TRAVERS SMITH

Corporate Governance Update

July 2010

The publication of the UK Stewardship Code by the Financial Reporting Council at the beginning of July marks the latest step in the recent re-evaluation of corporate governance in the United Kingdom, following the publication by the FRC at the end of May of the UK Corporate Governance Code.

The Stewardship Code

The Stewardship Code is based closely on the Institutional Shareholders' Committee's Code on the responsibilities of institutional shareholders issued in November 2009 (**"the ISC Code"**) whose principles were first published back in 1991.

The adoption of the Stewardship Code by the FRC will give greater force to its provisions and the FSA is currently consulting on an amendment to its Conduct of Business Rules under which UK authorised firms (other than venture capital firms), which manage investments on behalf of professional clients other than natural persons, would be obliged to disclose the nature of their commitment to the Stewardship Code.

The objective will be to encourage institutional shareholders to engage more actively with companies in which they invest for the benefit of all shareholders.

General nature of the Stewardship Code

Like the Corporate Governance Code, the Stewardship Code is to be applied on a "comply or explain" basis. This will require institutional investors to disclose on their website:

- how they apply the principles of the Code
- certain specific information required by the Code
- an explanation for non-compliance with the Code

The Code is addressed principally to fund managers, but the FRC strongly encourages all institutional investors to report on their compliance with the Code. The NAPF issued guidance earlier this year on how the ISC Code might be applied by pension funds. Overseas investors are also encouraged to apply the Code where appropriate, disclosing where their own national standards require a divergence from the Code's principles.

In the preface to the Code, the FRC acknowledges that institutional shareholders are free to choose whether or not to engage with companies, but their choice should be a considered one based on their investment approach. The FRC recognises that not all parts of the Code will be relevant to all institutional investors and that smaller institutions may judge that some of its principles and guidance are disproportionate.

The FRC requests institutions to notify it when they have made disclosures on their websites about their application of the Code. The FRC will retain on its own website a list of those investors that have published a statement on their compliance or otherwise with the Code. This list will be available from October 2010. The FRC considers that it would be good practice for institutions making disclosure to include in their statement the name of an individual who can be contacted for further information.

The principles of the Code

The Code consists of seven principles, which are the same as those in the ISC Code, and underlying guidance on each of the principles.

Principle 1

Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

The guidance to principle 1 is unchanged from the ISC Code.

Principle 2

Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.

The guidance to principle 2 is unchanged from the ISC Code.

Principle 3

Institutional investors should monitor their investee companies.

The ISC Code guidance has been amended to encourage investors (a) to meet the Chairman and, where appropriate, other board members as part of their regular monitoring of investee companies so as to satisfy themselves that the company's board and committee structures are effective; (b) to attend general meetings of companies in which they have a major holding where appropriate and practicable; and (c) to consider carefully any explanations for departure from the UK Corporate Governance Code and make reasoned judgments in each case. They should provide a timely explanation to the company in writing, as appropriate, if they do not accept the company's position and should be prepared to discuss their concerns with the company.

Principle 4

Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

The guidance to Principle 4 is unchanged from the ISC Code.

Principle 5

Institutional investors should be willing to act collectively with other investors where appropriate.

The guidance to Principle 5 is unchanged from the ISC Code.

Principle 6

Institutional investors should have a clear policy on voting and disclosure of voting activity.

The guidance to Principle 6 is unchanged from the ISC Code.

Principle 7

Institutional investors should report periodically on their stewardship and voting activities.

The guidance to Principle 7 is unchanged from the ISC Code.

The guidelines continue to suggest that investors should consider obtaining an independent audit opinion on their shareholder, engagement and voting processes. A number of consultees on the Code expressed concern that this might lead to costly verification exercises and the ICAEW is currently developing guidance on this issue in conjunction with a stakeholder group including fund managers, pension funds and auditors. A consultation on the topic is to be issued later this year. The FRC suggests that asset managers may wish to wait until these guidelines have been finalised before considering whether to comply with this part of the Code.

Future Developments

When it published the Stewardship Code, the FRC acknowledged that it had not addressed a number of significant issues which had been raised by the consultation including, for example, whether institutional investors should disclose their policies on stock lending, arrangements for voting pooled funds, and the nature of the information to be disclosed on voting records. The FRC was keen to publish the Stewardship Code as soon as possible to build on the momentum generated by the Walker Review and the revised UK Corporate Governance Code, but has stated that it will carry out further work on these issues.

The FRC also intends to do further work to develop an approach to monitoring the application of the Code and anticipates that the first full monitoring exercise will take place in the second half of 2011. In the meantime, the Investment Management Association will review adherence to the Code in 2010 and provide initial benchmarking data.

The ISC is also establishing a senior body, the Institutional Investor Council, which will work closely with the FRC in promoting the Stewardship Code.

In addition to the FSA consultation referred to above, the European Commission has recently issued a green paper on corporate governance in financial institutions which states that it will shortly launch a broader review of corporate governance within listed companies in general which will consider, in particular, the place and role of shareholders and the division of responsibilities between shareholders and boards of directors relating to board composition and management supervision. The FRC will take account of any proposals that arise out of these reviews.

The New UK Corporate Governance Code

On 28 May 2010, the FRC published a new edition of the UK Corporate Governance Code (the **"Code"**). This new edition will apply to listed companies for financial years beginning on or after 29 June 2010. The Code sets out standards of recommended practice for listed companies and operates on a "comply or explain" basis.

In the preface to the Code, the FRC highlighted two principal conclusions from its review. First, that much more attention needed to be paid to following the spirit of the Code as well as its letter. Secondly, that the impact to shareholders in monitoring the Code could and should be enhanced by better interaction between the boards of listed companies and their shareholders.

To deal with the first, the FRC has listed the main principles of the Code in a separate section at the front of the Code with a view to emphasising the importance of the principles. The FRC urges boards to think deeply and on a continuing basis about their overall tasks and the implications of these for the roles of their individual members. The leadership of the Chairman is recognised as key to this, but equally there is a need for a frankness and openness of mind of all directors in tackling issues which face them. Chairmen are encouraged to report personally on how the principles relating to the role and effectiveness of the board have been applied. The FRC hopes that this will avoid boilerplate statements, give investors a clear picture of how boards operate effectively and so encourage investors more readily to accept explanations when a company's practice diverges from the practice recommended by the Code. There is also a new section at the start of the Code entitled "Comply or Explain". This emphasises that the Code is not a rigid set of rules and that it may be justifiable not to follow a provision in particular circumstances if good governance can be achieved by other means. However, the company must give a clear explanation to shareholders as to why an alternative course of action is taken and how its actions are consistent with the relevant principle and contribute to good governance.

The FRC's second principal conclusion is to be addressed by the Stewardship Code (see above).

The ordering and structure of a new Code differs from the old Code with some of the previous principles being amended and four new Main Principles being added, some of which reflect wording previously used in the Supporting Principles.

The principal areas of change are as follows:

1. Composition of the board

New Main Principle B.1 states that the board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. Companies are also encouraged to have regard to the benefits of diversity on the board, including gender, when making appointments. (The FRC noted in its comments on the new Code that a quarter of FTSE 100 companies have no female board members.) The new Code makes clear that all directors should be able to allocate sufficient time to the company to discharge their responsibilities new (Main Principle B.3).

2. *The Chairman*

The Chairman's responsibility to lead the board and ensure its effectiveness on all aspects of its role has become a new Main Principle (A.3). The Code provides that he should ensure that adequate time is available for discussion of all agenda items, in particular strategic issues. There is a new provision requiring him to agree with each director their training and development needs and to review this regularly (B.4.2).

The Chairman is to be supported by the Senior Independent Director whose role has been expanded so that he is to act as a sounding board for the Chairman as well as serving as an intermediary for the other directors when necessary.

3. *Board evaluation*

The previous provisions of the Code requiring an annual evaluation by the board of its own performance and that of individual directors has been extended, in the case of FTSE 350 companies, to provide that every three years this evaluation should be externally facilitated. Any other connections between the company and the external consultants engaged for this purpose must be disclosed. This could be done by way of publication on the company's website.

Since the provision of evaluation services is a relatively new market, the FRC will monitor its development, but has indicated that if it is satisfied that the service providers meet sufficiently high standards, it may extend this requirement to all listed companies.

4. *Re-appointment of directors*

Whilst the Code maintains the recommendation that directors should be subject to re-election at least every three years, all directors of FTSE 350 companies should now be subject to annual re-election. The FRC emphasises that here, as with all other provisions of the Code, companies are free to explain rather than comply if they believe that a different approach to re-election ensures proper accountability and underpins board effectiveness, or if they consider that a transitional period is necessary before they introduce annual re-election. This is one of the areas whose impact the FRC has said that it will specifically assess as part of its next review of the Code. It will also be interesting to see how this provision, coupled with the greater engagement of institutional shareholders as a result of the Stewardship Code, results in a greater challenge to the position of individual directors. At the least, it is likely to encourage greater dialogue between shareholders and companies if concerns arise about any particular director.

5. *The business model and risk control*

Companies are now required by the Code to include in their annual report "an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company".

In spite of some opposition from respondents at the consultation stage, the FRC went ahead with this change because they felt that a statement of the company's strategy for long-term value would provide a context against which the Business Review, required by the Companies Act, can be set. It is recommended that the business model and strategy statement be included in the same section of the annual report as the Business Review.

On risk, the new Code includes a new Main Principle stating that the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. However, the Code does not go as far as the Walker Report on banking and financial institutions which recommended a special board risk committee supported by a chief risk officer. Guidance on risk management and internal controls is contained in the Turnbull Guidance which is to be reviewed in the latter part of 2010.

6. *Director remuneration*

The Code has been expanded to make clear that the remuneration of non-executive directors should include no performance related elements. As previously, the Code acknowledges that, exceptionally, share options may be granted, but in that event, shareholder approval should be sought. However, there is no similar requirement for any other performance related remuneration.

Schedule A to the Code, which follows largely the previous Schedule A, now provides that incentive schemes and options for other directors should be subject to performance criteria which reflect non-financial performance metrics where appropriate. The Code makes clear that remuneration incentives should be compatible with risk policies and systems, but no longer specifically refers to performance relative to a comparative group.

The Code now also suggests that companies should consider including a right to clawback variable components of remuneration packages in exceptional circumstances of mis-statement or mis-conduct. These recommendations reflect the conclusions of the Walker Report in relation to the bonus packages of directors in banking and financial institutions.

ISSUES FOR COMPANIES TO CONSIDER

1. Engagement with shareholders

Chairman to contact principal investors to discuss any concerns (but not disclose inside information) and allow any other board members the opportunity to meet major shareholders.

2. Board composition

Nomination Committee to consider diversity of board and have regard to diversity issues in recommendations for future board appointments.

3. Board evaluation

Chairman to arrange regular review with directors of their training and developments needs.

4. Risk

Board to review its risk strategy and identify the nature and extent of risks that it is prepared to take in pursuit of its strategy.

5. Remuneration

Review remuneration packages to ensure they are compliant with the Corporate Governance Code.

6. Annual Report

(a) Chairman to report personally on the principles in Sections A and B of the Corporate Governance Code relating to the role and effectiveness of the board;

(b) report to include a statement of the longer-term business model and strategy;

7. FTSE 350 companies

(a) Consider appointment of external consultants to assist in three-yearly board evaluation;

(b) Include resolutions at next AGM for re-appointment of all directors and consider reviewing terms of appointment to cater for possibility of non-re-election.

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