

March 2010

**CBI RESPONSE TO THE FINANCIAL REPORTING COUNCIL CONSULTATION
ON UK CORPORATE GOVERNANCE CODE**

INTRODUCTION AND EXECUTIVE SUMMARY

The CBI welcomes the FRC's endorsement of the "comply or explain" model and commitment to only amend Code proposals where it is appropriate for all listed companies. We welcome moves to encourage more investor engagement, but urge caution on proposed changes to annual director re-election and board evaluation.

1. The CBI is pleased to respond to the Financial Reporting Council (FRC) Final Report and separate consultation on proposed Code changes. We agree with the FRC's conclusion that the Combined Code and its "comply or explain" model remains fit for purpose. We also endorse the approach taken by the FRC that the Code should only be amended where new proposals are appropriate for all premium listed companies.
2. The CBI is cautious about proposed changes to director re-election and external board evaluation. We believe that the FRC should consider retaining the existing three yearly rotating renewal for board directors, as moves to annual election for either the chairman or the whole board run contrary to the desire to promote a long-term approach and are a poor substitute for better investor engagement. Concerns around external board evaluation are of a more practical nature, including the cost of the evaluation and the fact that there are currently few organisations with sufficient quality and experience to carry out external evaluations if made mandatory for all listed companies.
3. We welcome moves in the Code consultation to encourage greater investor engagement, and look forward to responding to the separate consultation on the proposed "Investor Code". We support re-designation of the Combined Code to the "UK Corporate Governance Code" as part of this revision.
4. On the detail of the proposed revised Code, we support the proposed restructuring of the content of the Code, including new Sections A and B on Leadership of the Board and Effectiveness of the Board respectively. We also support most of the proposed Code changes, subject to the comments below and later in the detailed response, including some suggested drafting improvements.

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The CBI opposes moves to annual re-election of directors

5. The CBI opposes moves to annual re-election of either the chairman or all directors, and instead urges the FRC to consider retaining the current Code provisions providing for re-election of all directors by rotation over a period not exceeding three years for each director.
6. The reasons for opposing the proposals are:
 - The underpinning philosophy of the review is to promote a long-term perspective, and we believe this move would run counter to that; and
 - We believe the motives behind the proposed change are to enable greater investor engagement, but we believe this proposal over an annual vote is a poor substitute for genuine shareholder engagement.
7. In any case we believe this would deliver little additional benefit to shareholders, given that they already have powers to call for the removal of one or more directors.
8. We also set out more detailed concerns later in this submission over the destabilising impact this could have on boards, the additional cost implications and the dangers of exacerbating an already limited talent pools of available non-executive directors and particularly chairmen.
9. We therefore strongly urge the FRC to retain the existing Code provisions. Alternatively, the FRC should offer in the Code all three options, and allow companies to choose the policy that they consider most appropriate and to explain their policy to shareholders.

Practical issues over external board evaluation

10. On Board evaluation, CBI members consider it premature to propose external evaluation at least every three years. Whilst this may be appropriate for banks and financial institutions, as recommended by Sir David Walker, extending such a requirement to all listed companies via the Code will put strains on the existing resources available in the market place to provide effective evaluation services.
11. This also appears to be recognised and acknowledged by the FRC itself in its proposed Actions that “the FRC will discuss with providers of board evaluation services and other interested parties what actions might be taken to address the quality of such services and concerns about conflicts of interest.” The FRC should undertake these steps and, if necessary, consult again before considering imposing such a requirement on all listed companies in a future update of the Code. We remain doubtful, however, that a prescriptive requirement for external evaluation will be appropriate for all listed companies.

Promoting more effective investor engagement

12. The CBI welcomes moves to encourage more effective investor engagement.
13. We also acknowledge that there should be more focus and attention on the practical issues and difficulties that can arise in seeking effective engagement between companies and their shareholders in practice, including in relation to a company’s governance policies, business strategy and objectives. Effective and productive engagement will hopefully encourage shareholders to take the long term view of their investments, and give support to the company’s management in developing and achieving the board’s objectives for the business, and in turn this should provide long term value and acceptable returns for shareholders on their investment.

14. We note the FRC proposal to consider options for producing practical guidance on good practice engagement, and we strongly support such an initiative.
15. We also support in principle the FRC taking responsibility for a new Code of Stewardship for institutional investors, and we will be responding in due course to the FRC's separate consultation on this.
16. We set out overleaf our further comments on the detail of the FRC proposals for updating the Code.

FRC POLICY PROPOSALS AND PROPOSED CHANGES TO THE UK CORPORATE GOVERNANCE CODE

SECTIONS A AND B OF THE CODE

We support the FRC's proposals for restructuring the Code provisions concerning the responsibilities of the Chairman and the Directors around new Sections on Leadership (Section A) and Effectiveness (Section B).

We comment further below on some of the specific provisions.

SECTION A - LEADERSHIP

Section A.1 – the Role of the Board

Supporting Principles

We note the proposed additional sentence as follows: "All directors are fiduciaries who must act objectively in the best interests of the company and in accordance with their statutory duties."

CBI members prefer slightly modified wording, along the following lines: "All directors are fiduciaries who must act in what they consider to be the best interests of the company consistent with their duties as directors." We consider that this better reflects the existing position with regard to directors' duties.

Section A.3 - The Chairman

We support creating a new Main Principle for "The Chairman", and the proposed wording of the Main Principle and the Supporting Principle.

Section A.4 - Non-Executive Directors

We support new Main Principle A.4, and the other proposed drafting changes to the Code provisions.

SECTION B - EFFECTIVENESS

SECTION B.1 - THE COMPOSITION OF THE BOARD

Main Principle

We support the new Main Principle that the Board and its committees should consist of directors with the appropriate balance of skills, experience, independence and knowledge of the company to enable it to discharge its duties and responsibilities effectively.

Supporting Principles

In the second paragraph, CBI members consider that the reference should be to “an appropriate balance” of executive and non-executive directors and not “strong presence”.

Code provisions

These are currently proposed to remain unchanged.

Criteria for determining independence

As mentioned in our earlier consultation responses, we draw attention to the provision in Code B.1.1 that one of the tests of independence is whether a NED has served on the board for more than nine years.

CBI members are supportive of the approach that the NED independence criteria should be balanced against the need for experience and expertise. We therefore continue to believe that placing an emphasis on achieving the right blend of experience and fresh thinking on the board is more important than a specific reference to “nine years”, which is overly prescriptive and arbitrary.

CBI members therefore consider that, instead of the reference to nine years, the criteria should be amended to refer to “**length of service**” as one of the factors to be taken into account by the board when addressing a director’s independence.

As part of the board’s evaluation of its effectiveness, and the other Code provisions in Section B.2 on keeping the board refreshed, the Chairman will no doubt wish to pay close regard to length of service, whilst at the same time wishing to ensure the availability of appropriate experience and expertise on the board.

SECTION B.2 - APPOINTMENTS TO THE BOARD

Supporting Principles

We note the proposed amendments to the Supporting Principles.

With regard to the second proposed amendment “and to ensure progressive refreshing of the board”, we would suggest that “to ensure” is replaced by “with a view to”, since it is not possible to ensure progressive refreshing.

SECTION B.3 - COMMITMENT

We support the new Section B.3 on Time and other commitments.

We welcome that the FRC has not sought to be prescriptive on specific time commitments, or minimum time commitments.

SECTION B.4 - DEVELOPMENT

Supporting Principles

We support the new additional Supporting Principle that “To function effectively all directors need appropriate knowledge of the company and access to its operations and staff.”

Code Provisions

B.4.1

On the proposed Amendment to B.4.1, CBI members prefer a reference simply to “shareholders” or “shareholders and investors”, rather than “major shareholders”.

B.4.2

We note the proposed Amendment “The chairman should agree and regularly review a personalised approach to training and development with each director”.

CBI members seek and strongly prefer slightly different wording, along the lines of: “The chairman should regularly review and agree with each director their appropriate training and developments needs.”

We consider that this offers greater flexibility and so will enable different companies to meet their differing training needs in the manner most appropriate to them.

Whether Development needs have been met is also a factor in the internal evaluation process of board effectiveness.

SECTION B.5 - INFORMATION AND SUPPORT

We note that the Main Principle, Supporting Principles and Code provisions are proposed to remain the same, which we support.

SECTION B.6 - EVALUATION

Main and Supporting Principles

We note that the Main Principle and the Supporting Principles are proposed to remain the same, which we support.

Code Provisions

We note that the FRC proposes a new additional Code provision **B.6.2** as follows:

“**B.6.2** Evaluation of the board should be externally facilitated at least every three years.

Where consultants are used a statement should be made available of whether they have any other connection with the company.”

We said in our response to the FRC second consultation that, whilst external evaluation has a role to play in improving boardroom performance, the requirements for this should not be prescriptive. Some companies have noted that the presence of external evaluators can hamper or distort normal and full boardroom discussion, and cause confidentiality problems. Many CBI members consider that the Company Secretary is often best placed to facilitate the evaluation process, in the light of his or her experience, regular attendance at board meetings and background knowledge.

The key aspect of board performance is behavioural, and therefore much less amenable to formal testing. External evaluation should not be a substitute for open debate and robust challenge between the Executive and the NEDs, nor a substitute for effective communication and engagement with shareholders.

CBI members therefore continue to have strong concerns at incorporating in the revised Code a prescriptive requirement for external evaluation at least every three years.

We remain doubtful that such a requirement will be appropriate for all companies and believe that it should not be imposed on them in circumstances where the additional cost and administrative burden is likely to be substantial. Some CBI members’ experience to date of external board evaluation is that they have produced no better results than those gained from an internal evaluation.

As the FRC itself acknowledges in its proposed Actions: “The FRC will discuss with providers of board evaluation services and other interested parties what actions might be taken to address the quality of such services and concerns about conflicts of interest.”

In line with this approach, CBI members believe that further consideration of this issue should at the very least be deferred until broader and more experienced systems for external evaluation have been developed and tested, and meet quality assurance standards, before imposing such an obligation on all listed companies. The FRC should carry out its proposed action, and also produce evidence that external evaluations can produce the benefits claimed, and only then consult again on whether to include such a provision in a future update of the Code.

Clearly if shareholders feel that an external evaluation is overdue, they can make that known to a company through engagement, and the company is likely to take those views into account.

It is also relevant to state that the board should be able to assess, on the basis of the facts at the relevant time, whether an external evaluation is appropriate in a particular year. In a year where there have not been major changes to personnel or governance processes, for instance, a board may justifiably feel that it is not worth incurring the substantial expense of an external evaluation and may decide that an internally-managed process is more appropriate. Companies may also feel that the presence of external evaluators will hamper or distort normal and full boardroom discussion, or cause confidentiality problems.

Therefore, if in the event the FRC should decide to make reference to external evaluation, rather than a prescriptive requirement for an external evaluation every three years, it would be better to require the board to keep under review whether it is appropriate to conduct an external evaluation of its performance, along the lines of:

“The Board shall keep under review whether it is appropriate to conduct an external evaluation of its performance.”

We note that the FRC is not proposing to make a requirement for an evaluation statement, as suggested by Sir David Walker for BOFIs, which we welcome. Instead Chairmen are encouraged to address board effectiveness issues in their personal statements how they have applied the Principles of the Code, in accordance with the Listing Rule requirement. We support this approach.

SECTION B.7 - RE-ELECTION

Main Principle

We note that the Main Principle remains the same that “All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance”, which we support.

Code Provisions

We note that the FRC invites views on alternative Code provisions that either all Directors should be subject to annual election by shareholders, or that the Chairman should be subject to annual election by shareholders. Under the proposal for the annual election of the chairman, remaining directors would be subject to the existing rule of rotation and re-election over a period of not more than 3 years, and NEDs who have served longer than 9 years would be subject to annual re-election.

However, CBI members still remain very strongly of the view that the current Code provisions in Section A.7 continue to be appropriate, providing for the rolling re-election of all directors over a period of not more than three years, commencing with the AGM occurring after first appointment.

Annual re-election of the chairman

The proposal for the annual re-election of the chairman is strongly opposed by CBI members. Singling out the chairman for annual re-election runs contrary to the principles of a unitary board and the legal concept that all directors are jointly responsible for the management and stewardship of the company. Setting different rules for different directors could also open up liability issues if a company failed or suffered significant losses, and generally encourage disputes and possible litigation against individual directors.

Moreover attracting a good chairman is very difficult. They are a scarce resource, with ever increasing expectations and burdens placed upon them, as is recognised in the proposed amendments to the Code in Sections A and B, discussed above.

Annual re-election of all directors

With regard to the annual re-election of all directors, CBI members consider that this would, in many cases, impose significant additional cost and administrative burden to companies, but with little additional benefit to shareholders, given that they already have powers to call for the removal of one or more directors. The annual re-election of all directors risks creating, or threatening the creation of, a dysfunctional board, if there are no, or not sufficient, replacements for the directors voted off.

In addition, implementation of this proposal would run counter to the stated desire to promote a long-term approach to Board decision-making and the stewardship of companies, as it risks encouraging directors to think only one year ahead, to their next election.

If Investors have concerns about the performance and contribution of an individual director, they always have the opportunity to raise it with the company at any time throughout the year.

CBI view

We therefore very strongly urge the FRC to retain the existing Code provisions, rather than either of the options proposed.

Alternatively, the FRC could offer all three options, and companies would choose their preferred approach, and explain their policy to shareholders, although we would note that the existing Code provisions already permit the annual re-election of all directors, for companies and boards who prefer this approach.

SECTION C - ACCOUNTABILITY

C.1 - CORPORATE REPORTING

Main Principle and Supporting Principle

We note that these provisions are unchanged.

Code Provisions

C.1.2

We note that a new provision is proposed as follows:

“The directors should include in the annual report an explanation of the basis on which the company generates revenues and makes a profit from its operations (the business model) and its overall financial strategy.”

This seems to go wider than the Business Review provisions in the Companies Act 2006, and some CBI members consider that this issue should be addressed in an amendment to the Companies Act, if appropriate. We do not, in any event, consider that this is something that companies should be required to address in their corporate governance statements, and so we do not see it as an appropriate issue for inclusion in the Code.

SECTION C.2 - RISK MANAGEMENT AND INTERNAL CONTROL

We broadly support the FRC’s proposed actions. Risk is a matter for, and the responsibility of, the board as a whole, supported by the audit committee. Whilst large and complex businesses might benefit from a separate risk committee, for listed companies generally this should be a matter for individual companies and boards. We are therefore pleased that the FRC has supported the CBI view that it would be excessive and inappropriate to include a Code provision recommending that every listed company have a separate risk committee.

We support a limited review of the Turnbull guidance at the appropriate time, and the CBI and CBI members will be pleased to be involved in that process. As we said last year in our response to the Second Consultation, CBI members do not see a review of Turnbull as an urgent or priority issue, and Turnbull remains largely fit for purpose.

Proposed Code changes

We support the proposed Code changes. Code provisions, C.2.1 and C.2.2, could perhaps also include a reference to the Audit Committee, such as:

“The board, assisted by the audit committee....”

This would clarify the position, in circumstances where it is currently suggested in various places in the Code that both the Board and the Audit Committee have responsibilities with regard to risk management and internal control.

SECTION C.3 - AUDIT COMMITTEE AND AUDITORS

Main Principle

We support the drafting amendment to refer to “corporate reporting and risk management and internal control” principles.

SECTION D - REMUNERATION

Supporting Principle

We note the new Supporting Principle as follows:

“The performance-related elements of executive directors’ remuneration should be stretching and designed to align their interests with those of shareholders and to promote the long term success of the company.

CBI members consider that the phrase “stretching and” is inappropriate and should be deleted or alternatively replaced by “appropriate and”, so as to avoid encouraging undue risk-taking to meet ‘stretching’ targets.

Schedule A

We suggest the amended fifth paragraph would better read as follows:

“Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria, including financial and non-financial metrics, and reflect and take into account the company’s risk policies.”

SECTION E - COMMUNICATION

Section E.1 – Dialogue with Shareholders

We make the following suggestions for improvements to the Code provisions :

Supporting Principles

The opening wording of the first paragraph should include a reference to the chairman as follows:

“Most board contact with shareholders is by the chairman, chief executive and finance director, and they, and any other director in contact with shareholders, should ensure that all directors know of any major issues and concerns that shareholders bring to their attention.

Code Provisions

In Code E.1.1 Line 1, after “The chairman” insert “and the directors”.

We also suggest joining the second and third sentences together along the following lines :

“The Chairman and the executive directors should discuss governance and strategy with shareholders and non-executive directors should be offered the opportunity to attend meetings with shareholders, and should expect to attend meetings if requested by major shareholders.”

III OTHER MATTERS DISCUSSED IN FRC FINAL REPORT

(I) MEANS OF COMMUNICATING DISCLOSURE REQUIREMENTS IN CODE - IN ANNUAL REPORT AND / OR VIA COMPANY'S WEBSITE

We note that the FRC will consult on whether to allow companies the choice of meeting the disclosure requirements of the Code either in the annual report or on the website.

Some CBI members are concerned that this proposal could result in core corporate governance disclosures appearing only on a company's website, and not in the annual report.

In particular Audit firms have responsibilities not just for the audited accounts but also an obligation to review other disclosures made by the company and the board concerning corporate governance and other matters. CBI Audit firm members consider it would be difficult, and more costly, to discharge their obligations, and to assess whether disclosures were satisfactory or deficient, if those disclosures were to appear in different places. The quality and navigability of websites to ascertain and find information can also vary greatly.

Nevertheless, some CBI members consider that there is scope for companies to use their websites to improve the quality of their disclosures, provided that the concerns of Audit firms may be adequately addressed, and we therefore suggest that this is something which might be explored further in the context of the FRC's project on Reducing Complexity.

(ii) ENGAGEMENT BETWEEN COMPANIES AND SHAREHOLDERS

We support the FRC proposed actions.

We agree with the FRC conclusion that the FRC or the FSA should not have a greater role in monitoring and enforcing comply or explain statements. After all, where not prescribed by law or regulation, the Code is meant to be best practice and comply or explain, not comply or else.

It is for companies and their shareholders to engage in dialogue, and we support the FRC considering options for producing practical guidance on good practice engagement between companies and investors.

We support in principle the FRC taking responsibility for the sponsorship of the proposed Stewardship code for institutional investors, and we will respond in due course to the FRC's separate consultation on this.

(iii) TITLE AND COVERAGE OF THE CODE

We support the change in title of the Code to "the UK Corporate Governance Code", or something equivalent. We understand that Irish registered listed companies also report against the Code, so some style change to reflect that may be necessary.

(iv) OTHER CODE CHANGES

We support deletion of Schedule B of the existing Code on Directors' liability, although it might be appropriate to take account of some of the issues currently addressed in Schedule B in the supplemental Guidance.

(v) "APPLY OR EXPLAIN"

We note the FRC comments on the alternative approaches.

We also aware that in South Africa the King Committee's proposed Governance Code is favouring "Apply or Explain", and we reiterate our support for that expression.

(vi) OTHER CHANGES TO RELATED GUIDANCE

We note that the FRC guidance for Audit Committees may be updated following the results of the APB consultation on Non-Audit Services, and following the earlier consultation on Audit Partner rotation.