

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

Email: [codereview@frc.org.uk](mailto:codereview@frc.org.uk)

5 March 2010

Dear Sir

## **Consultation on the Revised UK Corporate Governance Code**

We write in response to your request to provide comments on the proposed changes to the Code set out in the above document. We congratulate the FRC on its measured and proportionate response to the recommendations set out in the Walker Review. As stated in our earlier responses in this review process, we believe that the recommendations arising from the Walker Review are best dealt with by FSA rules and guidance specifically for financial institutions, rather than in the Code. At this time when the economy remains fragile, it is important that boardroom time is focussed on keeping the business strong. Further views are set out below.

### **Timetable for change**

1. The current consultation document sets out the proposed changes to the Code and suggests that a revised Code will be published in April or May 2010 with application to periods beginning on or after 29 June 2010. We have concerns with this timetable given that the review of key elements of the Code's supporting guidance will not have been concluded at this time. In particular we refer to the limited review of the Turnbull Guidance on internal control due to take place during 2010 which will be subject to a separate consultation, potential changes to the Smith Guidance for audit committees arising from the Auditing Practices Board's review of the provision of non-audit services and the outcome of the FRC's consultation on a Stewardship Code for institutional investors. Having an extended period of piecemeal changes adds to the cost burden for UK corporates and also for investors in seeking to consider changes over successive periods rather than focussing in one period on how companies are complying with the revised code and supporting guidance. These three reviews may result in the need for the Code to be revised further or, alternatively, those involved

may feel that suggesting appropriate amendments would be unwelcome. We recommend that the timetable for implementation of the revised Code is for periods beginning on or after 29 June 2011. This will allow for the outcomes of the related reviews to be reflected and incorporated as appropriate.

### Terminology

2. Whilst we support the reasons behind many of the proposed changes, the terminology used needs to be clearer. A number of new terms are incorporated in the revised Code. For example, the proposed main principle C.2 states that “the board is responsible for defining the company’s **risk appetite** and **tolerance**”. But these highlighted terms are not defined or explained in the Code. We believe that the FRC must do this if there is to be consistent understanding, interpretation and application. Further detail on terminology is provided in the appendix to this letter.

### Annual re-election of directors and/or the chairman

3. As stated in our previous letter (dated 7 October 2009) we are against annual re-election of the chairman or board committee chairs. We also do not support the proposed requirement for annual re-election of all directors as an alternative to merely the Chairman standing. This could be potentially de-stabilising and lead to tensions among board members. It could also encourage short-termism. Annual re-election would deter many people from taking on these roles because of the risks to personal reputations. It may also create pressure for increased remuneration and could create serious practical issues. It also raises questions as to what would happen if the chairman or the entire board failed to be re-elected at the AGM. Would a potential replacement need to have been pre-arranged each year in case this eventuality arose? We believe there may be some merit in having non-executive directors who have served longer than nine years subject to annual re-election as suggested in the second version of B.7.1.

### Premium versus standard listings

4. The introduction of the new regimes of premium and standard listings means that UK companies may now opt for a standard listing which would not require them to comply or explain non-compliances with the UK Corporate Governance Code. We believe that, if the UK Corporate Governance Code were to become too prescriptive, there is a risk that companies would move away from premium listings, which would ultimately have a detrimental effect on the perceived quality of the UK market and corporate governance. Regarding the proposed amendments to the Code at this time, the proposals to have annual re-election of chairman/directors (see 3 above) and periodic externally-facilitated board evaluations (see Section B in the appendix) will, in our opinion, lead some boards to consider their listing regime.

5. Further detailed comments are provided in the appendix to this letter.
  
6. Martyn Jones and Isobel Sharp would be pleased to discuss with the FRC our comments and other matters related to the review of the UK Corporate Governance Code.

Yours faithfully

*Deloitte LLP*

**Deloitte LLP**

## APPENDIX

### *Section A: Leadership*

#### *Main principle*

*Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.*

We note that the FRC has made explicit reference to statutory duties of directors in section A of the revised Code but we believe that inserting “long-term” into the main principle makes it inconsistent with the duties placed on directors in the Companies Act 2006. Section 172 of the Companies Act 2006 states that “A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to... the likely consequences of any decision in the long-term...”

Whilst there is the reference to having “regard to the likely consequences of any decision in the long-term” in section 172, this is different to a direct and sole responsibility for the “long-term success of the company”. We recommend that the FRC re-writes this principle to read “*Every company should be headed by an effective board which is collectively responsible for the success of the company for the benefit of its members as a whole*” and include a cross-reference to the statutory duties. (There is also reference to “long-term success” in Schedule A but we are happy that this reference is in a different context as it relates specifically to performance conditions.)

In addition, whilst we are aware of fiduciary duties or activities, we are not aware of “fiduciaries” being a description of directors (A.1 Supporting Principle “All directors are **fiduciaries** who must act objectively in the best interests of the company and in accordance with their statutory duties”). We recommend that this wording is also revised.

### *Section B*

#### *Code Provisions*

*B.6.1 Evaluation of the board should be externally facilitated at least every three years.*

We believe that the proposed B.6.1 should not form part of the Code.

While external facilitation of the evaluation process will be of considerable value to particular boards at particular times, we do not believe it is of such pervasive value that it merits inclusion in the Code. We suspect that many companies would consider the cost of such to be unjustifiable and so they would have to explain a non-compliance with the Code. Our research shows that only 35% of listed companies comply fully with the Code at the

moment. We would not wish to see that percentage fall significantly as it would damage the standing of the Code.

## *Section C*

### *Code Provisions*

*C.1.2 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.*

We support this addition to the Code but have concerns about the terminology. We suggest moving away from referring to profits. In the current environment it is clear that the ability to generate profits is not always equivalent to a resilient and robust business model. We believe that the focus should be on the creation, delivery and capture of value. Suggested wording for this provision is as follows: “The directors should include in the annual report an explanation of the business model and the overall financial strategy (how the company creates, delivers and captures value)”. An alternative approach would be to use the existing law on narrative reporting and to ask the boards to confirm that the disclosures required by law ensure that the key components of a company’s operational and financial strategies are disclosed.

## *Section C*

### *Main principle*

*C.2 The board is responsible for defining the company’s risk appetite and tolerance.*

If the board is to be responsible for defining the company’s risk appetite and tolerance, there needs to be clear, unambiguous guidance on what these terms mean. Our other concern with this addition to the principle is that it pre-judges the outcome of the limited review of the Turnbull Guidance. We believe there is considerable merit in carrying out that review as part of that process determining if and how the Code should be amended. We look forward to participating in the review of the Turnbull Guidance later this year.

## *Section D*

### *Code provisions*

*D.1.3 Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for nonexecutive directors should not include share options or other performance related elements. 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 B.1.1).*

This provision has been extended to state that remuneration for non-executive directors should not include share options or 'other performance related elements'. We support this addition but note that in the next section, for clarity, it should then read:

'If, exceptionally, options **or other performance related elements** are granted, shareholder approval should be sought in advance...'

### *Section E*

#### *Supporting Principles*

*Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman should ensure that all directors understand their major shareholders' issues and concerns.*

We recommend that the word "understand" in this section should be replaced with "are made aware of". This reflects a more realistic expectation.

### *Section E*

#### *Code Provisions*

*E.1.1 Non-executive directors should be offered the opportunity to attend existing meetings with major shareholders and should expect to attend meetings if requested by major shareholders.*

We think that the word "expect" should be amended to "be encouraged". The schedule of meetings for non-executive (and executive) directors is already challenging and so we believe that it would be unrealistic to "expect" non-executive directors to attend all meetings requested by major shareholders. Time spent within the company, understanding the processes, risks and opportunities, is vital and we would not wish to see this receive less emphasis than attending meetings with major shareholders.

### *Schedule A*

We are uncomfortable with the reference in Schedule A to performance criteria being risk adjusted. We think that the current wording is too prescriptive and that there is a lack of clarity about how performance criteria should be 'risk adjusted'. We fully support including a provision that risk should be taken into consideration when determining remuneration policy but would prefer something less prescriptive:

'Remuneration committees should ensure that risk has been properly taken into consideration when determining performance measures and targets and incentive arrangements do not encourage excessive risk taking.'

We support the idea that the use of non-financial performance measures may be helpful in reflecting the company's objectives. However, we are concerned that the current drafting suggests that non-financial measures are a requirement of the Code. We would prefer wording along the lines of:

'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, giving consideration to non-financial performance metrics where appropriate.'

*Positioning of governance disclosures*

There is a question about whether governance disclosures should be included in the corporate governance statement in the annual report or whether it should be possible to cross-refer to website disclosure. Our preference is that the requirement to provide these disclosures in the annual report should remain as this should provide maximum transparency for stakeholders. This would not prevent corporate governance disclosures also being made available on a website as long as they were consistent with the disclosures made in the annual report.

We appreciate that some commentators may call for excessive clutter in annual reports to be eliminated. However we believe that this should be addressed by the overall review already in progress rather than by way of piecemeal exercises such as on governance reporting.