22 July 2011

Our ref: ICAEW Rep 73/11

Mr Michel Barnier
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By email: markt-complaw@ec.europa.eu

Dear Sir

GREEN PAPER ON THE EU CORPORATE GOVERNANCE FRAMEWORK

ICAEW is pleased to respond to your request for comments on *the EU Corporate Governance Framework Green Paper*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

GREEN PAPER ON THE EU CORPORATE GOVERNANCE FRAMEWORK

Memorandum of comment submitted in July 2011 by ICAEW, in response to European Commission consultation paper EU Corporate Governance Framework Green Paper published in April 2011

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *the EU Corporate Governance Framework Green Paper* published by the European Commission.

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council (FRC). As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide. ICAEW is listed in the Commission's Register of Interest Representatives (ID number: 7719382720-34).

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

PRELIMINARY OBSERVATIONS

4. It is important to take into account all shareholding structures when looking at ways to encourage shareholders to take an interest in and be an active participant in the corporate governance issues of companies. Not all solutions will fit all shareholding structures and so whatever is proposed will need flexibility and to be proportionate to the size of the company and the very differing shareholding structures. There is a wide disparity in approach to company law and ownership structures in European national markets and one size does not fit all.

5. Finding ways to improve the application of corporate governance codes is a key challenge for all countries and oversight in this area could be enhanced. We would favour voluntary best practice mechanisms above legislation. The EU Corporate Governance Framework Green Paper sets out the widespread support amongst market participants for the comply or explain concept but it is right to look at ways these systems can be improved. That being said any measures contemplated at EU level should be subject to robust cost benefit analysis and be firmly grounded in evidence which supports policy implementation. Any measures which may have unintended consequences or tend to limit access to European capital markets or restrict existing rights of capital providers should be avoided.

6. Corporate governance is one of a number of mechanisms that can be employed to curb harmful short-termism (we do not consider all short-termism to be necessarily bad) and excessive risk taking. Corporate governance does not however sit in isolation from the other mechanisms that can be employed to address short-termism and excessive risk taking and cannot in and of itself insulate companies and society from systemic issues. It is also important to make the distinction between the governance of banks and other financial institutions, which pose a systemic risk, and other corporations. There is no evidence of failure in corporate governance in the wider corporate community following the financial crisis of 2008.

7. Enlightened investors will actively seek jurisdictions where there are good standards of governance, transparency, accountability, fairness and responsibility. Nevertheless, putting excessive burdens on listed companies in Europe could make listing in Europe less attractive. Therefore any additional burdens on listed companies need to be outweighed by the added attractiveness of better governed markets: a full range of investor views on these issues should be sought. We hope that the Commission will be able to find the right balance in this area.

8. Market and internal company and investor dynamics contribute to short-termism as does political short termism. There is a need to consider structural, informational, behavioural and incentive problems operating within both firms and markets that are not covered within the scope of this Green Paper.

RESPONSES TO SPECIFIC QUESTIONS

GENERAL QUESTIONS

Q1: Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.

9. We agree that there should be flexibility in EU corporate governance measures to allow for a differentiated approach as this is an area where one size of code does not fit all eventualities. In the UK, the UK Corporate Governance Code serves as a standard to which public companies can aspire but full adherence for all companies is not necessarily the expectation as not all provisions will be directly relevant due to the company size or lack of complexity. Flexibility within capital markets to allow companies incorporated outside any particular jurisdiction to comply with national corporate governance codes and guidelines is a desirable policy aim.

10. Shareholders expect companies to be properly governed and it is right that regulators and policy makers seek to encompass a wide range of concerns. In recent years, and certainly since the financial crisis of 2008, corporate governance has moved away from a narrow focus on the way that companies are controlled and directed. There has been a move towards wider issues of improving shareholder engagement and investment and this is a logical and progressive direction for corporate governance to take. In the UK the principal framework for corporate governance is the UK Corporate Governance Code. Companies on the Official List with a premium listing are subject to the UK Corporate Governance Code on a 'comply or explain' basis and those with a standard listing of shares are also subject to the Disclosure Rules and Transparency Rules (DTR) 7.2 which impose a corporate governance 'comply or explain' obligation (Listing Rule14.3.24R). AIM companies are not required to comply with the Listing Rules or with the majority of the DTR but have their own AIM Rules for companies and Corporate Governance Guidelines for Smaller Quoted Companies published by the Quoted Companies Alliance. In addition, all companies incorporated in the UK are bound by any corporate governance provisions contained in the Companies Act 2006. Any AIM companies that are incorporated outside the UK may also need to comply with the appropriate corporate governance regime in their country of incorporation. These different systems work well and so we support corporate governance measures which are proportionate and flexible enough to take into account the size of the entity.

Q2: Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?

11. Good governance is important in all organisations but it is especially important where ownership and management are separated. This does not only manifest itself in listed entities but in other ownership structures. It would be beneficial if the EU encouraged, but did not mandate through legislation, the use of governance codes by non-listed companies. A voluntary approach could be stimulated by the EU in the unlisted sector which could be beneficial but not overly prescriptive and allow for differences in organisational structures and for guidelines to be set at national level. It would also be beneficial to take into account the work that has already been done in this area by other international organisations such as the OECD and ecoDa. It would be helpful if a principles based approach was taken. A principles based approach can set a high benchmark and provide a framework for organisations to strive towards. For example, in the UK much of the UK Corporate Governance Code which is intended primarily for listed entities can be, and is, used as a benchmark for other organisations. Many other national governance codes in Europe could be used in this way in their jurisdictions.

BOARDS OF DIRECTORS

Q3: Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?

12. In listed companies it is essential that no one individual should have unfettered powers of decision. It has to be for companies to articulate clear divisions of responsibilities at the head of their company to suit their corporate structure and individual circumstances. However, as a guiding principle it has to be right that there is a clear division between the two roles of chair and chief executive officer where they exist. Companies should be able to have procedures that suit their business and their jurisdiction rather than follow a prescribed structure as long as they can demonstrate that there are reasons for any concentration of power in one individual. Given differing board structures across Europe in different jurisdictions a 'one size fits all' approach may be unworkable and we would urge the Commission against considering regulation in this area at EU level and encourage the handling of this issue at national level.

Q4: Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance, i.e. at national, EU or international level?

13. We believe that board composition is vital to the successful performance of a company and that greater board attention should be directed at on-going composition and director evaluation. However, we do not believe that this is an area where hard and fast rules help because when it comes to defining the most suitable set of criteria for board appointments this has to be done on a case by case basis depending on the circumstances of each individual company. This is an area where guidance is helpful but prescription is not.

14. There is much that can be improved in this area at both national and international level to increase transparency and accountability towards shareholders. There could be greater transparency at national level of recruitment policies and also of recruitment practices to allow investors and other stakeholders to form a view on whether robust practices are being employed by the company. Transparency will allow practices to be scrutinised and shareholders to take a view.

15. There is a concern that the activities of recruitment consultants are not always as transparent as they could be and greater disclosure in this area could be beneficial. Encouraging voluntary codes of practice for board recruitment specialists would be useful.

16. What is essential is that board appointments are made by listed companies based on merit against objective and transparent criteria, and with due regard to the benefits of diversity. We believe that diversity on boards can increase overall effectiveness.

17. Greater diversity on boards is a key means to reducing 'group think' which has been identified as a major problem in some boards. Board members who bring different experiences to the board will increase opportunities for diversity of thinking. Diversity on boards can also promote greater and more effective challenge within the boardroom and increase overall board independence.

Q5: Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?

18. We believe that all listed companies should disclose their diversity policies and report regularly (annually would be sufficient) on their performance against their diversity policy on a comply or explain basis. Greater transparency in this area would be beneficial to allow shareholders to assess performance.

Q6: Should listed companies be required to ensure a better gender balance on boards? If so, how?

19. We fully support greater gender diversity on boards as a way of increasing board effectiveness. Diversity is an essential element to board effectiveness as it enables differing perspectives and avoids 'group think' or similar attitudes prevailing. We are in favour of listed companies considering and making appointments based on merit, against objective criteria and with due regard to the benefits of diversity. We think that lack of diversity in some listed company boards is an issue but that the diversity debate deserves to be wider than gender. This is not to say that we do not believe gender diversity to be an essential topic but we believe that this diversity debate is an opportunity to address all diversity issues not simply gender. We think that there should be a requirement on listed companies to ensure a diverse board and that gender is one important component part of this diversity.

20. We support current European Commission initiatives on board diversity. The European Commission has called ('Women on the Board Pledge for Europe') on publicly listed EU companies to sign a pledge to increase the presence of women on corporate boards to 30% by 2015 and 40% by 2020. As we understand it the pledge is a voluntary commitment and on 8 March 2012 the Commission will assess whether this self-regulatory initiative has worked and decide on any further course of action. We feel that this voluntary approach is to be encouraged and we do not see a need for regulatory intervention on board gender balance and we do not support quotas. In the UK Lord Davies published in February 2011 his report on 'Women on Boards' in which he rejected the introduction of statutory quotas as a means of improving female representation on boards. However, the UK Government intends to hold in reserve the possibility of statutory quotas, in case a business-led approach does not result in significant change. The steering group which supported Lord Davies will meet every six months to consider progress against the recommendations and will report annually as to whether sufficient progress is being made. http://www.bis.gov.uk/assets/biscore/business-law/docs/w/11-745-women-on-boards.pdf

21. We believe that quotas are very blunt and crude instruments with which to tackle lack of diversity on boards and in companies generally. In the past, the UK Corporate Governance Code has been successful in effecting real change in behaviours in a relatively short period of time, for example by encouraging the separation of the roles of chief executive and chairman and by stimulating the change towards a majority of non-executive directors on boards. The FRC is currently consulting on changes to the UK Corporate Governance Code to require listed companies to establish a policy concerning boardroom diversity, including measurable objectives for implementing the policy, and to report annually against such policy and objectives.

22. All market participants need to play a role to ensure better gender balance in the work place. Much more needs to be done to provide a level playing field to ensure that all potential candidates get the same treatment in terms of mentoring, networking and training for management positions. ICAEW launched its 'Women in Leadership' programme in February 2011 which is designed to support female finance professionals with their career progression. In addition our 'Narrowing the Gap' programme continues to support career breakers with their return to work.

23. Perhaps the EU could play a role in providing a central information source for women on careers advice. A central source of information through an EU website with useful links to national initiatives would be extremely beneficial to people who move cross-border and are looking for board opportunities in the EU.

24. As a supplemental point it would be desirable if all listed entities were required to provide greater disclosure of the breakdown not only of directors but also of their senior management so that investors could clearly see where there are diversity gaps in the 'pipe-line' of the next generation of directors and hold companies to account where appropriate.

Q7: Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?

25. Too much prescription in the number of mandates individual directors can hold may be counter-productive. Not all individuals are the same and undue prescription may be unfair, and a loss to society as a whole, for certain high-performing individuals. Not all companies place the same demands on non-executives and not all individuals have the same abilities. For some individuals one appointment may be the maximum and others may be comfortably able to handle more than one appointment. A principles-based approach to the number of directorships any one individual should hold rather than one that is too prescriptive has many advantages. Pure compliance with strict requirements could suppress talent availability rather than increase or encourage additional appointments in appropriate cases. For these reasons we do not favour measures at EU level limiting the number of boards that individuals may serve on. However, we think that greater transparency of the number of directorships held by individuals across all EU countries would be beneficial.

Q8: Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

26. Board and individual director evaluations play a critical role in board effectiveness. Some listed companies already provide transparency of process in this area and we would like to see all listed companies in Europe doing the same although this is not an area where legislation is needed. We are supportive of all listed company boards looking at the time they devote to directors' continuing professional development and the degree of formality and structure involved.

27. Greater disclosure of the process of board and committee evaluation is positive and a separate section of the annual report focussed on this and the activities of the nomination committee would be a welcome development but we believe this is something that should be dealt with on a national level. However it is, once again, important to approach this on the basis of principles and to avoid any undue or unnecessary prescription which may dilute the quality of the evaluations and subsequent reporting.

28. Board evaluations should periodically be undertaken by external firms, possibly every third year, although we think the frequency of external exercises should be a matter for the individual company. A company's policy on board evaluation could be disclosed annually in its report and accounts together with details of the firm that has facilitated the external evaluation. An explanation that there are no conflicts of interest with the external evaluator would also be useful for investors.

Q9: Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?

29. It should be for individual businesses to decide, within the context of the regulatory framework, the most appropriate levels and mix of remuneration. How remuneration is structured is a fundamental driver of any business. The remuneration policy and how it links to risk appetite should be transparent and disclosed in the annual report. We believe that it is worth exploring the existing role of remuneration committees to determine if a better structure would produce better outcomes for companies and investors but that this is better done at a national level.

Q10: Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

30. Shareholders have a major role to play in influencing director remuneration. It should be mandatory that shareholders have an advisory vote on the remuneration report and remuneration policy and any new share incentive schemes should be put to shareholder vote at annual general meeting. In this way shareholders can have influence on the key aspects of remuneration.

Q11: Do you agree that the board should approve and take responsibility for the company's 'risk appetite' and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?

31. We agree with the analysis in the Green Paper that it is not appropriate to have a European approach to risk management. We believe that this is best dealt with at a national level by guidance rather than legislation at EU level.

32. Risk management, the effectiveness of risk management systems and the methods that boards employ to ensure that their organisations have robust risk management are central to good governance in all organisations. We believe that the board as a whole is responsible for risk and should report fully on risk to shareholders.

33. There should be a clear distinction between the setting of risk appetite and the management of risk within an organisation. A company needs to establish its risks and that has to be done at board level. The setting of risk appetite and the management of risk are separate issues but completely linked in that risk appetite will determine how the risk needs to be managed. Boards should determine risk appetite and should take responsibility for oversight of risk and determination of risk profile. Oversight of risk management could potentially be delegated to a committee of the board but setting the risk appetite should be a matter reserved to the board.

34. There should be clear disclosure in annual reports of a company's risk appetite although guidance would need to be developed on how to achieve this. There should also be mechanisms to allow shareholders to have a clear understanding of when a firm significantly deviates from its traditional business model.

35. The primary responsibility for information flows on risk to the board should be a shared responsibility of the chief executive officer and chair. Executive directors should have a responsibility to make all relevant information available to the board.

Q12: Do you agree that the board should ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

36. It is fundamental that each board should ensure that the company's risk management arrangements are appropriate and commensurate with the company's risk profile. Greater clarity about how risk management information flows up to the board and how this information is aggregated, collated and reported would be useful to investors and regulators but this could be covered in general guidance at national level. As with financial information, it is important that reliable and meaningful risk management information forms an integral part of a company's annual disclosures. The inclusion of a risk discussion in the annual report which not only discloses risk appetite but also the major risks and how these have been managed could be considered. Disclosure of principal risks and uncertainties is already required under the Transparency Directive and disclosure of internal controls over financial reporting is required under the 4th Company Law Directive.

SHAREHOLDERS

Q13: Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.

37. As is implied in the consultation paper, EU legal rules are probably less significant than developments in international capital markets in contributing to inappropriate short-termism among investors. However, we believe that it would be useful to seek further evidence on whether rules, for example in relation to solvency and pensions accounting, have had unintended consequences.

Q14: Are there measures to be taken, and if so, which ones, as regards the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

38. It is right that the focus is on institutional investors (pension funds, mutual funds, hedge funds and sovereign wealth funds) as they act for long-term beneficiaries who have an obvious interest in preserving wealth in their investment portfolios and tend naturally to focus on long-term issues.

39. Encouraging investors and intermediaries to adhere to codes of best practice would be a useful way to make shareholder accountability more effective. We believe that this should be done on a national basis.

40. Performance based fees can produce undesirable incentives. When fees are measured as a percentage of the gain without regard to losses, a fiduciary may risk an investment to increase their fee. However, regulation of fee structures and their transparency can provide only a partial solution to the incentive problems and could raise other potential problems. We would be cautious of any policy developments in this area without further research and consultation.

Q15: Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?

41. It would be useful to look at more effective monitoring in this area but we do not believe that there is a place for legislation. There has been concern about how well governance specialists are linked to fund managers within investment firms and how far companies act upon engagement messages from investors. The Stewardship Code in the UK is a helpful national development in this area.

42. It would be beneficial to apply a higher degree of accountability and enhanced fiduciary duties to financial intermediation through increased disclosures on compensation, incentives, trading, policies on pay, voting and other matters that indicate compatibility with funds' stated objectives and the goals of ultimate beneficiaries. By requiring investor institutions to consider their fiduciary duties more carefully when issuing mandates, the accountability of asset managers to their clients could be increased. However, we do not believe that this is an area where EU legislation is required.

Q16: Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

43. Investment mandates are vital to improving the long-term emphasis on stewardship but we would be wary of legislative measures in this area. It would be useful to have a debate on the fiduciary duties of those in the investment chain and further research in this area would be useful to ensure that informed policy decisions are taken.

Q17: What would be the best way for the EU to facilitate shareholder cooperation?

44. Lack of investor engagement is currently perceived as an obstacle to effective corporate governance. However there are underlying factors that militate against cooperation which should be taken into account such as the EU regulation on ‘acting in concert’ and also the market reality that often shareholders are in a competitive position. We would urge the Commission to further explore with the investment community ways in which shareholder co-operation could work better at a European level.

45. We believe that there is very little that legislation could do to enhance shareholder co-operation. However, it would be helpful to make cross border voting easier and remove barriers to cross border voting. The initiatives in the Securities Law Directive are helpful in this regard but should be monitored to ensure that they are adopted and being effective.

Q18: Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest and their policy for managing them and/or whether they apply to a code of conduct? If so, how can this best be achieved?

46. Proxy advisers should be subject to greater transparency and should have a voluntary code of conduct which they are required to report against on a comply or explain basis. There are three main concerns about proxy advisers: that their activities lack transparency, that they are potentially subject to conflicts of interest and that potentially they get in the way of constructive dialogue between investors and companies. Proxy firms play a valuable and a necessary role in enabling shareholders to reach decisions about the companies they invest in. Some minimal self-regulation and greater transparency would be beneficial. Compulsory registration, for example, would provide a basis for minimum standards on such matters as publishing how voting policies are decided.

47. Amongst the most neglected variables in current research on corporate governance is the role of reputational intermediaries and the structure of financial institutions. The effective lack of competition, high barriers to market entry for many areas of financial intermediation and current market practices pose problems with existing mechanisms which have become evident.

Q19: Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

48. We do not believe that legislative measures are currently required. However, a voluntary code which proxy advisors are required to report against on a comply or explain basis would be useful to ensure that any conflicts of interest are dealt with appropriately if proxy advisors are providing additional services ancillary to their proxy advisory role. It would be useful at EU level to convene a forum to discuss these issues with proxy advisers, companies and investors and arrive at market solutions.

Q20: Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

49. This issue of shareholder identification is crucial to effect dialogue between companies and their shareholders. In the UK there are two effective mechanisms to identify shareholders on the corporate register. Public companies have the right under section 793 Companies Act 2006 to demand the identity of their beneficial owners and to place restrictions on the shares in question if the owners do not respond. Together with the section 793 Companies Act 2006 process the UK Financial Services Authority DTR (where a notification by investors to the issuer is required when an investor has acquired an interest in more than 3% of the issued share capital) establish an operating framework for shareholder identity which is well established. However, there are some well voiced limitations (timing issues, costs and territoriality) to the current section 793 Companies Act 2006 procedure. In addition, notwithstanding the section 793 procedure it is still easy for shareholders who wish to remain anonymous on any corporate register to do so. The DTR rule changes in the UK made in June 2009 require disclosure of long contracts for difference and other derivative products having similar economic effects and extend Chapter 5 of the DTR. These were useful in giving companies and investors a clearer picture of who has significant economic control over listed shares.

50. The section 793 right applies to companies domiciled in the UK and to their shareholders all over the world. However, in practice investors may challenge that right where there may be local banking secrecy rules so companies therefore have certain powers to force disclosure and these powers, if used effectively, can remove the right to vote from the shares. Companies have been bombarded with disclosure requirements over the last 20 or so years but investors with hidden identities (and sometimes hidden intentions) can remain hidden on the register very effectively. This seems to be a very unfair position especially as stewardship principles by investors are becoming more widely discussed. The effects of the lack of disclosure of investors affect all market participants. This is an area where we believe it would be beneficial to consider changes at European level so that there is a more common approach taken across Europe.

Q21: Do you think that minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

51. We understand that the comply or explain model is challenging in companies with controlling shareholders but we believe that it is still viable as a mechanism. The protection of minority shareholders in such cases needs other mechanisms and we believe that existing EU rules should be examined to ensure that in each EU jurisdiction there are sufficient workable mechanisms to protect minority shareholders' interests.

52. In addition, what happens to the perceived alignment of interests when there are controlling shareholders and the attitudes of managers in these situations towards minority interests are issues worthy of research.

Q22: Do you think that minority shareholders need more protection against related party transactions? If so, what measures could be taken?

53. The statement by the European Corporate Governance Forum supporting a requirement for a shareholder vote on significant related party transactions is a sensible suggestion and one we support.

Q23: Are there measures to be taken, and if so, which ones, to promote at EU level employee share ownership?

54. Employee ownership can mean many different things to different people and there are very many different ways employees can hold shares. There are several rationales for employees to hold shares and research indicates that employee ownership appears to increase productivity and profitability and improve employees' dedication and sense of belonging.

55. In general terms we believe that at EU level it is right to promote employee share ownership. However, it must always be remembered that employees around the world have lost much of their retirement savings by over investing in their employers' shares and so it is important to remember there can be disadvantages to employees. Employee share ownership can be stimulated by providing incentives in the tax system to make it advantageous for employees to hold their employers' shares. However, careful thought should be given to the incentives within the system as shares can sometimes act as a disincentive if they remain under water or actually lose employees' money.

56. There needs to be fresh and innovative thinking to look at ways in which market participants seek to incentivise boards, managers and each other to act in the interests of those that they are meant to serve.

57. Corporate boards have traditionally operated on the assumption that superior shareholder value could be achieved if the interests of management were aligned with those of shareholders. Thus options and grants became commonplace with a majority of schemes being fixed-price schemes which reward the option holder even when the share price increase is below that of competitors over a similar period of time. Indexed options which reward superior performance relative to competitor indices in both rising and declining markets may avoid the weakness of fixed-price options. While equity compensation in the form of stock options can be appropriate as an incentive, many other types of incentives may be more appropriate for aligning management and shareholder interests.

MONITORING AND IMPLEMENTATION OF CORPORATE GOVERNANCE CODES

Q24: Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

58. Yes we agree that any departure from corporate governance recommendations should be explained fully.

Q25: Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should their role be?

59. In the UK, the Financial Reporting Review Panel, which reviews narrative and financial reporting, already monitors on behalf of the Financial Services Authority the mandatory corporate governance disclosures required under the 4^{th} and 8^{th} Company Law Directives. In addition, compliance with the UK Corporate Governance Code is monitored by shareholder bodies and private sector organisations who are interested in corporate governance trends. The current system is based on the approach that shareholders oversee and monitor disclosures and take actions against those companies not complying. It is perhaps right to review this approach in light of the changes that have taken place in share ownership patterns which directly impact the perceived alignment of management and shareowner interests.

60. More external regulation to monitor and enforce any governance regime may at first sight appear appealing but in practice regulation can, and does, become routine and self-perpetuating and lead to box ticking which in the long term may lead to complacency. There is a real concern that additional monitoring might interfere with the operation of existing governance codes. However, there is perhaps scope for a comprehensive review of the existing monitoring mechanisms in the EU to establish how effective shareholders really are as an effective control mechanism.

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