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Our ref tc/815

5 March 2010

Dear Chris

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

We welcome the opportunity to respond to the consultation paper *Consultation on the Revised UK Corporate Governance Code*.

First and foremost we are very supportive of the measured response the FRC has taken in relation to this revision of the 'UK Corporate Governance Code' and in particular we are encouraged by the renewed emphasis on board behaviour, the role of the chairman and the long-term success of companies. We also support the introduction of the Walker recommendations for banks and financial institutions only where, and to the extent that, they are suitable for listed companies generally.

Above all else we appreciate the steps taken by the FRC in the opening narrative sections to reposition 'comply or explain' framework in the minds of preparers and investors alike. For a long time we have believed that full compliance with the Combined Code has become the expected norm (a situation encouraged both by successive relaxations of the Code in those areas where non-compliance was most apparent and by 'special rules' for smaller listed companies) and a compliance mentality has dominated the market.

Consequently we consider that if the Code is to be effective in offering flexibility rather than the brittleness and rigidity of legislation, then some, albeit not too many, rational and properly explained deviations from the Code should be commonplace – we are hopeful that the positive steps taken by the FRC will bring renewed focus to the behavioural aspects of governance; better explanations of non-compliance and a more objective approach to each companies governance practices from investors, voting agencies and the media.

We are also supportive of the re-designation of the Code as the 'UK Corporate Governance Code' and the structural changes which are a logical means to reinforce the way in which the Code should be viewed and applied. In particular, separate reference to both 'leadership' and 'effectiveness' is an helpful way of directing more and considered thought to separate principles.

ABCD

**KPMG LLP**  
*Consultation on the Revised UK Corporate Governance Code*  
5 March 20 10

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Our comments on some of the specific amendments to the Code are set out in Appendix 1 and our other comments are set out in Appendix 2. We hope that our comments prove to be useful and we welcome on-going dialogue. Please do not hesitate to contact me should you wish to discuss any of the points raised in this response.

Yours Sincerely

Oliver Tant  
Head of Audit  
KPMG LLP

*Enclosures:*

## APPENDIX 1

### AMENDMENTS TO THE CODE

#### Section A.1 - The Role of the Board

We note the proposed additional sentence within the supporting principles “All directors are fiduciaries who must act objectively in the best interests of the company and in accordance with their statutory duties.” We would, however, 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.”

#### Section A.3 - The Chairman

We support creating a new Main Principle for “The Chairman”, and the proposed wording of the Main and 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.1 - The Composition of the Board

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.

With regard to the independence criteria, we believe there is merit in looking afresh at provision B.1.1 – reworking this provision might cause both corporates and investors to think differently when interpreting code compliance (or otherwise). The current provision does not, in our opinion, seek to establish independence criteria as such; but identify a number of circumstances which *may* appear relevant to the determination of independence. This is not well understood and as a result a ‘box ticking’ approach to this provision is common place. In particular, the so-called ‘nine year rule’ is unnecessarily prescriptive and, in tune with the nature of the Code, be amended to a generic point about ‘length of service’

Furthermore, some thought should be given to differentiating the concept of independence used in the Combined Code with that used in the Companies Act. As currently drafted, the Code recommends that boards should include a significant cadre of non-executive directors who are considered by the board to be ‘independent in character and judgement’. Yet the Companies Act (s.173) requires *all* directors (both executive and non-executive) to exercise ‘independent judgement’. Are non-independent non-executive directors therefore unlawful?

### **Section B.2 - Appointments to the Board**

We support the proposed amendments, however, 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”.

### **Section B.3 - Commitment**

We support the proposed amendments.

### **Section B.4 - Development**

We support the proposed amendments. In particular we believe it important that the chairman consider the training and development needs of *all* directors – not just the non-executive directors – as this might encourage a behavioural change whereby executive directors better understand their responsibilities as directors and distinguish that role from their executive management role.

### **Section B.5 - Information and Support**

We support the current wording.

### **Section B.6 - Evaluation**

We fully support the proposed amendment whereby external facilitation of board evaluation (at least every two or three years) is encouraged as, in our opinion, this is one of the few measures that might get to the heart of many of the ‘behavioural’ and ‘cultural’ issues raised by all governance breakdowns.

Whilst many companies already engage in some form of board evaluation; questions have to be asked about the thoroughness of such reviews. Externally facilitated evaluation can bring rigour to the process and provide a good baseline for subsequent internal reviews which one would hope would naturally become more robust over time. Other advantages include the ability of ‘outsiders’ to bring out tensions in a non critical way and engender a willingness to listen. Involving an external facilitator every two to three years can also serve to prevent the evaluation process becoming stagnant over time.

Furthermore, if revisions to the Combined Code are to encourage the behavioural shift that might be necessary in some organisations, consideration should be given to establishing certain ‘ground rules’ for carrying out board evaluation – whether internally or externally facilitated. For example, perhaps boards should solicit feedback from major investors – say those owning more than 5% of the company? This would certainly test the appetite of institutional investors to actively engage with those companies in which they invest.

Lastly we note that the Code does not call for disclosure – other than how the evaluation exercise has been conducted. This might be a missed opportunity. Clearly there are practical issues to be overcome, however, there are sufficient good examples from both the financial and

non-financial sectors that serve to illustrate that useful information can be disclosed without straying into the realms of seriously prejudicial information.

### **Section B.7 - Re-election**

As we have previously commented we are not convinced that the annual re-election of the chairman (or all directors) is necessary and we therefore strongly urge the FRC to retain the existing arrangements whereby all directors are proposed for re-election by rotation over a period not exceeding three years for each director.

In our opinion the proposed amendments are a (proposed) solution to a problem that doesn't exist. Shareholders already have the power to remove any director if they so wish – though they rarely chose to exercise such powers.

Singling out of the chairman for annual re-election runs contrary to the principles of a unitary board and the legal concept that all directors are jointly liable for the management and stewardship of the company. Also, 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.

Furthermore, notwithstanding the 'problem free' voluntary adoption of such a policy by a number of companies, in our opinion the widespread adoption of 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. Also, such a short-term measure seems to run at odds with the need to embed a long-term approach to the success of the business which many of the other proposed amendments seek to encourage.

Lastly, activist users of shareholder rights can be primarily driven by short term objectives whereas longer-term shareholders are often passive. What this means for shareholder enforcement as a driver of good governance is an important question in a world increasingly dominated by hedge funds.

### **Section C.1 – Corporate Reporting**

We recognise that the recommendation to explain the basis on which the company generates revenues and makes a profit from its operations (the business model) flows from the work of the Treasury Select Committee and the FRC's own recent review of narrative reporting.

In principle we support the recommendation, but question:

- whether the issue should be addressed elsewhere – such as within the Business Review provisions in the Companies Act 2006? Inclusion in the Code of something that is both fundamental and prescriptive does not feel appropriate
- whether more guidance is necessary? Reference has already been made to the increase in boiler-plate and we are anxious that this provision does not add further to this.

**Section C.2 – Risk Management and Internal Control**

We support the proposed amendments; however, we believe that the board’s role with respect to ‘risk appetite’ and ‘risk tolerance’ should be addressed further as and when the Turnbull report is updated.

**Section C.3 - Audit Committee and Auditors**

We support the proposed amendments.

**Section D.1 - The Level and Components of Remuneration**

We support the proposed amendments.

**Section D.2 - Procedure**

We support the proposed amendments.

**Section E.1 – Dialogue with Shareholders**

We support the proposed amendments.

**Section E.2 - Constructive Use of the AGM**

In line 3 of E.2.2, we suggest replacing ‘after’ with ‘where’, in order to acknowledge that some votes may be via a poll.

## **APPENDIX 2**

### **OTHER MATTERS**

#### **Disclosure by Means of the Annual Report and/or Corporate Website**

While we recognise the flexibility allowed under section 7.2 of the DTR we would be concerned by any initiatives to ‘relegate’ corporate governance disclosure to corporate websites rather than the annual report. Firstly, we believe the corporate governance to be fundamental – and by no means the first thing to be moved from the annual report to website disclosure.

Furthermore it should be recognised that auditors have specific reporting responsibilities with respect to nine of the Code provisions and a general duty to read other disclosures made by the company and the board concerning corporate governance and other matters presented with the financial statements. It is difficult to see how auditors could discharge such duties in a meaningful way if the relevant disclosures were included on a corporate website rather than in the annual accounts.

Notwithstanding the above, the use of websites is an issue that the FRC Complexity project might investigate.

#### **Engagement between Companies and Shareholders**

We agree that the FRC or FSA should not have a greater role in monitoring and enforcing comply or explain statements. 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.