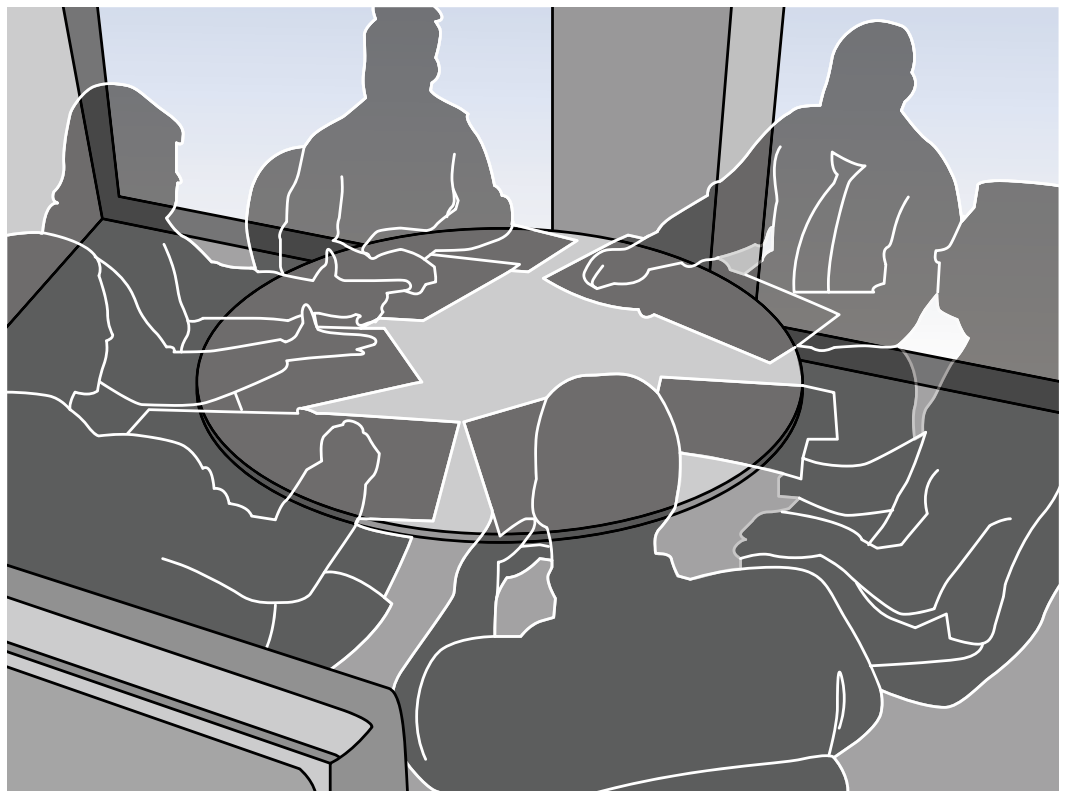


The Combined Code on Corporate Governance

An Annotated Version for Mutual Insurers



July 2005

© Copyright 2005

Published with permission of the Financial Reporting Council.

The text and the annotations in this document may be reproduced free of charge in any format or medium providing that it is reproduced accurately and is not used in a misleading context. The material must be acknowledged in the correct way.

Any enquiries relating to this document should be sent to:

Association of Mutual Insurers (AMI)

PO Box 21, Altrincham, Cheshire, WA14 4PD, United Kingdom

tel: 0161-952 5092 fax: 0161-929 5163

www.mutualinsurers.org

Association of Friendly Societies (AFS)

51 Gresham St, London, EC2V 7HQ, United Kingdom

tel: 0207-216-7436 fax: 0207-216-7373

www.afs.org.uk

Introduction

1. This document is a copy of the July 2003 version of the *Combined Code on Corporate Governance*, including the *Related Guidance and Good Practice Suggestions* appended to this, ('the Code') to which annotations have been added. The annotations, as with this Introduction, are given in boxes. The original text of the Code itself has not been amended. The *Related Guidance and Good Practice Suggestions* includes *Guidance on internal control (The Turnbull Guidance)*, *Guidance on audit committees (The Smith Guidance)*, and *Suggestions for good practice from the Higgs report*.
2. The guidance in this document, which comprises this Introduction and the annotations, is intended to assist mutual insurers in having 'regard' to the Code. The annotations follow a 'by exception' approach, in that they are given only for those elements of the Code that either raise particular issues for mutual insurers or are not considered to be relevant to mutual insurers. All parts of the Code are regarded as being appropriate in their present form unless this Introduction and/or annotations indicate otherwise, with direct references to 'listed companies' being read as mutual insurers. The annotations are not intended to alter the principles of the Code but rather to promote interpretations that should best uphold these principles. Code provisions that are not annotated should not be regarded as any less important than those that are.
3. The Code follows a 'comply or explain' approach. An important element for listed proprietary companies adhering to the Code is the disclosure statement required by the UKLA Listing Rules 12.43A (which is discussed in the Preamble to the Code and elaborated upon in Schedule C to the Code). Mutual insurers should also produce a disclosure statement observing the 'comply or explain' principle in accordance with the approach set out in this Rule.
4. Listed companies are subject to certain external disciplines that do not apply to mutual insurers, such as those arising from considering the price of their equity (and hence the cost of capital) and from having significant shareholders. Mutual insurers should consider these differences in their approach to corporate governance and adherence to the annotated Code, in particular when determining the overall composition of the Board (including the appropriate number and skills of non-executive directors) and how they demonstrate accountability to members. Mutual insurers should also be minded as to how they use the flexibility of the 'comply or explain' principle of the Code, adhering to each provision of the annotated Code unless their individual circumstances mean that they cannot do so, or that it is demonstrably in the best interests of their members for them not to do so.
5. Although the 'comply or explain' disclosure statement plays an important part in ensuring that a firm is accountable to its members on governance matters, it may not alone be sufficient. It may be appropriate, for example, to discuss governance arrangements directly with member representatives as part of the dialogue discussed in the annotations to section D.1 of the Code.
6. The Code makes several references to 'shareholders' (A1, A2.2, A3.3, A7.1, A7.2, B1.1, B2.3, B2.4, C2.1, C3.7, D1, D2.4). Although mutual insurers do not have shareholders, the principles underpinning these provisions of the Code are relevant and should be considered in relation to members.
7. The Code also makes several references to 'the major shareholders', 'a range of major shareholders', 'principal shareholders', and 'institutional shareholders' (A2.2, A5.1, B2, D1). Again although mutual insurers do not have shareholders, the principles underpinning these provisions of the Code are relevant and should be considered in relation to appropriate methods for facilitating direct member dialogue and involvement that may be in place (such as member forums or panels and/or delegate systems) and/or any members with significant membership rights.
8. Mutual insurers' policies on facilitating member dialogue and involvement should be clearly articulated to members in the Annual Report and on the firm's web site.
9. In relation to the above paragraphs 4. 5. 6. 7. and 8. in this Introduction, mutual insurers should consider any best practice guidelines on member relations produced by the AMI and the AFS.
10. Certain provisions within the Code may use terminology that is not used by some, or all, mutual insurers. Where there is a difference in terminology, mutual insurers should consider the provisions of the Code in relation to the most

appropriate equivalent. For example, where the Code refers to the 'Board', this should be taken to mean the governing body of the undertaking, whatsoever this might be called. Similarly 'directors' should be read as the members of the governing body of the undertaking. 'Articles of Association' should be read as the relevant constitutional document, which may be Articles or Rules. 'Company' should be read as society as appropriate.

11. The FSA has been consulted about the development of the annotated Combined Code for mutual insurers and has welcomed this initiative. The FSA expects that such guidance will be helpful in identifying the issues to be considered by mutual insurers' boards when seeking to apply the latest version of the Code to the different circumstances of a mutual insurer and to their particular firm. Some of the draft annotations to the Code refer to AMI and AFS best practice guidelines, which have yet to be produced. The FSA awaits the outcome of these guidelines but shares the objective of the AMI and the AFS that, by following the guidance in the annotations, and the best practice guidelines, firms should be able to demonstrate that they have had regard to the FSA's own high-level guidance relating to corporate governance.
12. Mutual insurers should anticipate that the FSA will wish to discuss compliance and their explanations for departures from the provisions of the annotated Code in the context of a risk assessment or other supervisory work.
13. It is intended that the annotated Code should apply to all the forms of mutual undertaking engaged in insurance business in the UK, including small mutual insurers. While small firms will tend to operate under greater cost constraints than larger firms, the governance principles of the Code, such as independence, transparency, and the separation of function are applicable to all. The flexibility inherent in the principle 'comply or explain' should enable any small firm to achieve a manner of adherence appropriate to its circumstances, taking into account its size, legal form, and any relevant constitutional documents such as the Rules of the society or the Articles of Association of the company. Small mutual insurers should consider any best practice guidance on the interpretation and application of the annotated Code that is produced on their behalf by the AFS working with the AMI.
14. This Introduction and the annotations to the Code will be updated in step with the periodic reviews of the Code itself that are to be undertaken by the FRC and following periodic review by the AMI and the AFS.
15. The Combined Code is reproduced by kind permission of the FRC.



THE COMBINED CODE ON CORPORATE GOVERNANCE

July 2003

Contents

	Page
The combined code on corporate governance	
Preamble	05
Section 1: Companies	07
A: Directors	07
B: Remuneration	13
C: Accountability and audit	15
D: Relations with shareholders	17
Section 2: Institutional shareholders	19
E: Institutional shareholders	19
Schedule A Provisions on the design of performance related remuneration	20
Schedule B Guidance on liability of non-executive directors: care, skill, and diligence	21
Schedule C Disclosure of corporate governance arrangements	22
References	24

Related guidance and good practice suggestions

- Guidance on internal control (The Turnbull Guidance)
- Guidance on audit committees (The Smith Guidance)
- Suggestions for good practice from the Higgs report
 - Guidance for the chairman
 - Guidance for non-executive directors
 - Summary of the principal duties of the remuneration committee
 - Summary of the principal duties of the nomination committee
 - Pre-appointment due diligence checklist for new board members
 - Sample letter of non-executive director appointment
 - Induction checklist
 - Performance evaluation checklist

Preamble

1. This Code supersedes and replaces the Combined Code issued by the Hampel Committee on Corporate Governance in June 1998. It derives from a review of the role and effectiveness-of non-executive directors by Derek Higgs¹ and a review of audit committees² by a group led by Sir Robert Smith.
2. The Financial Services Authority has said that it will replace the 1998 Code that is annexed to the Listing Rules with the revised Code and will seek to make consequential Rule changes. There will be consultation on the necessary Rule changes but not further consultation on the Code provisions themselves.
3. It is intended that the new Code will apply for reporting years beginning on or after November 1, 2003.

For mutual insurers, the Code will apply for reporting years beginning on or after the start of the financial year 2005–2006.

4. The Code contains main and supporting principles and provisions. The existing Listing Rules require listed companies to make a disclosure statement in two parts in relation to the Code. In the first part of the statement, the company has to report on how it applies the principles in the Code. In future this will need to cover both main and supporting principles. The form and content of this part of the statement are not prescribed, the intention being that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances applying to them which have led to a particular approach. In the second part of the statement the company has either to confirm that it complies with the Code's provisions or – where it does not – to provide an explanation. This 'comply or explain' approach has been in operation for over ten years and the flexibility it offers has been widely welcomed both by company boards and by investors. It is for shareholders and others to evaluate the company's statement

Although the Listing Rules apply only to quoted firms, mutual insurers should produce a disclosure statement observing the 'comply or explain' principle. This should be in accordance with the approach set out in the UKLA Listing Rules 12.43A, which is given below:

In the case of a company incorporated in the United Kingdom, the following additional items must be included in its annual report and accounts:

- (a) a narrative statement of how it has applied the principles set out in Section 1 of the Combined Code, providing explanation which enables its shareholders to evaluate how the principles have been applied;***
- (b) a statement as to whether or not it has complied throughout the accounting period with the Code provisions set out in Section 1 of the Combined Code. A company that has not complied with the Code provisions, or complied with only some of the Code provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.***

5. While it is expected that listed companies will comply with the Code's provisions most of the time, it is recognised that departure from the provisions of the Code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions.
6. Smaller listed companies, in particular those new to listing, may judge that some of the provisions are disproportionate or less relevant in their case. Some of the provisions do not apply to companies below FTSE 350. Such companies may nonetheless consider that it would be appropriate to adopt the approach in the Code and they

are encouraged to consider this. Investment companies typically have a different board structure, which may affect the relevance of particular provisions.

For mutual insurers 'companies below FTSE 350' should be read as mutual insurers with gross premium income of less than £20 million per annum on average over the preceding three financial years and assets of less than £100 million on average at the end of the last three financial years.

7. Whilst recognising that directors are appointed by shareholders who are the owners of companies, it is important that those concerned with the evaluation of governance should do so with common sense in order to promote partnership and trust, based on – mutual understanding. They should pay due regard to companies' individual circumstances and bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces. Whilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches. Institutional shareholders and their agents should be careful to respond to the statements from companies in a manner that supports the 'comply or explain' principle. As the principles in Section 2 make clear, institutional shareholders should carefully consider explanations given for departure from the Code and make reasoned judgements in each case. They should put their views to the company and be prepared to enter a dialogue if they do not accept the company's position. Institutional shareholders should be prepared to put such views in writing where appropriate.

In regard to 'institutional shareholders', the above is relevant in the manner that mutual insurers act in their role as institutional investors in their own right.

8. Nothing in this Code should be taken to override the general requirements of law to treat shareholders equally in access to information.
9. This publication includes guidance on how to comply with particular parts of the Code: first, 'Internal Control: Guidance for Directors on the Combined Code'³, produced by the Turnbull Committee, which relates to Code provisions on internal control (C.2 and part of C.3 in the Code); and, second, 'Audit Committees: Combined Code Guidance', produced by the Smith Group, which relates to the provisions on audit committees and auditors (C.3 of the Code). In both cases, the guidance suggests ways of applying the relevant Code principles and of complying with the relevant Code provisions.
10. In addition, this volume also includes suggestions for good practice from the Higgs report.
11. The revised Code does not include material in the previous Code on the disclosure of directors' remuneration. This is because 'The Directors' Remuneration Report Regulations 2002'⁴ are now in force and supersede the earlier Code provisions. These require the directors of a company to prepare a remuneration report. It is important that this report is clear, transparent and understandable to shareholders.

Although the Directors' Remuneration Report Regulations 2002 apply only to quoted firms, all mutual insurers should produce a remuneration report equivalent to that described in Schedule 7A[†] of the regulations and hold an advisory vote on the report at the AGM (as per S241A). Mutual insurers should draw on any guidelines produced by the AMI and the AFS on the remuneration report.

†Those sections of Schedule 7A relating to share options will not be relevant to mutual insurers (unless directors of mutual insurers are involved in ownership schemes involving subsidiaries). These are Section 3 sub-paragraph(2)(a)(i), all of Section 4 (relating to the Performance Graph), Sections 7, 8 and 9 (the treatment of Share Options in the information subject to audit) and Section 11 subparagraphs (2) and (3).

Code Of Best Practice

Section 1: Companies

A: Directors

A.1: The Board

Main Principle

Every company should be headed by an effective board, which is collectively responsible for the success of the company.

Supporting Principles

The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

All directors must take decisions objectively in the interests of the company.

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

Code Provisions

- A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.
- A.1.2 The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees. It should also set out the number of meetings of the board and those committees and individual attendance by directors.
- A.1.3 The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non executive directors should meet without the chairman present at least annually to appraise the chairman's performance (as described in A.6.1) and on such other occasions as are deemed appropriate.
- A.1.4 Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.
- A.1.5 The company should arrange appropriate insurance cover in respect of legal action against its directors.

A.2: Chairman and chief executive

Main Principle

There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.

Supporting Principle

The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman should also facilitate the effective contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors.

Code Provisions

A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.

A.2.2 The chairman should on appointment meet the independence criteria set out in A.3.1 below. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report.⁵

In regard to “major shareholders” see the guidance under 7 of the Introduction.

A.3: Board balance and independence

Main Principle

The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.

Supporting Principles

The board should not be so large as to be unwieldy. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business and that changes to the board's composition can be managed without undue disruption.

To ensure that power and information are not concentrated in one or two individuals, there should be a strong presence on the board of both executive and non-executive directors.

The value of ensuring that committee membership is refreshed and that undue reliance is not placed on particular individuals should be taken into account in deciding chairmanship and membership of committees.

No one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee.

Code provisions

A.3.1 The board should identify in the annual report each non-executive director it considers to be independent.⁶ The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- has been an employee of the company- or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;

- has close family ties with any of the company's advisers, directors or senior employees; holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

A.3.2 Except for smaller companies,⁷ at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.

A.3.3 The board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate.

Mutual insurers that do not appoint a senior independent director should consider whether it is necessary to offer members an alternative mechanism for the handling of their concerns (i.e. to replicate the arrangements envisaged in Section A.3.3) that acknowledge that members may not always wish to contact the chairman or an executive director.

A.4: Appointments to the Board

Main Principle

There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.

Supporting Principles

Appointments to the board should be made on merit and against objective criteria. Care should be taken to ensure that appointees have enough time available to devote to the job. This is particularly important in the case of chairmanships.

The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board.

Code Provisions

- A.4.1 There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. The nomination committee should make available⁸ its terms of reference, explaining its role and the authority delegated to it by the board.
- A.4.2 The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.
- A.4.3 For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and included in the next annual report. No individual should be appointed to a second chairmanship of a FTSE 100 company.⁹

For mutual insurers, which are of equivalent size to a FTSE 100 company, a chairman should not be appointed to the chairmanship of either a FTSE 100 company or another company of equivalent size to a FTSE 100 company.

A.4.4 The terms and conditions of appointment of non-executive directors should be made available for inspection.¹⁰ The letter of appointment should set out the expected time commitment. Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and the board should be informed of subsequent changes.

A.4.5 The board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company.

For mutual insurers, which are of equivalent size to a FTSE 100 company, no full-time executive director should be appointed to more than one non-executive directorship, or the chairmanship, of either a FTSE 100 company or another company of equivalent size to a FTSE 100 company.

A.4.6 A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director.

In mutual insurers, the recruitment process should involve appropriate sources of objective external opinion. When seeking to appoint independent directors, as well as considering the use of external recruitment consultants to lead the process, the nomination committee may wish to seek other outside views, for example by utilising methods for facilitating direct member dialogue and involvement that may be in place (such as member forums or panels and/or delegate systems). The advertising of posts should also be considered as a way of reducing the reliance on the personal connections of existing board members.

A.5: Information and professional development

Main Principle

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

Mutual insurers should consider any best practice guidance produced by the AMI and the AFS in relation to the induction and professional development of non-executive directors.

Supporting Principles

The chairman is responsible for ensuring that the directors receive accurate, timely and clear information. Management has an obligation to provide such information but directors should seek clarification or amplification where necessary.

The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities.

Under the direction of the chairman, the company secretary's responsibilities include ensuring good information flows within the board and its committees and between senior management and non-executive directors, as well as facilitating induction and assisting with professional development as required. The company secretary should be responsible for advising the board through the chairman on all governance matters.

The secretary of a mutual insurer should endeavour to fulfil an equivalent role. The roles of secretary and chief executive should ideally be split. If the same person holds both positions, the responsibility of ensuring good information flows to the board and its committees and between senior management and non-executive directors should be delegated to a different individual reporting to the chairman.

Code Provisions

A.5.1 The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, the company should offer to major shareholders the opportunity to meet a new non-executive director.

In regard to 'major shareholders' see the guidance under 7 of the Introduction.

A.5.2 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.

Boards should establish clear procedures through which non-executives can obtain advice from independent external advisers at the firm's expense when required. The availability of independent sources of advice should be made clear at the time of appointment. The Higgs best-practice guidance contains a draft non-executive's letter of appointment, in which a commitment to allow access to external advice is made.

Non-executives need not seek to appoint a relevant adviser for each and every subject area that comes before the board. When difficult issues arise, the first course of action should always be to encourage further and deeper analysis to be carried out within the firm. But it is important that any non-executive can access advice at the firm's expense from a source that is independent of the executive when there is an important issue on which he or she does not feel comfortable despite having sought clarification and amplification from within the firm.

A.5.3 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole.

A.6: Performance evaluation

Main Principle

The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

Supporting Principle

Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

Code Provision

A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

The appraisal of the chairman should be led by an independent director if a senior independent director has not been appointed.

A.7: Re-election

Main Principle

All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.

Code Provisions

- A.7.1 All directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election.
- A.7.2 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Acts provisions relating to the removal of a director. The board should set out to shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual should be elected. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role. Any term beyond six years (e.g. two three-year terms) for a non-executive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board. Non-executive directors may serve longer than nine years (e.g. three three-year terms), subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

Reference to Companies Acts provisions should be read as to Friendly Societies Acts provisions, or as to the provisions of such other statute as may be appropriate to the mutual insurer, in the event of any divergence.

B: Remuneration

B.1: The level and make-up of remuneration

Main Principles

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

Supporting Principle

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when, determining annual salary increases.

Code Provisions

Remuneration policy

B.1.1 The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels. In designing schemes of performance-related remuneration, the remuneration committee should follow the provisions in Schedule A to this Code.

Long-term incentive schemes should use performance criteria that properly reflect the best interests of members. The strategies that mutual insurers pursue and therefore the performance criteria that will be used in long-term incentive schemes may both be different from those of equivalent proprietary firms.

B.1.2 Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.

Although the Listing Rules apply only to quoted firms, mutual insurers should consider following the appropriate provisions of the Listing Rules in relation to the above.

Note, share options may be relevant to mutual insurers, in the above provision, if executive directors of mutual insurers are involved in ownership schemes involving subsidiaries.

B.1.3 Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

B.1.4 Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report¹¹ should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

Service contracts and compensation

B.1.5 The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

B.1.6 Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

B.2: Procedure

Main Principle

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Supporting Principles

The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.

The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

In regard to 'principal shareholders' see the guidance under 7 of the Introduction.

Code Provisions

B.2.1 The board should establish a remuneration committee of at least three, or in the case of smaller companies¹² two, members, who should all be independent non-executive directors. The remuneration committee should make available¹³ its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, a statement should be made available¹⁴ of whether they have any other connection with the company.

B.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.

B.2.3 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.

'Articles of Association' should be read as the relevant constitutional document, which may be Articles or Rules.

B.2.4 Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

The Listing Rules only apply to quoted companies. Mutual insurers should consider the above in relation to share option schemes if executive directors of mutual insurers are involved in ownership schemes involving subsidiaries.

Other significant long-term incentive schemes should be detailed as part of the directors' remuneration report, which is subject to an advisory vote at the AGM (see the annotation under 11 of the Preamble). Mutual insurers should draw on any guidelines produced by the AMI and the AFS on the remuneration report.

C: Accountability and audit

C.1: Financial Reporting

Main Principle

The board should present a balanced and understandable assessment of the company's position and prospects.

Supporting Principle

The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

Code provisions

C.1.1 The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.

C.1.2 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

C.2: Internal control¹⁵

Main principle

The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

For mutual insurers, 'shareholders' investment' should read as members' interests.

Code provision

C.2.1 The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

C.3: Audit committee and auditors¹⁶

Main principle

The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies¹⁷ two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;

- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
 - to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
 - to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.
- C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.¹⁸ A separate section of the annual report should describe the work of the committee in discharging those responsibilities.
- C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.
- C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.
- C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.
- C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

D: Relations with shareholders

D.1: Dialogue with Institutional Shareholders

In regard to 'Institutional Shareholders' see the guidance under 7 of the Introduction.

Main Principle

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.¹⁹

Supporting Principles

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman (and the senior independent director and other directors as appropriate) should maintain sufficient contact with major shareholders to understand their issues and concerns.

In regard to 'major shareholders' see the guidance under 7 of the Introduction.

The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

Code Provisions

D.1.1 The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.

D.1.2 The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion.

D.2: Constructive use of the AGM

Main Principle

The board should use the AGM to communicate with investors and to encourage their participation.

Mutual insurers should use the AGM in a manner that facilitates accountability and communication to members and encourages member participation.

Mutual insurers should consider any best practice guidelines produced by the AMI and the AFS in relation to the use of the AGM.

Code Provisions

D.2.1 The company should count all proxy votes and, except where a poll is called, should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution and the number of abstentions, after it has been dealt with on a show of hands. The company should ensure that votes cast are properly received and recorded.

D.2.2 The company should propose a separate resolution at the AGM on each substantially separate issue and should in particular propose a resolution at the AGM relating to the report and accounts.

-
- D.2.3 The chairman should arrange for the chairmen of the audit, remuneration, and nomination committees to be available to answer questions at the AGM and for all directors to attend.
 - D.2.4 The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

Section 2: Institutional shareholders

In regard to mutual insurers, this section is relevant to the manner in which they act in their role as institutional investors in their own right.

Members, particularly those acting under arrangements put in place to facilitate direct member dialogue and involvement (such as member forums or panels and/or delegate systems) or those with significant membership rights, might usefully consider the guidance in this section in any dialogue or other active involvement they have with the mutual insurer.

E: Institutional shareholders²⁰

E.1: Dialogue with companies

Main Principle

Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.

Supporting Principles

Institutional shareholders should apply the principles set out in the Institutional Shareholders' Committee's 'The Responsibilities of Institutional Shareholders and Agents - Statement of Principles',²¹ which should be reflected in fund manager contracts.

E.2: Evaluation of governance disclosures

Main Principle

When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.

Supporting Principle

Institutional shareholders should consider carefully explanations given for departure from this Code and make reasoned judgements in each case. They should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position. They should avoid a box-ticking approach to assessing a company's corporate governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces.

E.3: Shareholder Voting

Main Principle

Institutional shareholders have a responsibility to make considered use of their votes.

Supporting Principles

Institutional shareholders should take steps to ensure their voting intentions are being translated into practice.

Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.

Major shareholders should attend AGMs where appropriate and practicable. Companies and registrars should facilitate this.

Schedule A: Provisions on the design of performance-related remuneration

Share options will not be relevant to mutual insurers, unless directors of mutual insurers are involved in ownership schemes involving subsidiaries.

Long-term incentive schemes should use performance criteria that properly reflect the best interests of members. The strategies that mutual insurers pursue and therefore the performance criteria that will be used in long-term incentive schemes may both be different from those of equivalent proprietary firms.

1. The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to enhance shareholder value. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period.
2. The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities.
3. Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or at least form part of a well considered overall plan, incorporating existing schemes. The total rewards potentially available should not be excessive.
4. Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return.
5. Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.
6. In general, only basic salary should be pensionable.
7. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

Schedule B: Guidance on liability of non-executive directors: care, skill, and diligence

Mutual insurers should consider any best practice guidance produced by the AMI and the AFS in relation to the induction and professional development of non-executive directors.

1. Although non-executive directors and executive directors have as board members the same legal duties and objectives, the time devoted to the company's affairs is likely to be significantly less for a non-executive director than for an executive director and the detailed knowledge and experience of a company's affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director. These matters may be relevant in assessing the knowledge, skill and experience which may reasonably be expected of a non-executive director and therefore the care, skill and diligence that a non-executive director may be expected to exercise.
2. In this context, the following elements of the Code may also be particularly relevant.
 - (i) In order to enable directors to fulfil their duties, the Code states that:
 - The letter of appointment of the director should set out the expected time commitment (*Code provision A.4.4*); and
 - The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. The chairman is responsible for ensuring that the directors are provided by management with accurate, timely and clear information. (*Code principles A.5*).
 - (ii) Non-executive directors should themselves:
 - Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company (*Code principle A.5 and provision A.5.1*);
 - Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice. (*Code principle A.5 and provision A.5.2*);
 - Where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the board and, to the extent that they are not resolved, ensure that they are recorded in the board minutes (*Code provision A.1.4*); and
 - Give a statement to the board if they have such unresolved concerns on resignation (*Code provision A.1.4*)
3. It is up to each non-executive director to reach a view as to what is necessary in particular circumstances to comply with the duty of care, skill and diligence they owe as a director to the company. In considering whether or not a person is in breach of that duty, a court would take into account all relevant circumstances. These may include having regard to the above where relevant to the issue of liability of a non-executive director.

Schedule C: Disclosure of corporate governance arrangements

The Listing Rules require a statement to be included in the annual report relating to compliance with the Code, as described in the preamble.

See the guidance under 4 of the Preamble in regard to the statement to be included in the annual report relating to compliance with the Code.

For ease of reference, the specific requirements in the Code for disclosure are set out below:

The annual report should record:

- a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management (A.1.1);
- the names of the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees (A.1.2);
- the number of meetings of the board and those committees and individual attendance by directors (A.1.2);
- the names of the non-executive directors whom the board determines to be independent, with reasons where necessary (A.3.1);
- the other significant commitments of the chairman and any changes to them during the year (A.4.3);
- how performance evaluation of the board, its committees and its directors has been conducted (A.6.1); and
- the steps the board has taken to ensure that members of the board, and in particular the non-executive, develop an understanding of the views of major shareholders about their company (D.1.2)

The report should also include:

- a separate section describing the work of the nomination committee, including the process it has used in relation to board appointments and an explanation if neither external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director (A.4.6);
- a description of the work of the remuneration committee as required under the Directors' Remuneration Reporting Regulations 2002, and including, where an executive director serves as a non-executive director elsewhere, whether or not the director will retain such earnings and, if so, what the remuneration is (B.1.4);
- an explanation from the directors of their responsibility for preparing the accounts and a statement by the auditors about their reporting responsibilities (C.1.1);
- a statement from the directors that the business is a going concern, with supporting assumptions or qualifications as necessary (C.1.2);
- a report that the board has conducted a review of the effectiveness of the group's system of internal controls (C.2.1);
- a separate section describing the work of the audit committee in discharging its responsibilities (C.3.3);
- where there is no internal audit function, the reasons for the absence of such a function (C.3.5);
- where the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, a statement from the audit committee explaining the recommendation and the reasons why the board has taken a different position (C.3.6); and
- an explanation of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded (C.3.7).

The following information should be made available (which may be met by making it available on request and placing the information available on the company's web site):

- the terms of reference of the nomination, remuneration and audit committees, explaining their role and the authority delegated to them by the board (A.4.1, B.2.1 and C.3.3);
- the terms and conditions of appointment of non-executive directors (A.4.4) (see footnote 10 on page 9); and
- where remuneration consultants are appointed, a statement of whether they have any other connection with the company (B.2.1).

The board should set out to shareholders in the papers accompanying a resolution to elect or re-elect:

- sufficient biographical details to enable shareholders to take an informed decision on their election or re-election (A.7.1).
- why they believe an individual should be elected to a non-executive role (A.7.2).
- on re-election of a non-executive director, confirmation from the chairman that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role, including commitment of time for board and committee meetings and any other duties (A.7.2).

The board should set out to shareholders in the papers recommending appointment or reappointment of an external auditor:

- if the board does not accept the audit committee's recommendation, a statement from the audit committee explaining the recommendation and from the board setting out reasons why they have taken a different position (C.3.6).

References

- 1 *Review of the role and effectiveness of non-executive directors*, published January 2003.
- 2 *Audit Committees Combined Code Guidance*, published January 2003.
- 3 *Internal Control: Guidance for Directors on the Combined Code*, published by the Institute of Chartered Accountants in England and Wales in September 1999.
- 4 The Directors' Remuneration Report Regulations 2002, S.I. no.1986.
- 5 Compliance or otherwise with this provision need only be reported for the year in which the appointment is made.
- 6 A.2.2 states that the chairman should, on appointment, meet the independence criteria set out in this provision, but thereafter the test of independence is not appropriate in relation to the chairman.
- 7 A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.
For mutual insurers a "smaller company" is a mutual with gross premium income of less than £20 million per annum on average over the preceding three financial years and assets of less than £100 million on average at the end of the last three financial years.
- 8 The requirement to make the information available would be met by making it available on request and including the information on the company's web site.
- 9 Compliance or otherwise with this provision need only be reported for the year in which the appointment is made.
- 10 The terms and conditions of appointment of non-executive directors should be made available for inspection by any person at the company's registered office during normal business hours and at the AGM (for 15 minutes prior to the meeting and during the meeting).
- 11 As required under Directors' Remuneration Report Regulations.
- 12 See reference 7.
- 13 See reference 8.
- 14 See reference 8.
- 15 The Turnbull guidance suggests means of applying this part of the Code.
- 16 The Smith guidance suggests means of applying this part of the Code.
- 17 See reference 7.
- 18 See reference 8.
- 19 Nothing in these principles or provisions should be taken to override the general requirements of law to treat shareholders equally in access to information.
- 20 Agents such as investment managers, or voting services are frequently appointed by institutional shareholders to act on their behalf and these principles should accordingly be read as applying where appropriate to the agents of institutional shareholders.
- 21 Available at web site: www.investmentuk.org.uk/press/2002/20021021-01.pdf.



Association of Mutual Insurers

PO Box 21, Altrincham, Cheshire, WA14 4PD, United Kingdom
tel: 0161-952 5092 fax: 0161-929 5163

www.mutualinsurers.org



Association of Friendly Societies

51 Gresham St, London, EC2V 7HQ, United Kingdom
tel: 0207-216-7436 fax: 0207-216-7373

www.afs.org.uk
