Walker Review consultation

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

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Dear Sir David,

The Walker Review of the corporate governance of UK finance industry

Thank you for giving the Institute of Directors (IoD) the opportunity to respond to your independent review of the corporate governance of the UK finance industry. This paper presents our response. Issues surrounding corporate governance are of considerable interest to the United Kingdom business community in general and to the IoD in particular (particularly in the wake of the financial crisis). We are therefore pleased to participate in the consultation.

About the IoD

Founded by Royal Charter in 1903, the IoD is an independent, non-party political organisation of 50,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. It seeks to be a leader in corporate governance, both in terms of shaping the development of the overall corporate governance system and through the professional development of directors (particularly by means of its Chartered Director qualification, which is also authorised by Royal Charter).

The membership of the IoD is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies.

Introductory remarks

The current financial crisis has highlighted ways in which existing corporate governance arrangements have – in certain instances - failed to provide an effective check against poor decision making. This has damaged the confidence of the general public in both the financial sector and the overall UK business system.

It is hence appropriate that government and key stakeholders take this opportunity to re-evaluate the extent to which the current UK corporate governance framework is “fit for purpose”. This is a responsibility that the IoD takes particularly seriously, given the central role played by directors in any system of corporate governance.

Consequently, your review of the corporate governance of financial institutions (along with the FRC Review on the functioning of the Combined Code on Corporate Governance) is well timed. In addition, we hope that your review will reduce the risk of a knee-jerk policy response to the crisis - which has been a feature of corporate governance reforms in other countries - and help ensure that any proposals for UK corporate governance reform are based on objective analysis.

This response is in two sections. First, we provide an evaluation of the existing UK corporate governance framework – both with respect to financial and non-financial companies - and identify areas of strength and weakness. Second, we offer a number of proposals that are intended to improve the functioning of certain aspects of the UK corporate governance system.

UK corporate governance – an evaluation

Over the last two decades, the UK has been the pioneer of a distinctive corporate governance model. In contrast to the legislative approach of the United States, the UK framework has sought to achieve a favourable balance between "hard law" (e.g. the Companies Act, the FSA Listing Rules) and best practice principles ("soft law").

A central feature of the UK model is The Combined Code on Corporate Governance, which is implemented on the basis of the "comply or explain" principle. This allows boards a degree of flexibility in their implementation of corporate governance best practice, and encourages dialogue between boards and shareholders.

The Combined Code has driven a significant improvement in UK corporate governance standards. This has been achieved without the imposition of significant regulatory costs on companies. It is an approach that has been widely praised and imitated by policy makers around the world (particularly in the other EU member states).

In our view, this overall model of corporate governance remains fundamentally sound. We are not convinced that a more regulatory-oriented approach to corporate governance would be more effective in improving corporate governance standards. Although far from perfect, the current UK model of corporate governance appears to be at least as effective as the alternatives.

Furthermore, we do not believe that the current financial and economic crisis is indicative of the failure of the overall UK corporate governance framework. As a number of authoritative reports have described, the causes of the current crisis extended far beyond corporate governance, and were mainly specific to the financial sector[1]. Global macroeconomic imbalances, cheap money, unprecedented financial innovation, inadequate financial regulation and supervision, and the inherent difficulty of persuading consumers and politicians to apply the brakes were all contributing factors[2].

Indeed, in the absence of appropriate financial regulation, it is unlikely that any corporate governance framework could have significantly mitigated the effects of the financial crisis. This conclusion is also implied by the global impact of recent events. Although corporate governance regimes vary significantly around the world (e.g. in terms of regulation and ownership structure), there has been no systematic pattern in the way in which particular corporate governance regimes have coped with the crisis.

Nonetheless, there is no room for complacency. There remain areas of concern in the functioning of the UK corporate governance system. Some of the outstanding issues are longstanding, whilst others have been highlighted by the events of recent months. We consider them in three sections: i) the corporate governance of systemically important financial institutions; ii) the functioning of boards, and iii) the engagement of boards with shareholders.

i) The corporate governance of systemically important financial institutions

Systemically important financial institutions require a distinctive approach to corporate governance. Such institutions have the potential to transmit significant negative externalities to the rest of the economy. As a result, they must ultimately be underpinned by the taxpayer.

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[1] The Turner Review (FSA, March 2009); Corporate Governance Lessons from the Financial Crisis (OECD, February 2009).
[2] To that extent, the current crisis is different from that of the Enron/Worldcom debacle at the beginning of the decade, which was much more a pure crisis of corporate governance.

Consequently, it is appropriate that government regulation and supervision should play a greater role in the financial sector than would be appropriate in other sectors of the economy. To that end, the reforms to financial regulation proposed by the Turner Review are to be welcomed. We also support greater international coordination of financial regulation - ideally at a global level, but also at the level of the EU.

However, an excessive reliance on regulation – even in the financial sector - should be avoided. The inherent and long-standing problems of regulation as a means of controlling corporate behaviour remain unsolved, and include the following:

- Regulations become outdated as market participants find ways around them, and they come to distort market behaviour in unforeseen and undesirable ways. New metrics of company and macroprudential oversight suggested by the Turner and other regulatory reviews – such as leverage ratios, liquidity ratios, and counter-cyclical capital adequacy ratios – remain subject to this fundamental problem.

- Financial supervisors lack the financial resources and human capital to effectively monitor market participants. Although the resources allocated to financial regulation are likely to increase in the wake of the financial crisis, regulators will continue to face an uphill struggle.

- Compliance with regulations imposes significant costs on business. In the US, the onerous requirements of the Sarbanes-Oxley Act gave rise to massive implementation costs for US business (and generated substantial revenues for consultants). The American Enterprise Institute has quantified the cumulative cost to the US economy at $1.4 trillion.

- Regulation encourages a “box-ticking” approach, which focuses on minimum compliance rather than adhering to the spirit of regulation.

- A regulatory-oriented approach leads to excessively risk-averse behaviour amongst market participants. While a return to the risky activities of recent years is not sought, it is necessary that financial institutions evolve to match the growing financial sophistication of their clients. They should not be frozen in time by regulators whose incentives are entirely focused on avoiding downside risks.

- Regulation can readily be exploited by interest groups or nation states to promote their own economic or political interests. For example, it is possible that increased EU coordination of financial regulation – which may appear to make sense from a functional perspective – may be exploited by certain countries to undermine the competitive position of the City of London as a global financial centre.

Finally, it should be noted that the much tougher approach to financial regulation adopted in the United States did not succeed in averting the financial crisis. The SEC, the Sarbanes-Oxley Act, and numerous federal and state regulatory bodies failed to prevent the implosion of the US financial system.

Consequently, there is a danger that a shift to excessive reliance on financial regulation may lead to the worst of all worlds: stagnation in the wealth-creating abilities of the financial sector and a false sense of security regarding the underlying risk profile of market participants.

An improved regulatory framework in the financial sector should hence be complemented by a strengthening of non-regulatory means of promoting good corporate governance. In particular, shareholders should continue to play a major role in the corporate governance of financial institutions (as in the rest of the economy). Shareholder monitoring is ultimately more conducive to wealth creation than regulatory oversight due to the incentives of shareholders to pay regard to both upside performance and downside risk.

Furthermore, even systemically important financial institutions should be subject to as much market discipline as possible. It is inherently dangerous for financial institutions to believe that they are “too big to fail” or beneficiaries of an implicit government guarantee.

A key ingredient of a reformed financial system is a robust resolution regime for systemically important financial institutions. Management, shareholders and creditors of financial institutions should be subject to penalties for business failure that are equivalent to those experienced by their peers in other sectors of the economy.

The Banking Act 2009 has gone some way to addressing this issue through the introduction of the Special Resolution Regime. However, this measure was rushed through Parliament with some haste at the end of last year without sufficient time for a detailed consultation. It is important to ensure that the new Special Resolution Regime is providing a credible means of dealing with failing financial institutions, and thereby reducing moral hazard to acceptable levels.

ii) The functioning of boards

The financial crisis has exposed a number of instances in which boards lacked the expertise and/or a sufficiently critical mindset to ask tough questions of executive management. This has been a particular issue with respect to overseeing the risk appetite and risk profile of complex financial institutions. It is hence important to consider ways in which boards can upgrade their ability to monitor and critique executive management.

In recent years, there has been an emphasis on meeting formalistic criteria for "independence", e.g. in corporate governance codes and legislation. However, fulfilling independence criteria is not an end in itself. Such criteria are only of use if they help identify individuals with an independent and critical mindset. It is not clear that adherence to such formal criteria necessarily achieves this objective.

Furthermore, independence should not be seen as a sufficient criterion for board membership. To be meaningful, independence must be combined with relevant expertise. Although there should be a diversity of skills (and professional backgrounds) on the board, all board members should possess the technical ability to assess strategies or products that could determine the overall success or failure of the company. Such a minimum level of expertise was apparently lacking on certain bank boards prior to the financial crisis.

As part of the process of increasing the professionalisation of the board, a greater emphasis should be placed on the training of board members in their specific role as directors. Board members assume a key role in corporate governance which is distinct from that of senior operational managers. An understanding of the distinct perspectives required at board level cannot be taken for granted.

Even in those cases where non-executive directors possess the appropriate knowledge and experience, it remains challenging for them to obtain sufficient company-specific information to fulfil their role. Most NEDs operate on a part-time basis, and are positioned outside of the company's normal information flows. Consequently, they are likely to suffer from a significant information asymmetry vis-à-vis executive management.

In order to exercise effective oversight, the NEDs of large and complex enterprises need access to administrative support and resources from within the company. They must also be able to commit a sufficient amount of time to their duties (particularly if they are involved in boardroom committees). This is likely to be difficult to achieve if they hold an excessive number of board positions in other organisations (particularly in the capacity of Chairman or CEO).

Efforts to improve the functionality of boards should not neglect the central role of the Chairman. An otherwise competent board may fail to function effectively if the Chair lacks the necessary skills or personal qualities to fulfil his or her role. Furthermore, the qualities required to be successful as a Chairman are not necessarily the same as those of an effective CEO.

The key tasks of the Chairman are central to effective corporate governance, and include facilitating the contributions of individual board members; encouraging diversity in boardroom composition; ensuring an effective channel of communication between executive and non-executive board members; leading engagement with shareholders; and ensuring that board meetings are conducted in an effective manner.

Consequently, a key challenge for the future is to consider how the performance and accountability of chairmen can be improved. Some form of effective boardroom appraisal process – which enjoys the confidence of the investor and corporate community, and is consistently applied across the corporate sector – would contribute to progress in this area.

Remuneration has been a high profile topic in recent debates on corporate governance. In our view, the role played by remuneration in causing the current financial crisis is sometimes exaggerated. Nonetheless, the crisis has served to remind boards of the importance of connecting employee incentives – both at board and sub-board level – with risk-adjusted long-term performance. We support application of the principles of best practice outlined in the recent remuneration code published by the FSA, and in the two recent EU Recommendations on remuneration (relating to both financial services sector pay and the remuneration of directors of listed companies).

iii) Engagement of boards with shareholders.

The UK corporate governance system – centred on the Combined Code and the operation of the "comply or explain" principle – demands a close relationship between boards and shareholders. Unlike in a regulatory-oriented system, shareholders are the designated actors with primary responsibility for monitoring and overseeing boards.

The financial crisis has highlighted the fact that shareholders are not always sufficiently committed to the fulfilment of this role. Leading up to the crisis, they failed to ask the right questions and did not engage sufficiently with boards in respect of proposed business strategies and risk profiles. As Lord Myners has commented, many institutional shareholders continue to behave like "absentee landlords".

Shareholder need to increase their willingness to act as long-term "stewards" of companies. The alternative scenario – in which regulators rather than shareholders play the major role in monitoring boards – would have negative implications for governance and wealth creation. It is hence essential that the relationship between shareholders and boards is made to work effectively.

Although company-shareholder dialogue has improved in recent years, there should be more intensive dialogue across a wider range of issues (not only remuneration, which is currently the focus of most shareholder voting). This dialogue should take place throughout the financial year, not only as a prelude to voting at the AGM

There are, however, a number of obstacles to effective engagement between boards and shareholders.

They include the following:

- Dispersed company ownership

The ownership of UK listed companies is highly dispersed. Investors hold only small stakes in individual companies. Consequently, they lack the incentive to pursue an activist ownership strategy. Furthermore, despite the efforts of industry associations (e.g. the ABI, the NAPF), there are collective action problems in coordinating the views of multiple owners on company-specific issues.

- Declining importance of UK institutional investors

The main owners of large UK listed companies have traditionally been UK institutional investors. However, in recent years, new types of investor, e.g. foreign investors, hedge funds, sovereign wealth funds and (most recently) the government, have become bigger players in UK company ownership. UK institutions now own less than 50% of the UK equity market.

These diverse groups of shareholders often have differing ownership objectives. They may not share the same perspectives on "good governance". Some may have a short-termist trading mentality, whilst others may be entirely passive. These contradictory objectives make it difficult for boards to understand the objectives of shareholders.

- Box-ticking.

In certain cases, companies resort to "boiler plate" (i.e. standardised and uninformative) explanations of their deviations from the Combined Code. Equally, investors have a tendency to adopt a box-ticking approach to Code compliance, i.e. they do not give due attention to explanations, and mechanically penalise companies for deviations from the Combined Code. The latter is particularly true of proxy voting agencies, to which shareholders may outsource their voting rights.

Both of these practices undermine the development of a meaningful dialogue between boards and shareholders.

- Communication difficulties between boards and shareholders

Boards are often unable to identify and contact their shareholders on a timely basis. They may also be unable to monitor their voting behaviour. This makes it difficult to establish an effective dialogue.

- Low priority given to corporate governance by fund managers.

Boards often observe a lack of experience and status amongst the employees within fund managers responsible for assessing corporate governance. This inhibits the development of a meaningful dialogue between boards and investors.

Some of the above problems are not readily solvable, e.g. dispersed company ownership and the declining importance of UK institutions. However, it is possible to further improve board-shareholder relationships through greater company transparency, a strengthening of shareholder rights and an increased focus on the governance of investment institutions themselves (see below).

IoD proposals for UK corporate governance

Proposal 1

A standardised boardroom appraisal process should be endorsed by the main stakeholders of the UK corporate sector (i.e. regulators, investors and boards). Listed companies should be encouraged to undertake this appraisal process on an annual basis, and disclose the outcome in their annual report.

Principle A.6 of the Combined Code states that “The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors”. A related Code Provision (A.6.1) states that “The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted”.

Although board evaluation has become more widespread amongst larger companies in recent years, evaluation techniques vary in rigour and objectivity. According to a recent ICSA report (based on the 2008 reporting season), only 21% of the 200 largest UK companies utilise external assessors to undertake a board evaluation. A PwC report in 2007 found that less than 50% of the FTSE 350 disclosed that their boards were operating in an effective manner. In many cases, these disclosures in the annual report were unhelpfully “boilerplate” in nature.

As a result, external stakeholders – particularly shareholders – gain insufficient reassurance regarding the functionality of boards. The worries of investors on this issue were recently expressed by the International Corporate Governance Network. In its second statement on the global financial crisis, it argued that “competence and board dynamics must be tested through independent evaluation, and the process for this should be evident to the market” (recommendation 5.1.2).

The need for transparent assessment of board governance has never been greater. But companies and investors need a consistent and objective method of ensuring that it creates value for all stakeholders.

In response to this problem, the IoD proposes a standardised methodology with which to analyse boardroom governance: SIGA (Standardised Independent Governance Analysis). We believe that the

widespread and consistent implementation of SIGA could play a significant role in rebuilding confidence in UK boards.

The key features of the SIGA methodology are as follows:

i. Each year, board members complete a confidential questionnaire. This requires directors to report their view of the board's performance in a number of key areas of corporate governance (most of which relate to the principles and provisions of the Combined Code). The type of issues that individual directors are asked to address include the following:

   - Is the distribution of power in the boardroom appropriate?
   - Is there sufficient challenge of executive management in board meetings?
   - Is the current level of risk to which the company is exposed acceptable?
   - Does the board have the right balance between expertise and independence?
   - Do board members devote sufficient time and effort to the company and their boardroom role?
   - Do board members have adequate access to information and advice?
   - Does the Board engage sufficiently with shareholders and key stakeholders?
   - Are there factors that might inhibit individual board members from fulfilling their duties in an independent and objective manner?

ii. The questionnaire responses are then reviewed in an interview with an accredited SIGA assessor. The role of the assessor is to ensure consistency in the way in which the questionnaire is completed. The assessor is not there to provide advice on governance or strategy, or to provide any other form of consultancy-type service. It is necessary for SIGA assessors to adhere to strict guidelines concerning their independence from the company (i.e. not having any other form of business relationship for a fixed period of time).

iii. There is a requirement for a formal sign-off by each director to confirm that the response represents an accurate and independent reflection of their views.

iv. The results are collated on an unattributable basis by the assessor in a summary report. This is presented to the Chairman and Senior Independent Director. Within this report, scores in various categories of corporate governance are benchmarked against those of comparable companies.

v. The Chairman presents the board with his or her response to the SIGA assessment. The response may contain an action plan to remedy shortfalls from best practice (e.g. as defined by the Combined Code), or an explanation of why an alternative approach is preferred.

vi. The chairman's response is voted on by the board.

vii. An overview of the survey results and the chairman's report are disclosed in the annual report and/or on the company website. An IoD kitemark appears alongside the disclosure to confirm that the SIGA methodology has been followed.

viii. It should be stressed that the completion of the SIGA process does not verify that company is necessarily applying "good governance" practices. Nor does the IoD kitemark signify an IoD endorsement of a company's corporate governance.

ix. Oversight of the SIGA methodology and the accreditation of SIGA assessors is undertaken by an IoD-coordinated steering committee. It is proposed that the steering committee contains representatives of all relevant stakeholder groups, e.g. regulators, investors and business organisations.

x. To avoid conflicts of interest, the IoD does not intend to be involved in applying the SIGA to individual companies. This role will be open to any professional firm that can meet IoD-defined criteria in terms of expertise and independence. However, the IoD will provide training in the SIGA process to those firms that wish to act as assessors.

Completion of the SIGA process is intended to fulfil the following objectives:

- Shareholders benefit from an annual high-level audit of a listed company's board fundamentals. They have greater assurance that the board of a company is not dysfunctional (e.g. as a result of groupthink or the excessive dominance of the Chairman/CEO in board meetings).
- Chairs have the opportunity to receive objective feedback on the functioning of the board, thereby allowing them to take corrective action if necessary.
- Chairs perceive a higher level of accountability towards their fellow board members.
- Non-executive directors have the opportunity to remove themselves from the "groupthink" of formal board meetings, and offer an objective assessment of how their contribution to the board – and those of other board members - could be improved.
- Boardroom governance is evaluated in a manner that is meaningful, cost-effective, avoids potential conflicts of interest, and is comparable across all listed companies.

The next step in this process is to form the SIGA steering committee. All relevant stakeholders are invited to signal their support of the SIGA concept by indicating their willingness to appoint a representative to this committee.

Proposal 2
Chairmen should encourage a greater presence of Chartered Directors on company boards. The Combined Code should include a provision to support this objective.

An effective means by which boardroom functioning can be professionalized is through the greater presence of Chartered Directors on company boards. Chartered Directors would ensure that a professional approach to governance was embedded into boardroom decision-making processes. Investors and other stakeholders would be reassured that boards had the necessary expertise to exercise their strategic and legally-defined duties.

Chartered Director is the only board-specific qualification of its kind in the world. It requires candidates to take a certificate and diploma in company direction (by written exam), and to complete a professional review of their board level experience (by interview). Chartered Directors are thereafter subject to a Code of Professional Conduct, and Continuing Professional Development (CPD) requirements.

In recent years, the Chartered Director designation has gained a substantial level of endorsement from UK business and government[3]. There is now a critical mass of more than 800 fully-qualified Chartered Directors. Several thousand more candidates are engaged at various stages of the qualification process. Chartered Directors contribute a profound understanding of the board's role in strategy, risk oversight, internal control, and stakeholder accountability. As a result, they are already making significant contributions to business leadership across all sectors of the UK economy (including in the public and voluntary sectors).

However, a vital next step in the roll-out of Chartered Director is to include explicit mention of the designation in the Combined Code. Specifically, we propose the addition of a provision in section A.5 of the Code along the following lines: "The Chairman should encourage board members to become Chartered Directors or to engage in equivalent professional training that specifically enhances their functioning as company directors".

In addition, we propose that the Chartered Director qualification be incorporated into the FSA's "Approved Persons" regime. The FSA should explicitly state that the Chartered Director qualification is relevant to its assessment of an individual's suitability in relation to an executive or non-executive role on the board of an FSA regulated company.

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[3] Some of the organisations that have formally endorsed Chartered Director include the following: The CBI; Co-operative Insurance; National Association of Pension Funds; Hermes; The Building Societies Association; Investors in People; Secretary of State for Business, Enterprise and Regulatory Reform; Department for Education and Skills; Tomorrow's Company; USS; The British Bankers Association; Investment Management Association; The Institute of Business Ethics; The Quoted Companies Alliance; Institutional Shareholder Services; Association of Investment Trust Companies; Local Authority Pension Fund Forum.

Combined Code and FSA recognition would send a strong message regarding the importance of board-level training and professionalism. It would further encourage the engagement of institutional investors with boards on the issue of professional training. At the company level, it would stimulate chairman to explicitly consider the professional development needs of their board members, as any lack of compliance would need to be disclosed and justified in the annual corporate governance statement.

Proposal 3
The non-executive directors of large, complex companies should have greater access to significant in-house administrative support, coordinated by the company secretary.

In order to reduce their information asymmetry vis-à-vis executive management, non-executive directors need access to resources and logistical support. Furthermore, they should not have to rely solely on executive board members for information and analysis.

There are currently two provisions in the Combined Code that are relevant to this issue. Provision A.5.2 states that "The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should be provided with sufficient resources to undertake their duties". In addition, provision A.5.3. states that "All directors should have access to the advice and services of the company secretary".

In our view, these provisions should be brought together and strengthened within the Code in order to define a more formal responsibility for the company secretary vis-à-vis the support of non-executive directors. Non-executives of large, complex listed companies should have access to significant administrative support and/or research assistance through the company secretary's office. This may include permanent office accommodation, allocated members of staff and a designated budget.

A blueprint for this kind of arrangement is provided by the Monetary Policy Committee of the Bank of England. The members of this committee are independent of the Bank's staff. However, they are provided with substantial designated research support from within the Bank in order to fulfil their role.

To support this objective, best practice should dictate that the company secretary of a listed company should jointly report to the Chairman (as well as the CEO). If the company secretary reports solely to the CEO, he or she may feel inhibited in serving the interests of the non-executives in an independent manner. NEDs should indicate their satisfaction with their access to resources through the proposed annual boardroom appraisal process.

The strengthening of the company secretary in the role of supporting non-executives is preferable to that of encouraging non-executive directors to seek independent advice from outside the company. Except in cases where it has been pre-discussed with executive management, the latter approach has the potential to create an atmosphere of mistrust and confrontation between executive and non-executive board members (although it may be necessary in extreme circumstances).

Proposal 4
The Combined Code should provide guidance on the maximum number of board positions that should be held by directors of listed companies.

It should be recognised that the role of non-executive director at a large listed company requires a significant time commitment. It is implausible to believe that such a commitment can be realised if individuals are directors of numerous other large companies.

In particular, fulfilling the challenging role of Chairman or CEO is likely to significantly constrain the ability of an individual to devote sufficient time to the non-executive board memberships of other organisations.

Consequently, we propose that the Combined Code should state that the following are incompatible with best practice:

- board membership of more than 5 companies listed on the Main Market of the London Stock Exchange;
- board membership of more than 3 companies in the FTSE 100;
- occupying the office of Chairman of more than one FTSE 100 company.

Restrictions on chairing more than one FTSE 100 company were removed as part of the last revision of the Combined Code (in June 2008). In retrospect, we believe that this was a mistake, and that this provision should be reinstated. As we have argued above, the office of Chairman is central to the functioning of the board. Consequently, it is essential that Chairs devote sufficient time to their crucial role.

We recognise that there should be some scope for flexibility in the implementation of these guidelines. For example, an individual without executive responsibilities, i.e. with a portfolio of non-executive positions, may be able to manage a larger number of board appointments than someone fulfilling the role of CEO or Chairman at a major company. Time commitment will also be dependent on the individual's involvement in boardroom committees.

However, individuals with board appointments in excess of the above guideless should at least have to justify their position to shareholders, and explain how they are able to devote the necessary time to each boardroom role. This explanation can then be either accepted or rejected by shareholders.

Proposal 5
Shareholders should have an advisory vote on risk at the Annual General Meeting of all listed companies.

A major failing of a number of bank boards during the financial crisis has been their inability to exercise effective oversight of risk. Of equal concern has been the lack of engagement between boards and shareholders on this issue.

There is evidence to suggest that advisory votes at company AGMs are effective at focusing the minds of investors on particular issues. For example, the introduction of an advisory vote on remuneration (in 2002) has increased investor's interest in firm's remuneration arrangements.

Notwithstanding the importance of remuneration to corporate governance, investors should equally be engaging with boards with respect to the company strategy and risk profile. Consequently, it is proposed that shareholders should also be granted the right to an advisory vote on risk - based on the forward looking risk disclosures contained within the Business Review - at the annual general meeting.

A number of commentators have suggested that risk oversight could be improved by the formation of a specialist board risk committee or the appointment of a Chief Risk Officer to the board.

We do not think that these proposals represent the right solution for most companies (with the possible exception of large, complex financial institutions). Both are likely to encourage a "siloing" of risk expertise, and the shifting of accountability for risk issues to particular board members. This may inhibit the development of risk awareness across the board as a whole.

Even within complex financial institutions, risk should be a central concern for the entire board, and not a specialist responsibility for certain board members. The CEO should view himself or herself as the Chief Risk Officer, and not seek to delegate this responsibility elsewhere.

It should also be recognised that risk management – as the term implies – is primarily the responsibility of executive management. Although the board should seek to provide a second level of assurance, it should not seek to duplicate the detailed risk management activities of executive management.

If boards do not have confidence in existing management to undertake effective risk management, they should seek to replace them. The risk oversight function of boards should be more focused on big picture risks ("enterprise risk"), and not become immersed in excessive technical detail. The role of the board is risk oversight not risk management.

However, we recognise that there is a need for flexibility. In certain instances, the board or shareholders may determine that risk committees, Chief Risk Officers at board level, or other risk oversight arrangements could assist the board in the fulfilment of its responsibilities. These arrangements should be disclosed and justified in the risk report, and voted on by shareholders through the proposed annual vote on risk.

Proposal 6
Investors should be subject to their own combined code, with regard to which they should either "comply or explain"

As a means of increasing the incentive for investors to engage with boards, shareholders should be subject to a "Combined Code" for investors in relation to which they should either "comply or explain".

Such a code would contain statements of best practice in respect of investor's engagement with boards. The beneficiaries of investment institutions would hold the governing body of investment institutions (e.g. boards of directors or trustees) accountable with respect to their compliance with these principles of best practice. Although the "comply or complain" principle would allow investor flexibility regarding their compliance, such a code would increase the moral pressure on fund managers to be "good owners".

Best practice codes for institutional investors already exist. In 2007, the International Corporate Governance Network published its Statement of Principles on Institutional Shareholder Responsibilities (which was derived from an earlier statement of principles published in 2003). This defines best practice principles in respect of both the internal governance of investment institutions and with regard to the exercise of their ownership rights (both in terms of voting and ongoing engagement).

A similar set of principles has been published by the Institutional Shareholders' Committee. The latest version of their principles - The Responsibilities of Institutional Shareholders and Agents: Statement of Principles - was published in June 2007. However, unlike the ICGN code, this focuses on solely on the ownership responsibilities of shareholders. Sections of the ISC code set out best practice on:

- defining the policy by which investors will discharge their ownership responsibilities, clarifying the priorities attached to particular issues and when they will take action;
- monitoring the performance of, and establishing, where necessary, a regular dialogue between investors and investee companies;
- intervening with investee companies where necessary;
- evaluating the impact of engagement;
- reporting back to clients/beneficial owners on engagement and voting.

However, both the ICGN and ISC codes are entirely voluntary and are not widely used by beneficiaries to hold investors to account.

A section on investor responsibilities is included in section 2 of the existing Combined Code on Corporate Governance. However, this consists of only two pages of extremely limited guidance. Furthermore, these are not principles to which investors are held to account by their beneficiaries in any substantive manner. The intended audience of the Combined Code is boards and shareholders, not the beneficiaries of investment institutions.

Consequently, what is needed is an officially sanctioned code of best practice for investors – based on the "comply or explain" principle – which can be used by beneficiaries to hold investors to account, both in terms of investor's own internal governance and the exercise of their ownership rights vis-à-vis investee companies.

Such a code would not force investors to pursue a policy of engagement. Indeed, in specific instances, an activist ownership policy may not be consistent with a legitimate investment policy mandated by the investor's beneficiaries.

However, the code would shape the expectations and norms of beneficiaries with respect to appropriate company engagement policy. Over time, this could feed through to changes in investment behaviour amongst fund managers. It would also provide a reference point for new types of company owner, e.g. Sovereign Wealth Funds, regarding societal expectations of ownership behaviour in the UK.

Proposal 7
The FRC should produce guidance on remuneration to assist in the implementation of the principles and provisions of section B of the Combined Code.

Boards should be encouraged to implement a remuneration policy that rewards long-term performance, and avoids creating perverse incentives that encourage excessive risk-taking.

In April 2009, the European Commission published a non-binding Recommendation on the Remuneration of Directors of Listed Companies (IP/09/673). We are broadly in agreement with the principles of remuneration described in the Recommendation, and believe that the FRC should promote the application of these principles through guidance on remuneration (analogous to the Turnbull and Smith Guidance on internal control and audit committees). Such guidance would support boards in their implementation of section B of the Combined Code.

Specifically, we would like the guidance to promote the following remuneration principles in respect of executive board members:

- a limit on severance pay (2 years maximum) and an end to severance pay in case of failure;
- a balance between fixed and variable pay, and the linkage of variable pay to predetermined and measurable performance criteria;
- the use of remuneration to promote the longer-term sustainability of companies, e.g. through a balance between long and short term performance criteria (financial and non-financial); deferment of variable pay; a minimum vesting period for stock options and shares (at least three years); and retention of part of shares until the end of employment;
- The reclaim of variable pay paid on the basis of data which subsequently proves to be manifestly misstated ("clawback").

In addition, we support a strengthening in the role and operation of remuneration committees. For example, remuneration committees should include members with specific experience in the design of remuneration. Members of the remuneration committee should be present at AGMs to provide explanations to shareholders.

Remuneration committees should also exercise caution in their use of remuneration consultants or head-hunters in defining pay levels, and pay attention to consultant's potential conflicts of interest (e.g. in also advising executive management on remuneration issues).

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

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