From: Smith, Peter [peter.smith@rothschild.com]
Sent: 23 September 2009 09:23
To: Chris Hodge
Subject: FRC - Review of the Effectiveness of the Combined Code - Progress Report and Second Consultation

For the attention of Chris Hodge

Dear Chris

I am pleased to provide some comments on the second consultation document published in 2009. I do so in a private capacity, but as the chairman of two FTSE 250 companies, a non-executive director of a FTSE 50 company and as the chairman of the audit committee of three other organisations, two of which are smaller BOFIs.

My overall conclusion is that the FRC should try to minimise the number of changes to the Combined Code and instead focus on the behaviour required from directors and institutional investors to make the code effective. The priority should be to remain with the set of high level principles, avoid detailed prescription to meet what are likely to be short-term challenges and offer guidance on good practice in the preamble or supporting text..

In my detailed comments I suggest that there is more advantage to be had from a two-way engagement between the chairman of a company and major institutional shareholders than with the provision of more detail in the business review or elsewhere in the annual report. Experience at the FTSE 250 level suggests that the primary engagement with institutional investors is by the CEO/CFO with the fund mangers responsible for the investments. Governance matters are not on the agenda for those meetings and, in practice, get taken up with the company secretary through the voting services such as ABI, RREV etc rather than by individual shareholders. Indeed, attempts by chairmen to engage with individual investors regularly go unanswered - hopefully because the company concerned is in good shape, but possibly because interchange on governance matters has been sub-contracted to a third party.

I now comments in more detail using your sub-headings.

<u>The responsibilities of the chairman and the non-executive directors</u>

Sir David Walker focused on the need for non-executive directors to challenge. I am not convinced that there is a need for further prescription within the Combined Code, but there is a need for individual boards, through self-assessment systems, to ensure that they are satisfied with the roles played by individual directors and the associated time commitments and work together to ensure than the improvements they require actually come through..

Having board evaluations externally facilitated every three years may well provide the necessary additional rigour required to ensure that the chairman and non-executive directors are meeting their responsibilities. However, I would recommend that this is a matter of guidance rather than prescription since a poor quality external review may well be less helpful than one which is robustly undertaken internally. The substance is more important than the form.

<u>Board balance and composition</u>

There are undoubtedly some companies where industry expertise within the non-executive ranks is highly desirable. Generally, though, broad experience of problem-solving, strategy development and oversight is more valuable than narrow expertise.

I think that the "nine-year rule" has attractions and continuity really should be provided by proper succession planning. The annual assessment and re-election process each year after nine years service in my opinion remains appropriate.

The reduction in the size of a board should make the board as a whole more effective and an easier forum for challenging dialogue to take place. Senior executives typically are in attendance. There are suggestions that very large boards are ineffective; a longer period of study may be required before concluding that small boards do not suffer other disadvantages.

A clear responsibility of a board is to ensure that succession is being considered in key business areas. In my opinion that is a subject better dealt openly with between the chairman and major shareholder(s) rather than through additional non-specific discussion in the annual report.

Frequency of director re-election

Clearly directors serve only with the approval of shareholders. Ideally, investor concerns about the quality of the company's board or individual directors are best dealt with directly with the chairman. I would be interested as to whether there is significant evidence that, when approached by institutional investors, companies regularly fail address their concerns. In the smaller company where shareholder voting may be at a low level, I would have a concern that the annual re-election of the company chairman or other directors could provide excessive power to hostile minorities .

In order to avoid disfunctionality in the boardroom, annual re-elections if required should be on an advisory rather than a binding basis (except for the requirement that non-executive directors who have served for more than nine years should be re-elected annually.

Board information, development and support

In my opinion this is a behaviourial rather than a structural issue. Non-executive directors have to ensure that they are properly briefed on relevant matters. Whilst that might usually come through the company's executive, specialised briefings or studies by third parties should be available if the non-executives believe they are essential to getting the job done. This is common sense and I cannot see that it needs to be a prescriptive part of the code.

Board evaluation

As mentioned above, I would provide further guidance that externally facilitated evaluations are useful every three years, but would not mandate it. Since most annual board evaluations pick up the effectiveness of main board committees, it would seem sensible that they are put onto a two-year cycle if the directors feel happy with that.

Apart from explaining the process, it is very hard to communicate the outputs of board evaluation exercises to third parties and this is another area where the chairman should be able fully to explain the outcomes of the issues with major shareholders.

My limited experience suggests that non-executive directors have high expectations of the board evaluation process and expect the outcomes to be discussed within the board and any changes properly implemented.

Risk management and internal control

The recession has clearly focused attention on the way in which board's companies have set their risk appetite and managed risks. Risk tends to be dealt with in public statements as a comprehensive listing of risks but there is very little reference to the "appetite" for risk other than in BOFIs where there is an engagement with the regulators.

Such risk statements appear to look towards liability limitation and it is not always clear how the assessment and management of risk is embedded in the business, particularly within the CEOs business processes.

Risk is clearly a responsibility of the board and I am not supportive of the proposition that separate risk committees should be established. Once the board has set its appetite, guided by management, it is up to the CEO to ensure that risk management procedures are in place across the business, activities are conducted in line with the risk appetite and risk management is embedded into the business processes. It may well be appropriate for the Combined Code to be expanded so as to encourage further description of the way in which risk appetite is set rather than simply a current disclosure of the risks themselves.

Remuneration

This is clearly the most political of all the areas examined by Sir David Walker. In my opinion, it is preferable for the Combined Code to concern itself with the disclosure of the remuneration arrangements that have been put in place rather than try to codify best remuneration practice. The Code should keep to a set of high-level principles and related disclosure. I agree that the principles should cover more than just the small group of executive directors and require that the structures and arrangements in the firm as a whole are compatible with the business strategy. However, in larger global business, arrangements will usually vary by country because of culture, competitive position, regulation or whatever and it has to be accepted that the disclosures may appear bland or boilerplate.

With the changes in the level of UK income tax and pension arrangements, we are prospectively entering a complicated period for remuneration. It may be more attractive to key people to make their services available through joint ventures or partnerships rather than in the historic employee structure and the so-called excessive bonuses may well go "off P&L".

This is another area where a direct dialogue between the chairman of the company and the institutional investor may well achieve a better end result than further mandatory and detailed disclosure within the Code.

Engagement between boards and shareholders

There is clearly much to be done to secure the appropriate dialogue between the company and its major shareholders. The problem is complex; perhaps exemplified by the challenge that today's long only investor is tomorrow's short seller. With a significant (15%+?) shareholder, it is very much easier for a company to engage in a full dialogue on its governance and remuneration policies. Otherwise, the engagement on governance matters tends to be through the voting services, with the CEO/CFO taking the strategy forward to the fund managers themselves. From the business perspective, it would be much clearer to have an understanding as to how institutional shareholders wish to engage; some do, most do not.

Detailed points

There are a number of specific requirements within the code that might be addressed.

I question whether the requirements of A.1.2 is really helpful. Formal boards are only part of the work of a director. The school register leads to people attending by telephone to get a tick in the box but often a reduction in the real effectiveness of the board. Non attendance or non performance is best dealt with through the board evaluation process.

The requirement in C.3.5 is too narrow in that the scope of the work of internal audit is far more important than whether it exists.

In A3.2 there could be a good NED who ceases to be independent. If he/she remains on the board they will effectively then count as an executive, although they have no executive responsibilities. Of course, this can all be explained, but the real focus should really be on the balance between independent NEDs and the executive directors.

Yours sincerely

Peter Smith