

7 October 2009

Sir David Walker  
HM Treasury  
1 Horse Guards Road  
London SW1A 2HQ

Dear Sir David

**The Walker Review – A Review of Corporate Governance in UK Banks and Other Financial Institutions**

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 2008, IMA members managed holdings amounting to 43% 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, our members have an interest in the Walker Review on corporate governance in the UK financial services sector both as financial institutions in their own right and as institutional investors in companies.

It is widely accepted that the UK operates high standards of governance 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. However, it is now apparent that in the run up to the crisis there were failings in banks’ governance and investors’ scrutiny and challenge. These were largely failures in execution rather than of the current regulations and guidelines. These did not cause the crisis, nor would changes to governance have prevented it, but the experience prompts an examination of the framework to make it more effective – particularly at times of stress.

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Registered number 4343737. Registered office as above.

Thus IMA supports Sir David's Review and many of the Recommendations in the report. We believe that the existing framework of "comply or explain" in the Combined Code remains sound and welcome the Review stating at the outset that "the Combined Code remains fit for purpose"<sup>1</sup> and ruling out legislative proposals and a move to a rules based-approach.

There are, however, certain Recommendations that concern us. The proposals in Chapter 5 on the role of institutional shareholders do not take into account the fact that fund managers are fiduciaries acting on behalf of clients or the impact they proposals could have on the competitiveness of the UK market. There are other proposals that could be fine tuned to facilitate the dialogue between fund managers and companies. We also consider further thought is needed on the scope of the Review and its implementation.

We set out below our main concerns/observations and in the attached annex our comments on each of the Recommendations.

### ***The role of institutional shareholders***

Institutional investors are the owners of capital and over recent years, their role in holding the management of companies in which they invest to account has grown. In 2002, investors gave new impetus to engagement and issued new principles (the Statement of Principles)<sup>2</sup> drawn up by the Institutional Shareholders' Committee (ISC<sup>3</sup>), whose members, including IMA, represent virtually all UK institutional investors. This was the first comprehensive statement of best practice governing the responsibilities of institutional investors in relation to the companies in which they invest, on behalf of the ultimate owners.

IMA has benchmarked the industry's adherence to the Statement of Principles through regular surveys which have clearly demonstrated that engagement activity has evolved and become more transparent since the survey was started in 2003. The latest survey to 30 June 2008 shows that 32 fund managers representing 68% of UK equities under management actively engage, vote their UK shares, and increasingly publish their votes<sup>4</sup>.

Nevertheless, institutional investors recognise that in the run up to the crisis there were failings in their scrutiny and challenge to banks' strategy and excesses, and that in the future they need to address this. The industry took the first steps to do so in the ISC paper, Improving Institutional Investors' Role in Governance (the ISC Paper)<sup>5</sup>, issued in June, which had recommendations for both investors and all listed companies, not just banks and financial institutions. The ISC Paper states that investors need to be more prepared to vote against company resolutions and establish a mechanism whereby they can engage collectively when there are failings

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<sup>1</sup> Page 4.

<sup>2</sup> <http://www.investmentuk.org/press/2002/20021021.asp>

<sup>3</sup> 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.

<sup>4</sup> <http://www.investmentuk.org/press/2009/20090520-2-01.pdf>

<sup>5</sup> [http://www.investmentuk.org/news/research/2009/topic/corporate\\_governance/ISCpaperonimprovinginstitutionalinvestorsroleingovernance.pdf](http://www.investmentuk.org/news/research/2009/topic/corporate_governance/ISCpaperonimprovinginstitutionalinvestorsroleingovernance.pdf)

to ensure their message is heard. The ISC is reviewing the Statement of Principles, is designating it as a Code and intends publishing a list of signatories who sign up to it to enable beneficiaries/clients make informed choices when issuing mandates to fund managers.

In this context, fund managers are fiduciaries acting on behalf of their clients. They offer their clients a choice and take a range of approaches to managing money. Some believe that actively engaging with investee companies will achieve better returns. Others believe the best way to send a signal to a badly managed company and maximise returns for their clients is to sell their holding. Some make details of their engagement public on web sites, whereas others only report to their clients on whose behalf they act. How a fund manager manages its clients' money is between it and its clients.

Recommendation 20 that the FSA should encourage fund managers' commitment to the Principles of Stewardship "as a matter of best practice" and require clear disclosure on a "comply or explain basis" fails in our view to take this into account. We do not consider that one particular investment style can be considered best practice relative to another. Nor is this something that the FSA could or should become involved with, as it has no bearing on its statutory objectives. It is the clients that set the fund managers' mandates. Recommendation 19, which proposes that managers "should confirm their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity<sup>6</sup>", gets this the wrong way round.

Recommendation 19 also advocates public disclosure of managers' commitment to engagement with the intention of changing behaviour. We consider this a departure from basic legal tenets that people with rights are free to exercise them, or not, as they wish. As demonstrated in the IMA engagement survey, each of the 32 managers have a policy statement on their engagement in accordance with the ISC Statement of Principles which in 28 instances is on their websites, with the remainder making a statement available to clients or on request. Those that engage are already adhering to this Recommendation.

In terms of performance, the Review draws a contrast between what it perceives to be inconsistent outcomes in active management and the likelihood that long-term returns will be improved for all beneficiaries "by some form of governance, engagement or stewardship activity<sup>7</sup>". The relationship between active engagement and portfolio performance has been the subject of extensive academic and other research. The question is not confined to shares and extends to fixed income securities. Research looks at engagement from both a relatively narrow perspective (the impact of returns-driven investor behaviour) and wider environmental, social and governance criteria. This at best has been inconclusive<sup>8</sup>.

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<sup>6</sup> Recommendation 19

<sup>7</sup> Paragraph 5.7.

<sup>8</sup> This is perhaps not surprising given the methodological challenges in capturing the specific drivers of individual company performance over the long term (defined here as 3-5 years). At best, there is little evidence of adverse impact. For a fairly recent general study, see UNEP FI and Mercer (2007), 'Demystifying Responsible Investment Performance: A review of key academic and broker research on ESG Factors' [http://www.unepfi.org/fileadmin/documents/Demystifying Responsible Investment Performance 01.pdf](http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf).

In preparing this response, IMA sought to compare returns on UK authorised funds investing in UK equities, both on an absolute and a risk-adjusted basis, measured against an (admittedly subjective) classification of managers by the level of their engagement activity. Again this found no systematic link, giving us no reason to challenge the research consensus. We would be happy to provide you with further details on this should you wish.

There are limitations in what shareholder oversight can achieve. Fund managers are restricted in terms of the information that is made available to them. They do not have insider status and are not privy to the same information as the executive or indeed the non-executive directors. In many instances, it is now apparent that the boards and management of financial institutions failed to appreciate fully the risks on their balance sheets, thus, fund managers could not have been expected to either; this was not a problem which could have been avoided by better engagement. It is not unreasonable for fund managers to take in good faith assurances and information from management.

UK fund managers typically have relatively small holdings, particularly in larger companies. Indeed, as noted our opening paragraph, the UK fund management industry only accounts for 43 per cent of all UK equities. However, particularly given the lower propensity for non-UK shareholders to vote at general meetings, a manageable group of UK shareholders could together constitute a significant proportion of those voting on any poll. Hence, the ISC Paper recommends that there should be more collective engagement.

There are, however, concerns that acting collectively with like-minded investors to bring pressure to bear on management could trigger issues of insider trading, changes of control, and industry collusion and “the concert party” rules. The ISC Paper states “it is important that there are no regulatory impediments, real or imagined, to the development of collective dialogue”. The FSA has issued guidance and the Takeover Panel a Practice Statement to help allay these concerns and facilitate engagement. However, we understand that one major law firm has written to the Review team with concerns that the FSA guidance does not go far enough. A number of our members have confirmed that they still have concerns and that the guidance and Practice Statement will not necessarily change behaviour in that uncertainty still remains.

In summary, we believe good governance should help ensure a sustainable and stable financial system and recognise that investors have an important role to play in this and need to be more effective in the future. But investors do not run companies; they do not set strategy nor are they insiders, in that they only have access to information that is available to the market as a whole. Managers compensate for such information asymmetries by diversifying their portfolio construction. Even among those of our members who are committed to engagement, many are concerned that in their current form, the Recommendations fail to recognise adequately the over-riding right of the clients/beneficiaries to choose otherwise.

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See also the study by Stuart Gillian and Laura Starks, which examines the evidence of the impact in on both the shorter and longer term (*The Evolution of Shareholder Activism in the United States*, *Journal of Applied Corporate Finance* 19/1 (2007), 55-73)

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=959670&rec=1&srcabs=948907](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=959670&rec=1&srcabs=948907)

Lastly, if the UK fund management industry is going to be required to behave in a way that neither the client nor the manager is convinced is in the best interests of the beneficial owner, then the clients will seek fund management services overseas and the UK's fund management industry will follow.

### ***Proposals for boards***

Whilst we do not consider that Government or the FSA should mandate the best way for fund managers to manage their clients' money, we recognise that there were failings in managers' engagement and the industry needs to and is taking steps to improve it. In this context, we consider that certain of the Recommendations could be enhanced to facilitate the dialogue between fund managers and companies in that:

- the chairman should retain overall responsibility for communication with shareholders and/or their agents, and should inform the whole board of concerns expressed (Recommendation 9);
- the SID should be more proactive and not only be accessible to shareholders if communication with the chair becomes difficult, but, if warranted, should take independent soundings from investors and ensure an appropriate response from the whole board (Recommendation 11);
- the proposals on performance evaluation should be strengthened in that this is one of the key means whereby investors are assured as to the effective operation of the board on an ongoing basis (Recommendation 12); and
- the whole board should be aware of investors' concerns and should be responsible for the response, and the chairman and NEDs should be encouraged periodically to attend road shows with the portfolio managers (Recommendation 13).

To ensure that the dialogue is effective, boards themselves also need to challenge and have independent thought. IMA welcomes the fact that the Review does not propose any changes to the concept of the unitary board and we believe that many of proposals will help improve the operation of boards. However, we are concerned that certain of the Recommendations could shrink the pool of suitable candidates:

- requiring non-executives to spend at least 30 to 36 days is too inflexible, could be too onerous and would eliminate the possibility of an executive of a major company becoming a NED at another (Recommendation 3);
- although not a specific recommendation, potentially increasing the regulatory burden on NEDs (Recommendation 4); and
- requiring the chairman to stand for annual re-election which could also potentially destabilise boards (Recommendation 10).

### ***Differential voting rights***

Although not specifically mentioned in the consultation paper, the Sunday Times in July reported Sir David as suggesting that differential voting rights should be considered as a means of improving and better incentivising engagement<sup>9</sup>. This has

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[http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article6719065.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6719065.ece)

also been promoted in a European context as a way of restricting the activities of activist hedge funds.

Shares with different rights for different shareholders have been a feature of the French Code of Commerce for some time. Under articles L225-123, double voting rights can be granted to any shareholder. However, the cross-border intermediary systems across Europe make the necessary segregation and re-registration of holdings a long and complex process. Thus whilst there are no restrictions on the nationality of the shareholders concerned, in practice, the majority that benefit tend to be domestic and typically differential rights are perceived as granting additional influence to 'friendly' investors such as family groups, industrial investors and other core shareholders.

Over the last twenty years the UK has actively moved away from differential voting rights, and has sought to reinforce its traditional support for one share one vote. The Government has always supported this. Deeming one shareholder to be better than another for whatever reason is seen as reducing the value of voting rights and weaken the case for exercising those rights. There is also the question of who determines the rights. In all probability this would fall to the issuing company, for example, requiring that shares are properly registered etc. There is a risk that in practice differential rights would operate as a mechanism for companies to favour shareholders who support their strategy and entrench management.

Finally, there are significant practical issues around differential voting rights. Some investors (for example, index funds) are by definition long term but on their initial investment would be treated as short term. Nor is it clear why an active investor when it first makes a considered decision – which could be the outcome of prolonged analysis and research – to take a position in a company should be disadvantaged; this would almost certainly create market distortion. Also it is unclear how an increase (or reduction) in an existing holding would be treated; if an existing long term holder was able to get the same treatment for new purchases, it would be very easy for any investor to secure better rights by taking very small holdings in many companies.

For these reasons we would urge that this is not pursued.

### ***Implementation***

One important issue that is left largely unanswered is how the proposals are to be implemented - the Review states that "except in a few cases where responsibility for a proposed initiative is for the FSA, it is envisaged that most of the Recommendations will be incorporated as provisions and guidance in the Combined Code<sup>10</sup>".

It is part of the quality brand of a London listing that UK incorporated companies with a Premium listing adhere to the "comply or explain" approach in the Code. The majority of the banking institutions that have been casualties of the crisis were listed entities subject to this requirement: Royal Bank of Scotland; HBOS; Northern Rock; and Bradford & Bingley. However, there are others that are outside its scope, for example, the London and Dunfermline and West Bromwich Building Societies were mutuals and Heritable and Kaupthing Singer and Friedlander were UK subsidiaries of

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<sup>10</sup> Page 10

two Icelandic banks. The steps the Government took in relation to a number of such institutions has shown that they are “too big too fail” and, as such, they are underpinned by the tax payer.

Thus systemic issues arise with unlisted as well as listed institutions and both require a distinctive approach as to how they are regulated and their governance. To ensure that all such institutions are addressed, we consider those Recommendations that address systemic issues, such as those on the governance of risk, Recommendations 23 to 27, and remuneration, Recommendations 28 to 39 should be implemented by way of FSA guidance rather than amendments to the Combined Code. However, it is important the FSA is flexible in its approach and recognises that guidance is not rules as such and, as for the Combined Code, operates under a “comply or explain” regime tailored to a particular institution’s circumstances. The better regulation principles of proportionality and targeting should apply so that such requirements are only applicable to those institutions that present a systemic risk.

There are other of the Recommendations, however, that we believe would benefit all listed companies and which should be implemented in the Combined Code. Our detailed observations on these are set out in the Annex and in summary they are:

- improved training for chairmen and NEDs (Recommendations 1 and 2);
- clarification of the roles of the chairman, NEDs and SID (Recommendations 6, 9 and 11);
- although we do not support Recommendation 10 on the annual re-election of the chairman, boards should be made more accountable and the contribution of individual directors enhanced and the annual re-election of the chairs of the main committees has the general consensus of the industry; and
- improved board evaluation procedures and more informative disclosures on the process followed (Recommendations 12 and 13).

### **Scope**

“The focus of the review is on the governance of BOFIs that are systemically significant in the sense that they are much more leveraged and thus potentially more vulnerable than non-financial business<sup>11</sup>”.

Examples of BOFIs within the Review’s scope are set out in Annex 4. In this context, the original terms of reference for the Review related to governance in the UK’s banking industry. On 21 April these were extended so that the Review would identify where its recommendations were applicable to other financial institutions.

Undoubtedly, the crisis has shown that large banks and certain other large financial institutions give rise to certain systemic issues that necessitate measures to improve their governance. However, we do not consider it necessary or that the case has been made to include other types of financial institutions within the scope of the Review. Certain smaller listed financial institutions do not give rise to particular systemic issues and yet could struggle to implement a number of the proposals. In addition, the fund management industry’s business model is very different to that in the banking sector: a fund manager’s clients’ money and assets are segregated from those of the firms, and the manager’s activities do not put their security at risk. In a

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<sup>11</sup> Page 20

bank, on the other hand, client funds are held on the balance sheet and are used in the business. For this reason, we consider that the same systemic concerns do not apply to fund management firms.

The Review should not seek to adopt a "one size fits all" approach to its Recommendations and should recognise the differences in the underlying systemic risks that particular financial institutions pose in any package of reforms. This is particularly the case for the Recommendations on remuneration and the governance of risk. In the case of the former, FSA recently published its Policy Statement on the application of its Remuneration Code to large banks and broker-dealers. The list of institutions caught by that Policy Statement is different to the list of BOFIs in Annex 4. Arguably, the two should be consistent for the purposes of this section of the Review. We understand in October FSA intends publishing its proposals for the broader financial services industry. FSA's earlier papers have acknowledged that there is not the same systemic risk relating to remuneration practices in the wider industry; we hope that the October paper will reflect this.

In conclusion, if the Review adopts a "one size fits all", it could result in the UK becoming anticompetitive for a number of sectors in the financial services industry, drive them to relocate away from the UK and have an adverse impact on the UK economy.

Finally, there are a number of national and international bodies examining various aspects of governance, and it is vital that any response is co-ordinated to avoid confusion and opportunities for regulatory arbitrage.

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

A handwritten signature in black ink, appearing to read 'Liz Murrall', with a long horizontal flourish extending to the right.

Liz Murrall, Director, Corporate Governance and Reporting

## IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS

Our specific comments on each of the Recommendations in the Review are set out below.

### BOARD SIZE, COMPOSITION AND QUALIFICATION

#### **Recommendation 1**

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

IMA supports improved training for NEDs and welcomes this recommendation. However, it should be clear that this should extend to the chairman in that, in accordance with the Combined Code, a chairman is only considered independent on appointment<sup>12</sup>.

We also consider that there would be some merit in having a register of suitable, in some way qualified, non-executives, with a structure of on-going training and even an Institute of Non-executives and a charter mark. In this respect, the IOD already has a Chartered Director qualification that IMA has supported.

#### **Recommendation 2**

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

IMA agrees that there should be dedicated support for NEDs. This should also extend to the chair.

#### **Recommendation 3**

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

The banking crisis has highlighted the need for a pool of talented and experienced NEDs to perform a more effective oversight role. It is important that BOFIs have high quality NEDs committed to ensuring that their businesses are run effectively. Many consider NEDs should have fewer posts and be more involved in the companies on whose boards they sit.

IMA agrees that the quality of NEDs' oversight would be enhanced if they devoted more time to their role. However, requiring NEDs to spend at least 30 to 36 days a year in their role is too inflexible and could be too onerous - particularly in the context of the broad span of firms that are considered BOFIs in Annex 4. What is important is that boards have the right skills – better to have a few days of someone who makes a valuable contribution than a month of someone who adds very little. Also requiring such a high commitment would eliminate the possibility of an

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<sup>12</sup> Code Provision A.2.2

**IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS**

executive of a major company becoming a NED at another and further reduce the pool of available talent.

In summary, as stated by Peter Chambers, Chief Executive of Legal & General Investment Management, at the Treasury Select Committee on 27 January 2009 "non-execs should hold fewer posts and be more involved in the companies on whose boards they sit"<sup>13</sup>, but we consider requiring a such a commitment is too inflexible and could be too onerous.

**Recommendation 4**

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

IMA agrees with the proposal to "raise the bar in respect of overall board capability"<sup>14</sup> and that, where a BOFI gives rise to systemic risks, the FSA's supervisory process should consider these matters. In many instances, the FSA is already doing this. However, we do not believe that this should be extended to financial institutions that do not give rise to systemic issues – see covering letter.

Also, although not a specific recommendation, we are concerned that a more rigorous approach to FSA enforcement, as proposed in the FSA's consultation paper, CP08/25, The Approved Persons Regime: Significant Influence Function Review, together with a widening of the approved persons' regime, could deter able and experienced people from coming forward as NEDs<sup>15</sup>.

Both non-executive and executive directors of UK listed companies are subject to the "comply or explain" approach of the Combined Code; and the Companies Act 2006 codified directors' duties, and introduced a new claims procedure which potentially exposes directors to an increased risk of litigation. Further increasing the regulatory burden on NEDs may only decrease the pool of people willing to consider such a role.

**Recommendation 5**

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

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<sup>13</sup> The Combined Code requires that "the letter of appointment [of non-executive directors] should set out the expected time commitment. Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and the board should be informed of subsequent changes".

<sup>14</sup> Paragraph 3.20.

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<http://www.investmentuk.org/news/research/2009/recipient/fsa/imaresponsetofsacp0825dated300309.pdf>

## IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS

In principle, IMA supports the FSA interviewing NEDs. However, resourcing has often been an issue for the FSA and we question whether it will have the capacity to make such a process effective.

### FUNCTIONING OF THE BOARD AND EVALUATION OF PERFORMANCE

#### **Recommendation 6**

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

IMA supports the unitary board and welcomes the Review not proposing changes to this concept. It is now apparent that in the build up to the financial crisis within certain boards independent thought and an ability to challenge were missing. Moreover, certain bank's boards were dominated by the Chief Executive resulting in ineffective oversight by the NEDs and the concerns of shareholders being ignored.

We thus welcome the proposals to address these weaknesses and ensure that risks are properly managed and that the board's accountability is enhanced. However, we question how such behaviour can be ensured. Whilst including this recommendation in the NED's "letter of appointment and serve as guidance in the FSA (controlled function) authorisation process<sup>16</sup>", this is no guarantee that there will be such challenge on an ongoing basis. In this context, we do not consider that Recommendation 12 on external performance evaluation goes far enough.

#### **Recommendation 7**

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

IMA agrees that the chairman should commit a substantial proportion of time, not less than two-thirds, to the business of the BOFI which, if needed, should have priority over other business commitments. As for Recommendation 4, this could be addressed as part of the FSA's supervisory regime. Indeed, due the complexity of large banking groups, certain of our members consider that the role of chairing the board of a BOFI should be full time.

We also appreciate, as the Review acknowledges, that an increased commitment for the chair should be recognised in the fees received and consider this is relevant for all NEDs not just the chair.

#### **Recommendation 8**

*The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable, the board should give particular weight to convincing leadership*

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<sup>16</sup> Paragraph 4.11.

**IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS**

*experience since financial industry experience without established leadership skills is unlikely to suffice.*

IMA agrees that the chair of a BOFI should bring a combination of relevant financial industry experience and a track record of successful leadership and that this could be addressed as part of the FSA's supervisory regime. Although particular weight should be given to the latter, we do believe some industry experience is important and that the chair's expertise should be kept up to date such that, as for the NEDs in Recommendations 1 and 2; he/she should receive training and support.

**Recommendation 9**

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

On occasion investors are concerned that the matters they raise with the chairman are not reported to or discussed with the full board. Thus, whilst we agree that the chair should be responsible for the leadership of the board, as set out in the ISC Paper, we consider that the recommendation should clarify that chairmen retain overall responsibility for communication with shareholders and/or their agents, and are encouraged, through amendment to the Code, to inform the whole board of concerns expressed (whether directly or through brokers and advisers). In addition, both the chairman and the rest of the board should ensure that they understand the nature of the concerns and respond if appropriate.

**Recommendation 10**

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

Currently, in accordance with the Combined Code, directors have to stand for re-election every three years. IMA agrees that boards should be more accountable and, as set out in the ISC Paper, when investors are not satisfied with the company's response, they should be more willing to vote against the re-election of directors than they have been in the past. Clearly dialogue with companies would be more effective if companies recognised that this was a risk.

But we do not consider that proposing the chairman for re-election on an annual basis would achieve this in that it is somewhat of a "nuclear option" and may potentially only serve to destabilize boards and further limit the pool of talented individuals available. It is also inconsistent with the concept of the unitary board in that the board as a whole should be accountable.

A means of making boards more accountable that has the general consensus of the industry is set out in the ISC Paper. This proposes that the chairs of leading committees should "stand for re-election each year. If support for any individual fell below 75 per cent (including abstentions), 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".

## IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS

In this context, we do not consider the Review has made a clear case as to why a different approach should be taken on re-election of BOFI boards and we believe that such a requirement should be introduced for all listed company boards through an amendment to the Combined Code.

### **Recommendation 11**

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

IMA agrees with the recommendation on the role of the SID, except we do not consider he/she should act as an intermediary for the NEDs as to do so would call into question the unitary board structure. In addition, the SID should be more proactive and not only be accessible to shareholders if communication with the chair becomes difficult, but, as set out in the ISC Paper, 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.

### **Recommendation 12**

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

IMA supports the board undertaking a formal and rigorous evaluation. However, the recommendation does not go far enough in that this is one of the key means whereby investors can obtain some assurance as to the effective operation of the board on an ongoing basis. We consider:

- external input should be expected of BOFIs every year given their regulated status and the public interest aspect and not every second and third year as is proposed;
- the results should be discussed by the NEDs together and that, depending on the results of the review, changing board representation should be considered as part of that process.; and
- where there is external facilitation, there should **not** be any other business relationship that could give rise to a conflict of interest.

### **Recommendation 13**

*The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.*

**IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS**

In general IMA supports this recommendation but we are concerned that in indicating "the nature and extent of communication by the chairman with the major shareholders", the recommendation envisages a separate dialogue with the chairman. As part of the operation of the unitary board, the whole board should be aware of investors' concerns and should be responsible for the response and not just the chairman. Moreover, although such disclosures are helpful in highlighting the importance of such communications, they are likely to become boilerplate and formulaic. In the event that they are not, then they could well have the effect of dumbing down the engagement process.

In this context, most company meetings with institutional investors will be on issues about company strategy/performance and not longer-term stewardship and in the main are attended by portfolio managers and research analysts. Fund managers often, however, employ governance experts, with voting and other agencies to assist, and in some cases these individuals may have different lines of communication with companies, for example, via the Company Secretary or NEDs. As a matter of best practice, fund managers seek to ensure that different messages do not pass along these different channels of communication, however, we consider that this would be helped if the chairman and NEDs were encouraged periodically to attend road shows with the portfolio managers.

**THE ROLE OF INSTITUTIONAL SHAREHOLDERS: COMMUNICATION AND ENGAGEMENT*****Recommendation 14***

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

There are two broad ways by which shareholders exercise discipline over the companies in which they invest: by engaging with management and boards or selling shares. Market signals should have a restraining effect and IMA agrees that it would be helpful if BOFI boards were aware of any material changes in the share register, understood the reasons and, if necessary, took steps to respond. However, there may need to be better clarity around what is meant by "material" so that changes as a result of, for example, ordinary trading, following quantitative models, the operation of stop loss provisions, are not caught.

We appreciate the Review acknowledging the importance of the corporate broker in keeping the CEO, CFO or Chairman aware of any changes in investor attitudes<sup>17</sup>. However, we are concerned that negative investor feedback does not always reach the whole Board and consider it should be made available to all directors rather than selected individuals. In addition, where possible, feedback should be sought from short sellers.

***Recommendation 15***

*In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board an indication of whether and how it proposes to respond.*

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<sup>17</sup> Paragraphs 5.32 and 5.33.

**IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS**

Whilst IMA supports the principle behind this recommendation, the FSA should be aware that many of our members will be sensitive about releasing information that could give insight into their trading intentions. They are, therefore, unlikely to be particularly informative until trading is completed which could take weeks and even months.

We also consider that the proposal could have unintended consequences. For example, if a shareholder sold a major stake, alerting the regulator to respond, then it is likely that the share price could plummet at which instance the shareholder could buy back its shares at a more favourable price. Moreover, for every shareholder that sells there is one that buys and we believe the FSA should consider contacting those shareholders that purchase the shares concerned as well.

**Recommendation 16**

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

IMA had concerns when requirements which seek to encourage institutional investors to enter into a dialogue with companies were first introduced into a Code for listed companies. 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 Premium listing adhere to. We did not consider that this was the right locus for the obligations of institutional investors, and in seeking to address them, the Code was not keeping within its mandate. We thus welcome the content of the Combined Code being separated from the Principles for Stewardship.

We agree that the FRC's remit should be extended to cover the Principles for Stewardship, but it should not mandate adherence to the Principles as a matter of best practice. To do so is to endorse one investment style over another and does not take account of the fact that managers are fiduciaries acting on behalf of their clients – see also comments under Recommendation 19.

**Recommendation 17**

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

We agree that the Statement of Principles should become the core of the Principles for Stewardship. The Statement was developed by the ISC which 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. The framework in the Statement remains sound and is adhered to. IMA has benchmarked the industry's adherence to the Statement of Principles through regular surveys which have clearly demonstrated that engagement activity has evolved and become more transparent since the survey was started in 2003. The latest survey to 30 June 2008 shows that 32 fund

**IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS**

managers representing 68% of UK equities under management actively engage, vote their UK shares, and increasingly publish their votes.

**Recommendation 18**

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

IMA is a member of the ISC and agrees that the Principles should be reviewed on an annual basis. We consider that the ISC should be responsible for any changes to the Principles to ensure they remain effective.

**Recommendation 19**

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

Our comments on Recommendation 19 are set out in the covering letter.

**Recommendation 20**

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

Our comments on Recommendation 20 are set out in the covering letter.

**Recommendation 21**

*To facilitate effective collective engagement, a Memorandum of Understanding should be prepared, initially among major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate to the Memorandum of Understanding on collective engagement.*

We support the objective of improved cooperation between shareholders; the ISC Paper refers to the need to enhance the ability of institutional investors to cooperate together so that there is a critical mass of involvement.

However, we do not consider that a Memorandum of Understanding would help "establish a flexible and informal but agreed approach" to collective engagement in that it could be overly-bureaucratic, and not reflect the way institutional investors

## IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS

operate and communicate with companies. Our members are concerned that the existence of a standing executive would diminish the influence of individual investors when engaging bilaterally with investee companies. Whilst they have no objection to the creation of a mechanism which facilitates discussion between investors, they would be concerned if this discussion led to direct engagement, in that engagement should be carried out by the shareholders concerned, either jointly or individually, and not under the umbrella of a separate body or organisation.

Furthermore, such a Memorandum could potentially restrict active managers being able to dispose of their shares due to trading restrictions as a consequence of obtaining price sensitive information. In a competitive market, active investors and clients should be free to be able to choose an investment approach best for their clients.

### **Recommendation 22**

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

IMA supports transparency and investors disclosing to clients how they have voted. The Statement of Principles recommends they do this and helps ensure that disclosures are meaningful. The ISC also developed a voluntary framework which set out best practice on voting disclosure. This aimed to encourage firms to disclose and where they decide not to, states that they should explain their reasons for not doing so – a “comply or explain” approach. However, we are strongly against this recommendation and disclosure being mandatory or that it should be to the public for the reasons set out below.

- *The industry's voluntary guidelines are working and an increasing number of managers are making their voting records public.* IMA did not believe that legislation in this area was necessary at the time a reserve power was introduced into the Companies Act 2006 to enable HM Treasury to make Regulations to require institutional investors to disclose how they have voted<sup>18</sup>. We are committed to ensuring that the voluntary approach delivers and IMA's engagement survey has confirmed this is the case in that firms increasingly put details of their voting on their websites and make them public. As at 30 June 2008, 24 firms put details on how they had voted on their website, compare to 15 as at 30 June 2006; 10 in 2005; and seven in 2004. One discloses its policy on disclosure.
- *A "one-size-fits-all" requirement would undermine progress.* As well as looking at the number of managers that disclose, the survey analysed voting details published on web-sites. This showed a wide variation in the matters reported, indicating the complexity of this matter and the difficulty of introducing regulations that would require uniform disclosure. In effect, imposing a “one-size-fits-all” legislative requirement would undermine the progress made to date.

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<sup>18</sup> IMA had lobbied heavily against this power being introduced when the Companies Bill was debated in Parliament and it was initially voted out in the Lords. When Government finally reinstated the relevant clauses, they had been significantly amended to address IMA's detailed concerns.

## IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS

- *Disclosure would be costly.* For those that do not disclose, there would be costs in disclosure of: setting up systems; vetting the information; and analysing the information. These costs are likely to be significant with no real benefit as the majority of retail investors take little or no interest in how votes are cast – they invest in funds in order to secure a return.
- *The voting process could be undermined.* Public disclosure could undermine and generally “dumb down” the voting process due to the sensitivity of the issues and the confidentiality necessary. Public knowledge of a disagreement with investee company management may also have an adverse effect on shareholder value without solving the disagreement and could result in institutions, their employees or clients facing the risk of inappropriate pressure by special interest groups.
- *Mechanistic, meaningless reporting would result.* Requiring disclosure would result in pages of statistics and tables, which could be meaningless without further analysis. Furthermore, as fund managers act for different clients, they can vote a particular block of shares different ways. For example, some beneficial owners give managers discretion to vote, some give specific instructions and some ask that the recommendations of a particular voting service are followed. It would not be appropriate for the number of shares voted to be disclosed and thus they will end up disclosing "some shares were voted against, some were voted for and some were consciously with held".

### GOVERNANCE OF RISK

#### **Recommendation 23**

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

IMA supports the unitary board and it is important that the board as a whole retains responsibility for risk management. However, we recognise that it may be necessary to delegate certain functions to sub-committees, particularly where independence may be an issue and there are concerns that the demands placed on the audit committee can be great, particularly for large complex financial groups, such that insufficient time may be dedicated to risk management. In this context, the ISC Paper specifically recommended 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."*

Thus we welcome the board of a BOFI establishing a board risk committee separately from the audit committee. However, this should not be extended beyond large banks and financial institutions where there are systemic issues and which are exposed to extreme risks.

## IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS

**Recommendation 24**

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

Whilst in principle we accept that this recommendation could be helpful, we are concerned that it is overly prescriptive and could result in mechanistic compliance which may not be helpful in the management of risk.

**Recommendation 25**

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

IMA agrees that the board risk committee should have access to external input but would suggest deleting the phrase "in the normal course" as external sources may not always be required.

**Recommendation 26**

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

IMA agrees that a strategic transaction that involves an acquisition or disposal, should, as a matter of good practice, be for the board risk committee to oversee a due diligence appraisal of the proposition.

**Recommendation 27**

*The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.*

IMA welcomes the increased transparency as regards the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy, the associated risk tolerance, and information on the scope and outcome of the stress-testing programme. However, we do not consider that this should detract from the need to provide a full account of the business strategy and risk appetite in the Business Review.

## IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS

### REMUNERATION

#### **Recommendation 28**

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

We consider there should be flexibility with the remit of the Remuneration Committee; in that it would not be appropriate to apply all the recommendations in this section to every subsidiary within a financial group since some – such as fund managers – do not pose the same systemic risks. (See comments in the covering letter under scope.)

#### **Recommendation 29**

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

The FSA Remuneration Code extends to “employees whose activities have or could have a significant impact on the firm's risk profile”. The scope of this recommendation is different and could catch those employees whose activities do not impact on the firm's risk profile, and may not catch those whose activities do. In the case of those BOFIs which own substantial investment banks, it could lead to the board setting the pay of hundreds of employees each year. It could also have the unintended consequence of increasing the remuneration of the executive directors so that fewer employees are brought within its scope. On the other hand, there are advantages with this approach, which is less subjective, in that it will be much easier to identify those executives who fall within scope.

#### **Recommendation 30**

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

IMA considers that this seems reasonable.

#### **Recommendation 31**

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

As the Review acknowledges, IMA agrees that the problem with public disclosure is that it is likely to drive remuneration up and so could be counter-productive. For this reason, we believe that disclosure only to the Remuneration Committee and FSA would be preferable to public disclosure in the annual report.

## IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS

### **Recommendation 32**

*Major FSA-authorized BOFIs that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of "high end" executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of "high end" remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.*

See our comments under Recommendation 31.

### **Recommendation 33**

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

We consider these requirements are far too prescriptive. The Review acknowledges that the overall balance between basic salary and the variable components in remuneration should turn on the circumstances of the particular business and judgement by the Remuneration Committee. The same approach – i.e. leaving the detail to the judgement of the Remuneration Committee – should apply with regard to short-term bonuses and long-term incentives. In PS09/15, the FSA moved away from its more prescriptive approach in the earlier consultation paper.

### **Recommendation 34**

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

IMA agrees that senior executives should be incentivised and that maintaining a shareholding or retaining a portion of vested awards is a means of achieving this. However, it needs to be considered that in some cases it could have the opposite effect and encourage short-termism or excessive risk-taking. For example, in the run up to the financial crisis, there were instances of directors approaching retirement in major financial institutions who were more concerned about performance of the company in the short term until they retired rather than the longer term, and their strategy for running the company was accordingly motivated.

### **Recommendation 35**

*The remuneration committee should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance*

**IMA'S COMMENTS ON EACH OF THE RECOMMENDATIONS**

*objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.*

This seems reasonable. In the case of financial conglomerates, the board risk committee should seek input from risk committees in relevant divisions or subsidiaries.

**Recommendation 36**

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

IMA concurs with this Recommendation in that it accords with that in the ISC Paper.

**Recommendation 37**

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

This seems reasonable.

**Recommendation 38**

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

IMA does not believe that a voluntary Code would be effective. The proposals on conflicts seem particularly weak and should be brought into line with, for example, the FSA requirements. Many remuneration consultants are already subject to professional standards which have stricter requirements than those in the proposed voluntary Code and we believe that there should be a levelling up.

**Recommendation 39**

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

See comments under Recommendation 38.