



# **Proposed changes to the Combined Code**

**Response to the FRC from the Local Authority Pension Fund  
Forum**

**April 2003**

LAPFF Secretariat  
4th Floor, Cityside, 40 Adler Street, London E1 1EE  
Tel: 0207 247 2323 Fax: 0207 247 2457  
E-mail: [info@lapff.org.uk](mailto:info@lapff.org.uk)  
Regulated by the FSA

# Proposed changes to the Combined Code

## 1. Introduction

1.1 The Local Authority Pension Fund Forum brings together 27 public sector pension funds with combined assets in excess of £40 billion. The Forum's mission statement is to 'promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest, commensurate with statutory regulations.'

1.2 With this focus, the Forum takes a close interest in the ongoing debates over improving corporate governance among listed companies. The Forum made a submission to the Higgs enquiry. This document reflects our views on the proposed amendments to the Combined Code arising from the Higgs and Smith Reports.

## 2. General

2.1 In general, the LAPFF is very supportive of the proposals to amend the Combined Code contained in the Higgs and Smith Reports. We consider that non-executives play a vital role on boards in both a supervisory and advisory capacity and therefore contribute to securing long term investment returns and accountability to shareholders.

2.2 We support the stronger emphasis in the Higgs report on independence issues and also the definition of independence criteria provided, though we recognise that meeting the new recommendations on independent representation on the board will take time for some companies. In this regard, we particularly welcome the recommendations on strengthening and making more transparent the nominations procedure in order to attract directors from more diverse backgrounds.

2.3 We also particularly welcome the proposals to include provisions relating to appraisal, performance evaluation, induction and training.

2.4 We note that the proposals for senior independent directors have provoked some comment. We do not regard the post a divisive as there are a variety of roles already recognised within a unitary board. It is important that there are clear lines of communication between shareholders and directors and identifying a post with special responsibility for this is useful. We note that the requirement to identify a senior independent director has been a Combined Code provision since 1998 and has not caused obvious dissent.

2.5 We also welcome the discussion of the central role of the chairman and the requirement not to combine the posts of chairman and chief executive. We support the view that chief executives should not become chairmen.

2.6 As a general point, we support the 'comply or explain' approach. However, we would caution that shareholders should only take account of explanations provided if these are clear and specific to the company's own circumstances.

## Detailed comments on proposed Combined Code

We are commenting where there are changes to existing wording or additions.

Number	Proposed Code provision	Comment
<b>A. DIRECTORS</b>		
<b>The board</b>		
A1.1	Board's role to is provide entrepreneurial leadership including strategic aims, ensuring provision of financial resources, review of management performance, establishment of values and standards.	We support the new guidance on board responsibilities.
A1.2	Number of board and committee meetings and individual attendance to be disclosed in annual report	Support
A1.3	Board to publish statement on type of decisions taken by board and management	Support
A1.4	NEDs should constructively challenge, scrutinise performance, focus on financial information and risk management systems, be responsible for setting executive remuneration, appoint and remove senior management and plan succession.	Support
A1.5	NEDs to meet regularly without executives present and at least once a year without the chairman. Annual report to disclose whether such meetings have occurred.	Support
A1.6	Concerns should be recorded in board minutes. Written statement to the chairman when a NED resigns	Support
A1.7	Companies to arrange insurance cover for directors	Support
<b>Chairman and chief executive</b>		
A2.1	Roles should not be combined. Division of responsibilities between chairman and chief executive to be clearly set out in writing and agreed by the board	Support the recommendation that roles should not be combined. The division of responsibilities should be disclosed as well as put in writing internally.
A2.3	Chief executive should not become chairman	Support
A2.4	Chairmen should be independent on appointment	Support
A2.5	Chairman's responsibilities defined as board leadership, ensuring adequate information received by board, effective communication with shareholders, effective contribution by NEDs, constructive board relationships	We support this definition with caveat that regarding a chairman as not independent, once incumbent, may not be applicable to smaller companies where a chairman spends relatively little time.
<b>Board balance and independence</b>		
A3.1	Board should not be unwieldy	Support
A3.2	Should be a strong executive representation on the board to ensure that power is not concentrated	Support
A3.3	All directors must take decisions objectively	Support
A3.4	NED independence broadly defined as independent in character and judgement, no relationships that could affect or appear to affect the director's judgement.	We note the removal of reference to the materiality of relationship and inclusion of perception of independence. We support this.

Number	Proposed Code provision	Comment
A3.4	Factors affecting independence include: -former employment within five years; - material business relationship directly or via a third party body (eg broker) within three years; - receipt of payment other than fees - participation in bonus or pension schemes - close family ties with directors, advisers - cross-directorships or other links with other directors - representation of significant shareholder - director for more than ten years	We support the codification of independence issues. We support the criteria but consider that the length of tenure should be nine years rather than ten. This would appear to be consistent with the later provision requiring annual election for NEDs serving more than nine years. Also we note that the NAPF/ABI guidance and PIRC guidelines are based on nine years.
A3.4	Board should identify directors not considered independent and give reasons if it considers any director to be independent who may appear not independent	We support this, though would caution that explanations should be as full as possible if they are to be accepted by investors.
A3.5	At least half the board excluding the chairman should be independent	We support this though consider that it should be subject to phased implementation given that it significantly raises the minimum threshold for independent directors.
A3.7	No director should sit on all three principal committees unless board is small.	We note that along with the requirement for audit and remuneration committees to have at least three members, this effectively requires at least four independent NEDs on a board. We support the recommendation.
<b>Appointments to the board</b>		
A4.1	All companies to have a nomination committee	Support
A4.1	Nomination committee to have majority of independent directors	We would support wholly independent membership.
A4.1	Nomination committee should be chaired by an independent NED, not the board chairman, though chairman may be a member	Support.
A4.2	Nomination committee should make public its terms of reference	Support
A4.3	Nomination committee to evaluate board needs and set out description of role and capabilities required prior to appointment	Support
A4.4	Letter of appointment to include time required and responsibilities	Support
A4.5	Board should set out to shareholders why an appointment is being made and how the person meets the role's requirements	Support. A similar requirement should relate to any director being proposed for election at any time (not just on first appointment).
A4.6	NEDs should undertake to have sufficient time available and should disclose other commitments to the company prior to appointment	Support
A4.7	Nomination committee should review annually time required and commitment of director should be part of performance appraisal. Chairman and board should be informed of any new external appointments	Support
A4.8	Executives should not have more than one NED position.	Support

<b>Number</b>	<b>Proposed Code provision</b>	<b>Comment</b>
A4.8	Nobody should chair more than one FTSE100 company.	This may be too restrictive. The key issue is the number of other positions.
A4.9	Nomination committee should take responsibility for succession planning	Support
A4.10	Nomination committee should make a report in the annual report about its activities and its appointments process. It should explain if external advice or open advert has not been used.	Support
A4.11	Terms and conditions of appointment for NEDs should be published	Support
<b>Information and professional development</b>		
A5.2	Company secretary should be accountable to the board via the chairman for all governance matters	Support
A5.6	Chairman responsible for ensuring that all new directors receive comprehensive, formal and tailored induction including meeting major investors	Support
A5.7	All directors should continually update skills and knowledge. Company should budget for training.	Support
<b>Performance evaluation</b>		
A6.1	Performance evaluation of the board, committees and individuals to take place at least annually. Chairman should act on the results	Support
A6.2	Board to report on whether performance appraisal has occurred and process used.	Support
<b>Re-election</b>		
A7.3	NEDs normally to serve for two terms of three years. Any longer term to be explained to shareholders. NEDs serving nine years or more to be subject to annual election.	Having differing lengths of tenure for 'normal' term, for annual election and for determination of independence is potentially confusing. Annual election for some directors but not all could be divisive.
A7.4	Before proposing re-election, chairman should use performance evaluation to confirm that the NED continues to contribute effectively	Support
<b>B. Remuneration</b>		
<b>Level and make-up of remuneration</b>		
B1.3	Remuneration committees should be sensitive to 'broader issues'	We note the new wording more suggestive of consideration of factors outside the company. We support this.
B1.7	NED remuneration should reflect their time and responsibilities. Payment in options should be avoided.	Support.
<b>Service contracts</b>		
B1.8	Notice periods should be one year or less.	We support the stronger proscription of contracts longer than a year.
B1.10	Remuneration committees should consider compensation commitments and consider liquidated damages clauses but pre-defined compensation 'should not have the effect of rewarding poor performance'.	Support, though should make clear that pre-determined compensation should not amount to more than one year's salary and benefits only.
<b>Procedure</b>		
B2.1	Remuneration committee should have at least three members, all independent	Support

<b>Number</b>	<b>Proposed Code provision</b>	<b>Comment</b>
B2.2	Remuneration committees should have delegated authority for setting pay	Support.
B2.2	Committee should set the remuneration for executive directors and the chairman, and also the level and structure for senior executives.	No view in terms of extension of responsibilities to senior executives
B2.5	Committee should consult the chairman and/or the CEO about proposals and have responsibility for appointing remuneration consultants. If executive directors or senior management support the committee, 'this role should be clearly separated from their role within the business'.	Wording on separation of roles for internal advisers could be clarified.
	<b>Disclosure</b>	
B3.1	Board should make a remuneration report each year	We assume this will be deleted as it has been superseded by Directors Remuneration Report Regulations for listed companies
B3.2	Report should set out policy and factors specific to the company	As above
B3.3	Report should follow provisions of Schedule B	As above
B3.5	Remuneration report should not be a standard item on AGMs	As above
<b>C. Relations with shareholders</b>		
	<b>Dialogue with institutional shareholders</b>	
C1.1	Boards should report on how they have ensured that board members and particularly NEDs have developed an understanding of the views of major investors	Support
C1.2	The senior independent director should attend meetings with major shareholders along with management, and report views to other NEDs. NEDs should be able to attend meeting with major shareholders and should expect to do so if requested.	Support
C1.3	NEDs should meet major investors as part of their induction process	No view
	<b>Constructive use of the AGM</b>	
C2.1	Companies should count proxy votes and disclose level of proxies cast after the show of hands	Should require disclosure at AGM and subsequent publication of proxy votes in terms of absolute numbers of proxies cast for, against and abstain.
C2.3	Chairman should arrange for committee chairmen to attend the AGM and all NEDs should attend AGMs	Should specify that all directors should attend AGMs
<b>D. Accountability and audit</b>		
	<b>Internal control</b>	
D2.2	Review of need for internal audit function to be annual	Support
	<b>Audit committee and auditors</b>	
D3.1	All companies to have audit committee. All members to be independent and at least one to have 'significant, recent and relevant financial experience.'	We note the Smith Report guidance expands requirement further: the company chairman may not be a member, no one other than committee chair and members to have right to be present. We support the provision and guidance.

<b>Number</b>	<b>Proposed Code provision</b>	<b>Comment</b>
D3.2	Fuller specification of terms of reference	Provision should include public disclosure of terms of reference. Of the proposed terms of reference, we particularly support the emphasis on the role of the audit committee in leading on the appointment of auditors.
D3.3	Audit committee to be provided with sufficient resources	Support
D3.4	Annual report to contain a separate section describing audit committee's and responsibilities and actions taken to discharge them	Support
D3.5	AC chair to be present at AGM	Support
<b>E. Institutional shareholders</b>		
	<b>Shareholder voting</b>	
E1.2	Institutional investors should report to clients on proportion of resolutions voted upon	Should be extended to requirement to report on individual companies and individual resolutions.
E1.4	Institutional investors should attend AGMs where practicable	Support
E2.1	Institutional investors should apply the principles set out in the ISC's Code on activism and incorporate into contracts	Support