Chris Hodge
Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

8 March 2010

Dear Sir,

The CFA Society of the UK (the society) welcomes the opportunity to comment on the Financial Reporting Council's (FRC) Consultation on the Revised UK Corporate Governance Code (the code). The society values the code's contribution to standards of governance and, in particular, its support for the protection of shareholder rights and the promotion of high levels of transparency.

As the consultation notes, 'comply or explain' has been, and remains, an important feature of UK corporate governance. The society commends the FRC on its description of the way in which the 'comply or explain' regime should function. As the consultation observes, the concern that some shareholders pay too little attention to explanations and view those explanations mechanistically, rather than giving scope for qualitative assessment of the explanation weakens corporate support for the code to the detriment of the regime. The society believes that this might be a useful area for further research by the FRC.

Data in a survey conducted by CFA UK in May 2009 suggest that our members are aware of the value of good governance. 82% of respondent members agreed with the statement 'It is part of [fund] managers' fiduciary duty to engage actively in corporate governance'. In addition, 91% of respondents agreed that 'due diligence requirements necessitate that investors pay close attention to governance issues relating to potential and existing investments'. 92% of respondents supported Graham & Dodd's assertion that 'there is just as much reason to exercise care and judgment in being a shareholder as in becoming one'.

However, the same survey reported low levels of awareness of the UK Combined Code with the largest body of respondents unwilling to provide an opinion on the performance of the code. The society is broadly supportive of the proposed amendments to the code and encourages the FRC to do more to promote awareness of the code.

Engagement is valuable and can assist the creation of shareholder value. The additional recommendations in the code and the change of tone in the new code provide an opportunity for improved board governance and enhanced shareholder interaction.

Comments on the consultation

CFA UK supports the decision to change the code's title to the UK Corporate Governance Code. The name change provides greater clarity in relation to the code's purpose and nature.

The introductory comments describe the purpose of governance as being to create shareholder value over the longer term. The longer term is referenced repeatedly in the code and references are newly added in sections A1 and D1.

The society appreciates that a stated commitment to the long term is intuitively attractive. However, shareholders' investment time horizon ought not to be dictated by the code, but should be left to the determination of shareholders following discussion with management. While it is likely the case that most shareholders might have the opportunity to take a long term view, some will not.

Equally, shareholders with varied time horizons might reasonably assess that their long-term benefit is maximized by a short-term focus at a particular company. Further, it would be unfortunate if the code was relied upon by companies to provide an excuse for short-term failure with the promise of long-term success. It is quite possible that the short-term record might provide a more accurate forecast of the long-term outlook.

In aggregate, it is correct for the code to encourage boards to take a long-term view and for compensation to be linked to returns over the longer term. The interests of the majority of shareholders are likely to be better served over a longer period of time should boards operate with the long term in mind. However, the requirement to listen to and respond to the views of shareholders in relation to the location (by time) of the weight of returns deserves mentioning in order to provide some balance.

We have identified above our concern at the bias in favour of the long-term. We have a similar concern with respect to the revised code's treatment of risk.

The recent track record of risk management by some UK corporate boards – in the banking sector in particular – has been poor (though this is not uniformly the case). However, the code's language in relation to risk suggests that all risk is downside risk. The society supports the FRC's determination to encourage more effective management of risk. However, risk does not operate in just one direction. Though the current climate encourages a focus on the management of downside risk, the code should be careful not to require boards to see risk management as relating only to the downside. Boards need to take considerable care to identify, evaluate and manage the overall risk/return profile in a manner that is prudent but also supportive of corporate objectives.

CFA UK welcomes the addition of the new main principle on the composition of the board and appreciates its relevance in the context of the Walker Review and the FSA's recent paper on Effective Corporate Governance. The society suggests that at least one non-executive director ought to be proficient in financial analysis in order to support constructive challenges to proposed strategy and the development of strategic proposals.

In paragraph 2 of the supporting principles to B1, the code reads 'The board should include a strong presence of executive and non-executive directors…such that no individual or small group of individuals can dominate the board's decision-taking'. We are not clear as to how 'a strong presence' would be defined and feel that the paragraph would be clearer if this qualifying description was cut.

In section B4, the society welcomes the addition of the new principle that 'all directors need appropriate knowledge of the company and access to its operations and staff'. We believe that this is a valuable addition. However, we are less certain of the value of the new provision B.4.2 in relation to personalized training and development. What is the proposed purpose of this training? If the FRC has a particular concern about the skills and aptitudes of directors, perhaps this could be made clearer. As it stands, the code's recommendation could add to cost with little obvious benefit.

CFA UK welcomes the introduction of new provision B.6.2 relating to regular board evaluation. Board performance should be assessed internally each year with a three-year cycle for formal evaluation. In addition, we believe that boards should be encouraged to publish a brief summary of the evaluation on the company's website.

We welcome the clarity of section B.7 on re-election of directors, but do not support annual election for all directors. While it is the case that the remuneration, nomination and audit committees are typically chaired by members other than the chairman and that shareholders ought to have a regular opportunity to express an opinion on their performance, the potential benefit of annual election is outweighed by the potential cost of discontinuity through the failure of existing board members to gain re-election.

New section C.1.2 recommends that directors should include in the annual report an explanation of the basis on which the company generates revenues and makes a profit from its operations, the business model and its overall financial strategy. As not all companies make profits from their operations, perhaps this section should be abridged to read 'directors should include in the annual report an explanation of the business model and its overall financial strategy'.

The new supporting principle in section D states that 'the performance-related elements of executive directors' remuneration should be stretching and designed to align their interests with those of shareholders and to promote the long-term success of the company'. We recommend deleting 'be stretching and designed to' so that the section reads 'the performance-related elements of executive directors' remuneration should align their interests with those of shareholders and promote the long-term success of the company'. The difficulty here is that, while we appreciate the FRC's intention of encouraging reward for real achievement rather than the payment of supposedly performance-related elements as a form of entitlement, the code ought not to encourage undue risk-taking. It is more important to focus on the alignment of remuneration structures with the interests of shareholders.

CFA UK also welcomes the addition of the new paragraph in Schedule A on remuneration that states 'consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement and misconduct'. Our own position on this issue is that 'companies should disclose whether they have a mechanism to recapture incentive pay that is triggered by company results that are ultimately restated or changed in a manner that would have negated the original award. We would recommend adoption of our position on this issue which makes clear companies' responsibility to reclaim variable pay based on any restatement, irrespective of the original cause.

We support the clarification in the code that remuneration for non-executive directors should not include share options or other performance-related elements. We do not though support the suggestion in relation to executive director remuneration that only basic pay should be pensionable. We believe that it might be in the company's interest to have the flexibility to set appropriate pension arrangements.

<u>About CFA UK and CFA Institute</u>

The CFA Society of the UK (CFA UK) represents the interests of more than 8,500 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members also belong to the CFA Institute and reaffirm annually their adherence to its Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 98,000 members in 139 countries, of whom more than 87,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 137 member societies in 58 countries and territories.

Yours,

Natalie WinterFrost CFA FIA
Chair
Professional Standards & Market Practices Committee

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