SUBMISSION NO. 2 TO THE FINANCIAL REPORTING COUNCIL'S REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE - PROGRESS REPORT AND SECOND CONSULTATION

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I. INTRODUCTION

This follows my prior Submission to the First Consultation, and should be read in conjunction with it. Though I have a number of detailed comments on the Code, and on this Second Consultation paper, I believe that I should state clearly at the outset that in my opinion the Code is overall still applicable, and that most of the problems that have recently arisen are due to the failure of Boards to follow it; I would therefore strongly endorse the statement under 'Summary of Feedback to Date', that "the quality of corporate governance ultimately depends on behaviour not process, with the result that there is a limit to the extent to which any regulatory framework can deliver good governance". I also support the 3 guiding principles laid out in the Introduction to Section 1 of this Second Consultation. That said, I do believe that there are some important omissions, which I have attempted to identify below.

I also believe that the Walker Review, to which I have not responded separately, is a flawed and deeply unimpressive piece of work, as noted below, and that this is plainly indicated by the manifest lack of integration (in spite of the declared aim of close collaboration) of its numerous and ill-thought-out Recommendations with the body of this Review.

It is not easy to know how to respond to this Second Consultation, since (a) it does not cover all the issues which I think need to be raised, (b) it has the Walker Report as a very awkward bed-fellow, (c) with much of it I do not disagree, and (d) its sections are not numbered. I have therefore adopted the following approach: I comment in the next section on those 'Issues for further consideration' which seem to me to require it, and only those. The following section gives briefly my views on the Walker Report, and the final section spells out those issues which I consider important, but are omitted from the text as it stands - and which I think should be added to it.

II. ISSUES FOR FURTHER CONSIDERATION

N.B. Bullet-points are numbered in the order in which they appear, and I have selected only those on which I wish to comment.

* **Responsibilities of Chairman and NEDs:**

1. Would it be helpful to clarify further the various roles? My broad answer is ‘No’, but it would be useful to add something on what was required of the SID, the most recent addition to the list.

2. Would it be helpful to provide guidance on the time commitment expected? No, because these will vary so much, and it would not convey useful information: it is the quality, not the quantity, of the contribution which is vitally important.

* **Board balance and composition:**

1. Balance between independence and (relevant sector) experience on the Board: There can be no precise formulation of appropriate numbers of each, and nor should there be, but a sensible mix is only likely to be difficult in sectors with few comparable UK-based companies, and even here foreigners could be (and in the case of major multinationals often are) appointed. Where there is felt to be a problem, two supplementary approaches would help: firstly, a former ED, who is judged by the Chairman to have sufficient emotional distance from his previous employer, could be an immensely valuable addition to the Board, because he would know, and could inform his colleagues, ‘where the bodies are buried’. Secondly, someone drawn from the ranks of professional advisors and experts with extensive knowledge and experience of that sector would bring important insights and skills often not found in former CEOs and EDs of other companies.

3. Are the independence criteria still relevant? Yes, they are, but they need one small addition: under A.3.1 bullet-point 4 should read, “has close family *or personal* ties with any of the company’s advisers.......”, to deal with the issue of cronyism.

8. Is more guidance needed on succession planning and alignment of board composition with business requirements? This is an obvious part of the Chairman’s job description, but might usefully be added to A.2.

* **Frequency of director re-election:**

1, 2 & 3. I believe that annual re-election of any of these is an extremely bad idea, because it would either (and usually) become a tiresome formality or (if it often led to rejection) undoubtedly create the kind of pervasive insecurity which would undermine the independence of mind that is so much desired. If an individual director is appointed for a 3-year term, that should be that, unless either there is clear evidence of misconduct, or he totally loses the confidence of major shareholders, by reason of his decisions or behaviour: in these rare cases, it should be possible to call an EGM for the declared purpose of voting him out of office (rather like impeaching the President of the US).

* **Board information, development and support:**

2. Should NEDs be encouraged to obtain information more from independent sources? I believe that they certainly should be so encouraged: it is remarkable that the freedom which the Cadbury Report gave to do this is so little used; it is also extraordinary that no company has followed the example of BP in setting up a small advisory unit for NEDs under the Company Secretary, something which all companies with the necessary capacity should be strongly urged to do. Guidance on this should indeed be provided in the Code.

* **Board evaluation:**

1. Should the Code be amended to recommend external facilitation of board evaluation every 2-3 years? I strongly support this proposal - self-administered pats on the back are of no value whatsoever.

* **Risk management and internal control:**

1. Is the current balance between Code and Turnbull Guidance right? Yes, it would be very heavy to incorporate all the Turnbull detail into the Code itself.

3. Should companies with less complex business models than BOFIs have risk Committees? In general, the answer is no, but there are some sectors (e.g. pharmaceutical research) where there may be a case for this.

* **Remuneration:**

2. Are changes in the Code required? Yes - see my earlier Submission for details: essentially, apart from avoiding over-complication in package design (which, ironically, removes any real incentive effect) what is needed is to pay bonuses almost entirely in restricted shares which may only vest after a considerable lapse of time, and to avoid like the plague making TSR the performance measure, as this only encourages CEOs and others to game the system.

3. Should shareholders have a direct role in setting remuneration? This would be absurd, because remuneration is and should be a Board decision, and shareholders do not have the background information on which to base detailed decisions (for which in any event the process would inevitably be unbearably complex), any more than they do for other specific business decisions. What they should have is the possibility to call an EGM to rescind what they believed to be excessively generous awards (yes, that would be a nuclear option, but it might just make Remuneration Committees hesitate over some decisions - e.g. the pension award to Fred Goodwin).

III. THE WALKER REPORT

It is unfortunate that this Review has had to be carried out in such a close relationship with the Walker Report, which is in my opinion a sadly inadequate response to a very serious failure by banks and other financial entities either to behave in the best interests of their shareholders or to recognize their wider accountability to the society and economy oin which they operate. It is still far from clear that modifications to the structure of corporate governance in these BOFIs could have prevented the disaster, whereas greater competence and diligence on the part of boards, both EDs and NEDs, might well have done so.

The Report is excessively long (excluding Annexes, about 3 times the length of Cadbury), turgid and woolly in style, frequently repetitive and over-detailed, and largely lacking in evidence or argument for its many pronouncements. The fact that there are 39, often wordy, Recommendations seems to be thought by many to be a sign of weight and importance; it might more accurately be perceived as a sign of a failure to identfy clearly and state concisely what needs to be done to lessen the chances of a recurrence. The result of all this is that what is good (e.g. Recommendation 2, on the need for dedicated support for NEDs separate from that supplied as part of the normal Board process) is often submerged by much that is not.

IV. ISSUES OMITTED FROM THE SECOND CONSULTATION

I believe that the following issues, both covered in my earlier Submission, should not have been omitted from this Progress Report and Second Consultation, and should be addressed in the Final Report without fail:

1. The situation of private (individual) shareholders, whose interests are not even mentioned in this document: it is not just a question of “Grannies losing their blouses” as a former Government Minister contemptuously dismissed them, but a moral issue: private shareholders provide a substantial part of the equity, and they are given little information - none at all if they hold their shares through an ISA, and are treated with weary disdain at AGMs if they are bold enough to put questions to the Board. This is simply not good enough, and if they were organized so that they had a collective voice and vote, as is the case in France, Germany and Sweden, they would have as much clout as any institution. The Report should encourage UKSA to set itself up as a real interest group, just like its counterparts in the European Continent, and should as a means to this end give private shareholders the opportunity to vote separately for an NED to represent their interests - which nobody does at present.

2. The sources from which NEDs are drawn constitute a major limitation on supply, a situation which will only be exacerbated if the Walker Report and this Review of the Code lay more responsibilities on this relatively small number of people: in the main, these are almost exclusively those who have already served on a Board in another company as an ED. This experience, though valuable, is

restricted to the managerial perspective, and may therefore be a poor preparation for the more deliberative approach needed, and especially for the exercise of influence without power, a skill they may never have had to learn; furthermore, their experience may be and often is confined to one sector, sometimes one company, a poor preparation for grasping quickly the essence of a very different type of business. It so happens that it is precisely this combination of experience and skills which senior professional advisors and experts have had to acquire and master, making them potentially at least as good a source of NEDs. With rare exceptions, it is a source that is scarcely drawn upon, surely an unfortunate and serious neglect of a potentially valuable capability.

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