It is now apparent that this did not achieve the desired results. Although shareholder approval is required for major corporate actions, investors do not set strategy and cannot micro-manage companies' affairs. Nor are they insiders, in that they only have access to information available to the market as a whole and it is now apparent that some bank boards and even management seem to have been unaware of the risks they were running.

This experience prompts an examination of the UK's governance framework in order to make it more effective – particularly at times of stress and IMA welcomes the FRC's review. There are undoubtedly lessons to be learnt and the Institutional Shareholders' Committee (ISC)[1] has developed a paper on these which contains recommendations for both investors and companies. Institutional investors themselves need to be more assertive in their dealings with companies and be more prepared to vote against company resolutions. In addition, the Combined Code could be fine tuned to facilitate the dialogue between investors and companies.

We set out in the attached our observations on the matters raised in the Call for Evidence and summarise our key points below on our proposed amendments to the Code.

- Succession planning should be emphasised more clearly and the chairman should be encouraged to report annually on the process being followed and progress made.

- Board evaluation with external input should be expected of banks given their regulated status and the public interest aspect.

- To enhance boards' accountability, certain of our members consider that the chairs of the remuneration, nomination and audit committees should stand for re-election every year. If support for any individual fell below 75 per cent (including abstentions), then the chairman of the board should be expected to stand for re-election the following year.

- The Code should be clear that chairmen are responsible for overseeing communications with investors and should inform the whole board of investors' concerns (whether expressed directly or through brokers and advisers). The whole board should ensure they understand the nature of the concerns and respond formally, as appropriate.

- Where the above does not happen, the Senior Independent Director (SID) should intervene and, if warranted by the nature and/or extent of the concerns, should take independent soundings from investors and ensure an appropriate response from the whole board.

[1] The members of the ISC are: the Association of British Insurers; the Association of Investment Companies; the National Association of Pension Funds; and the Investment Management Association.

- The audit committee's terms of reference should be expanded to include oversight of the risk appetite and control framework of the company; in complex groups where this would overload the audit committee, it may be more practical to establish a separate Risk Committee dedicated to this function.

- Although the Code already gives independent directors the right to seek expert advice, it should encourage them to do so in cases where this is necessary to their understanding. In the case of complex businesses, it may be appropriate for the company secretary's department to be resourced to support the work of the independent directors.

- The Code should clarify that the chairman's duty is to always demand a poll when he is aware that the outcome would be different from that on a show of hands.

The FRC's paper specifically asks for views on Section 2 of the Code which seeks to encourage institutional investors, mainly the fund managers, to enter into a dialogue with companies. IMA had concerns when Section 2 was first introduced in that a Code for listed companies is not the right locus for the obligations of institutional investors, and in seeking to address them, the Code is moving away from its mandate. The requirement to "comply or explain" against the Code is part of the quality brand of a London listing that UK incorporated companies with a Primary or, as it is to be termed, Premium, listing adhere to and on which their shareholders form judgements. It not clear how obligations in the Code for institutional investors would "bite" and if anyone could ensure such obligations are effected in practice. Few fund managers are listed in their own right in that they tend to be subsidiaries of banks or insurance companies, independent entities, or even partnerships.

In addition, certain of the provisions in section 2 are not always practical. For example, it imposes obligations on fund managers:

- To take steps to ensure their voting intentions are translated into practice. A fund manager will typically invest in hundreds of UK companies which together could have as many as 1,000 meetings a year. Tracing the votes at every meeting would be an enormous task and the chain votes go through can mean that it is not always possible in practice.
- To attend AGMs where appropriate and practicable. Realistically fund managers can only attend a few AGMs - the majority of meetings fall in the same few months of the year and can be at various locations throughout the UK.
- To give an explanation to the company, in writing where they do not accept the company's position, where appropriate. Fund managers will as a matter of course advise companies of these situations but requiring explanations to be in writing puts additional pressure on resources at a time when managers are busiest. Otherwise they could become standardised, undermining investors' assessments and leading to a general dumbing down of the evaluation process.

The responsibilities of investors in relation to the companies in which they invest are clearly set out in the ISC's Statement of Principles. This recommends that investors should:

- publish a policy statement on engagement;

- monitor and maintain a dialogue with companies;
- intervene where necessary;
- evaluate the impact of their policies; and
- report to clients.

This framework remains sound and is adhered to – as clearly demonstrated in the IMA's survey on engagement which benchmarks the industry's adherence to the Principles. The latest copy of the survey is at:
http://www.investmentuk.org/press/2009/20090520-2-01.pdf

We consider that the ISC should be responsible for any framework for investor engagement in that the Committee brings together the main investor bodies in the UK and thus represents the consensus thinking of the major part of the UK's investment industry. Section 2 of the Code already refers to the Statement, and we do not believe it should go further than this.

Lastly, we would point out that the crisis is not yet over and question whether it is premature to review the Combined Code at this juncture in that other matters may come to light before the economy recovers.

Please do contact me if you would like clarification on any of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall, Director, Corporate Governance and Reporting

ANNEX

IMA'S COMMENTS ON THE MATTERS ON WHICH VIEWS ARE SOUGHT

IMA's comments on the matters on which views are sought are set out below.

APPLICATION OF THE CODE

Which parts of the Code have worked well? Do they need any further reinforcement?

IMA supports the existing concept of the unitary board and the "comply or explain" framework in the Combined Code and considers it should be maintained. It is widely accepted that the UK operates high standards and that successive codes and the operation of the "comply or explain" regime have led to a steady improvement in the stewardship of UK companies.

Thus whilst the "comply or explain" framework is not broken, it is now apparent that there have been failings in corporate governance and the ability of bank boards and investors to scrutinise and challenge certain bank's strategy in the lead up to the crisis. These did not of themselves cause the crisis nor would changes to governance have prevented it – there are limitations in terms of what governance and engagement can achieve. Investors do not, nor can they, micro-mange companies, do not have insider status, and are not privy to the same information as the executive or indeed, the non-executive directors. Furthermore, in many instances it is now apparent that the boards and management of financial institutions failed to fully appreciate the risks on their balance sheets.

Nevertheless, we recognise that there are certain improvements that could be made to ensure that engagement is more effective, not just with banks but with all companies, and, whilst in general the Code works well, we set out in this response proposals to amend it to facilitate this. We have also worked on an ISC paper that will contribute to the debate and will be responding to the Walker Review.

Have any parts of the Code inadvertently reduced the effectiveness of the board?

An aspect that may have inadvertently reduced the effectiveness of the board is the need to ensure that there are sufficient non-executives. IMA supports the unitary board concept and considers it important that a board has the right balance in terms of executives and non-executives. There should be sufficient non-executives to challenge and monitor performance and strategy and address matters such as remuneration and succession where the executive directors may be conflicted. However, in certain instances the pendulum may have swung too far in terms of the number of non-executives on particular boards. It is important that there are sufficient executive directors on a board to facilitate the board's understanding of the risks the company faces and how these are managed.

In addition, we question whether the reference in the Code that implies that a director is not considered independent if he has served on the board for more than nine years is necessarily being applied in the best interests of the company. Such experience can add significantly to a director's contribution and we would not want

to discourage companies from retaining directors that have served for a long time on the basis that they are no longer considered independent.

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

We comment below on enhancements that could be made to Code in relation to the operation and role of the Board. One other aspect that we consider should be addressed is in relation to the conduct of meetings and voting. Currently under the Companies Act, a resolution voted at a company meeting is decided on a show of hands unless a poll (a ballot of one vote per share) is called. Common law clarified the chairman's duty to: "ascertain the true sense of the meeting"[2]. Where the chairman as proxy is aware that if a poll was called the outcome would be different from that reached on a show of hands, and then he has a duty to demand a poll, if able to do so under the company's articles of association.

We are aware that there have been difficulties with this in the past, particularly in relation to non-binding votes, and believe it important that this is clarified and that the current review is an opportunity to do this. At the minimum, it should be clear that the chairman's duty is always to demand a poll when he is aware that the outcome would be different from that reached on a show of hands, regardless of whether the vote is binding on the company. Furthermore, it should be considered whether there should be a provision that it is best practice for all resolutions to be voted on a poll in that:

- voting is more exact and equitable in that one vote per share is counted – on a show of hands each shareholder has one vote and it is possible for a group of shareholders owning in aggregate a very small proportion of a company's outstanding capital to influence the outcome;
- voting is more transparent;
- overseas shareholders would be more inclined to vote UK shares as currently some are discouraged by the belief that the result is in most cases determined by a show of hands taken at the meeting; and
- although a show of hands is believed to involve or "enfranchise" the private shareholder, the majority cannot and do not attend the meeting, for reasons of geography or timing, but they do complete proxy cards which they may reasonably expect to be counted.

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

IMA considers that the "comply or explain" mechanism generally works well. However, its operation could be improved if the usefulness of companies' disclosures were more meaningful. Meaningful disclosures facilitate engagement, reduce the amount of time and resources required of investors and companies, and lessen the perception of a "comply or else" approach as investors cast fewer votes against

[2] Second Consolidated Trust Ltd v Ceylon Amalgamated Tea & Rubber Estates Ltd 1942, 2.E.R.567

management and fewer conscious abstentions. In this context, certain of our members have commented that:

- there can be a reticence for certain companies to "explain" non-compliance with the Code leading them to comply when this may not be in the best interests of the company;
- disclosures and explanations are increasingly becoming standardised and of limited use; and
- not all companies provide adequate explanations for non-compliance and some consider any explanation will suffice.

Our comments on engagement are set out in the covering letter.

CONTENT

The FRC is inviting views on any aspects of the Code, but in particular on the provisions highlighted below.

The composition and effectiveness of boards

As noted, IMA supports the existing concept of the unitary board but it can only be effective if the individual members have the right skills, conduct themselves with integrity and exercise sound judgment. This is difficult, if not impossible, to ensure through a Code other than through selection procedures and evaluation.

Presently, investors are not routinely involved in the selection of directors and are rarely consulted by the Nominations Committee – unlike remuneration issues where, since investors were given an advisory vote on the remuneration report, they have been regularly consulted. In the future, investors may want to be more proactive in the selection of non-executives. In this context, we consider that the Combined Code should emphasise succession planning more clearly, through a provision that encourages the chairman to report annually on the process followed and progress made.

We support the Code's provisions on a Board's performance evaluation. However in relation to banks, we consider that it should go further in that external input should be expected given their regulated status and the public interest aspect.

In addition, as noted in the covering letter, investors need to be more robust in their dealings with boards and when they are not satisfied with the company's response, they should be more willing to vote against the re-election of directors. Clearly dialogue with companies would be more effective if companies recognised that this was a risk and if the accountability of the board was enhanced.

Currently, in accordance with the Code, directors have to stand for re-election every three years. Certain of our members consider that the accountability of the board and the contribution of individual directors could be enhanced if the chairs of all the main committees (remuneration, nomination and audit) stood for re-election every year. If support for any individual fell below 75 per cent (including abstentions), then the chairman of the board should be expected to stand for re-election the following year. This would be a powerful incentive to resolve concerns during the intervening period.

The respective roles of the chairman, executives, non-executives, particularly the senior independent director

Both the chairman and the non-executives have a vital role as the first line of defence in ensuring that a company is run properly and protecting the interests of investors. It is important that investors have an effective means of communicating with them, and vice versa. We are supportive of initiatives that seek to enhance this, but would not favour a formal, separate dialogue.

The chairman is responsible for running the board and ultimately overseeing communications with investors. It is important that he is an independent, non-executive and we strongly support the separation the roles of the chairman and chief executive. In this respect, we are aware there have been instances when the role of the chair was weakened in that he/she became too closely associated with the management and there need to be safeguards to address this. We consider the Code should be amended so that:

- Chairmen are responsible for overseeing communications with investors and are encouraged to inform the whole board of investors' concerns (whether expressed directly or through brokers and advisers); and
- where this does not happen the Senior Independent Director (SID) intervenes and, if warranted by the nature and/or extent of the concerns, is encouraged to take independent soundings from investors and ensure an appropriate response from the whole board.

Moreover, the recent experience with banks has persuaded a number of investors of the merits of banks being chaired by those with relevant banking experience, although they should not come from line management. In addition, whilst we support the fact that non-executives should bring experience from other boards on which they serve – provided that they have sufficient time to devote to each one - the complexity of large banking groups has led a number to recognise that the role of chairing the board of such a group should be full time.

The board's role in relation to risk management

The financial crisis has served to highlight the importance of effective risk management to the business model and business strategy. The Combined Code and the Turnbull guidance, supported by the Business Review provisions in the Companies Act 2006, already seek to address risk issues. However, there are concerns that the demands placed on the audit committee can be great particularly for large complex groups such that insufficient time may be dedicated to the function at board level. We consider that the audit committee's terms of reference should be expanded to include oversight of the risk appetite and control framework of the company; in complex groups where this would overload the audit committee, it may be more practical to establish a separate Risk Committee dedicated to this function.

The role of the remuneration committee

We believe there is widespread agreement on the need to reform of remuneration structures in banking institutions and there are a number of moves afoot to address them – both by the FSA and European Commission. In this context, one size does

not fit all. We can see the need for more prescription with banking institutions where perverse incentives that encouraged excessive risk taking may have contributed to the financial crisis. But the same systemic issues do not apply to other types of financial institutions which played no part in the present crisis, and where the business model is very different to the banking sector. In banks, client funds are held on the balance sheet and used in the business. We consider that there needs to be more transparency about the remuneration culture in a banking institution, say within the business review; remuneration policies should be discussed at board level, and the whole board should take responsibility for them. Where in relation to individual board members independence is an issue, the remuneration committee should continue to decide.

Currently, in the UK investors can only engage with remuneration issues at board level and even then only have a non-binding advisory vote on the remuneration report In the event the above suggestion that there should be an annual re-election of the chairs of all committees is not adopted, IMA considers that companies would be more willing to address investors' concerns on remuneration if the Code required that when there is a significant vote against the remuneration report, then the chair of the remuneration committee should stand for re-election in the subsequent year.

The quality of support and information available to the board and its committees.

There have been suggestions that there is a need for improved training for non-executives which culminates in some sort of official qualification which in due course could become mandatory for all non-executives and be removed in the event of dereliction of duty. The merits of an officially sponsored institute responsible both for setting standards and for providing support for the work of non-executives have also been raised. Such an institute would enable the Government to have input into setting the necessary standards. In this context, the Institute of Directors already has a Chartered Director qualification that IMA has in principle supported in the past. However, although there are 700 qualified Chartered Directors, these tend to be directors of smaller companies and it is not clear how the standards are supervised and failures to adhere to those standards disciplined.

In the context of the Code, it already gives independent directors the right to seek expert advice. IMA considers it should encourage them to do so in cases where this is necessary to their understanding. In the case of complex businesses, it may be appropriate for the company secretary's department to be resourced to support the work of independent directors.

The content and effectiveness of Section 2 of the Code, which is addressed to institutional shareholders.

Our comments on section 2 are set out in the covering letter.