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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND

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Dear Chris

REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE: PROGRESS REPORT AND SECOND CONSULTATION

I am writing on behalf of the Institute of Chartered Accountants of Scotland and, in preparing this response, we have canvassed the views of the Institute's Business Policy Committee which is broadly based, with members representing different sizes of accountancy practice, industry, the investment community, and the legal profession; and the views of other interested members who work in the area of corporate governance.

As the Institute's Charter requires, we act in the public interest, and our proactive projects, responses to consultation documents etc. are therefore intended to place the general public interest first, notwithstanding our charter requirements to represent and protect our members' interests.

In relation to corporate governance, we consider the public interest to be maintaining and promoting confidence in an open, transparent and credible corporate environment that enables effective decision making by all interested parties and that allows boards to demonstrate effective stewardship of shareholders' funds, accountability to shareholders and appropriate responsibility to other stakeholders.

Following the publication of Sir David Walker's consultation paper and the draft Audit Firm Governance Code (AFGC), we welcome this further opportunity to contribute to the review of the Combined Code.

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In summary, we remain of the opinion that the current economic challenges have stemmed from the banking sector and we have no evidence of systematic failures of governance across all sectors. It is also important that the overall objectives of corporate governance for listed companies are retained and that in the reaction to the current economic difficulties there is not a backlash of prescriptive and burdensome amendments to the Combined Code. We believe the Code should remain principles-based, offer flexibility and relevance to different sizes of company, and encourage innovative explanation. In recent years there has been a tendency towards boilerplate 'explanation', which may have limited its quality.

In the main, the recommendations in the Walker consultation are sensible and we support many of them in relation to the governance of banking and other financial institutions but questions remain as to how they should be implemented. Our response to the Walker Review is attached for information.

We would have reservations about introducing the Walker recommendations in their entirety directly into the body of the Combined Code because there is no demonstrable need to apply them to all companies. Nor do we favour suggestions of additional provisions for specific industries, such as the banks and financial sector, being in the Code. This could set a precedent and lead to other industry specific provisions but we believe that the strength of the Code is that it is principles-based and all the principles can be applied by companies of different types and sizes. As noted in all recent consultations and reviews, the Combined Code remains fit for purpose and there is support for the 'comply or explain' principle As a result, whilst a number of the Walker recommendations may be adopted in the Code for companies generally and we have discussed these in the attached appendix, we do not believe there is a need for wholesale adoption of the 39 recommendations that have been made with one regulated sector, banking, in mind. It may be that some of the Walker recommendations should be introduced for banks and financial institutions in a similar fashion as the Higgs best practice guidance.

Walker puts forward a proposal that institutional investors should be subject to the 'Principles of Stewardship', encapsulating regular meetings with company directors and actively exercising an oversight role. Although the proposal is aimed at the banking sector, this will probably have a wider reach and may dovetail with principles in the draft AFGC. We agree that there should be more contact between the directors and the major shareholders. As noted in our earlier response, institutional investors might strengthen their input to the governance of the company if there was a separate meeting each year with the chairman and company secretary, and on occasion the senior independent director, specifically to discuss the governance of the company. It is most important, however, that there is not a form of engagement with larger institutional investors, whilst the smaller, individual investor is left on the sidelines. We were strongly supportive of the 'think small first' approach in the 2006 Companies Act and this is also pertinent in any review of corporate governance.

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Our additional comments on the issues identified in the Combined Code second consultation paper are in the attached appendix.

Please do not hesitate to contact me should you wish to discuss any of the above points further. We look forward to continuing to contribute to the FRC's work on the Code and its effective implementation.

Yours sincerely

DAVID A WOOD
Executive Director, Technical Policy

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APPENDIX

Section 1

Introduction – three guiding principles

- *Where there is a demonstrable need for best practice to be clarified or strengthened, this will be addressed either through amendments to the Code or additional, non-binding guidance;*
- *Where not constrained by regulatory requirements, we will seek to rationalise disclosure requirements in the Code to encourage more informative disclosure on the issues of most importance to investors and to discourage boiler-plating and box-ticking; and*
- *We will seek to avoid an increase in the overall level of prescription in the Code and to preserve its principles-based style.*

We are in agreement with these three guiding principles.

The responsibilities of the chairman and the non-executive directors

Specific issues for further consideration include:

- *Whether it would be helpful to give further clarification of the role, key responsibilities and expected behaviours of the chairman, the senior independent director and/or the non-executive directors, either in the Code or in non-binding guidance.*
- *Whether it would be helpful to provide further guidance on the time commitment expected of the chairman, senior independent director and/or non-executive directors.*

A strength of the Code is that it is principles-based and can be applied to different sizes of companies and, in our view, further clarification and guidance on roles and time commitment would make it overly prescriptive.

We do not think it is necessary or that it would necessarily improve the quality of non-executive input to a board to introduce a minimum time commitment for non-executives, in BOFIs or across the spectrum of listed companies. Likewise, the Walker Recommendation number 7, which suggests a time commitment for the chairman, would not in itself ensure either 'tone at the top' considerations including the ethical leadership, or the quality of input. We do not think that recommendations regarding specified time commitments should be incorporated into the Combined Code.

We agree that the Walker Recommendation number 11, which expands on the role of the senior independent director, may be appropriate for the largest companies, say FTSE 100 companies, but otherwise it should be left to company boards to decide what is appropriate in their specific circumstances. Consequently, we have reservations about including this in the Code.

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Board balance and composition

Specific issues for further consideration include:

- *Whether the Combined Code gives sufficient emphasis to the need for relevant experience among the non-executive directors collectively.*

It may be beneficial if the Code had more emphasis on evaluating the breadth and depth of relevant experience among the non-executive directors collectively and we would support this being introduced to the Code on the existing 'comply or explain' basis. The focus should be on behaviour, not on a time period, and with supporting explanation. Nevertheless, it is also important that fresh ideas, by way of new board members, are brought on and any revision to the Code should bear this in mind.

- *Whether the independence criteria and the way they have been applied by boards of companies and investors have unnecessarily restricted the pool of potential non-executive directors, and in particular whether the so called "nine year rule" has resulted in a loss of continuity and valuable experience.*

As we noted in our previous submission, we have reservations about the application of the existing independence criteria and believe that greater weight should be given to experience. Greater experience often brings a stronger contribution to the board; strength of character and independence of mind are also of considerable importance.

- *Whether the recommendation that the boards of FTSE 350 companies should comprise at least 50% independent non-executive directors has resulted in fewer executive directors sitting on boards and/or boards becoming larger.*

We think it is important that a board does not become too large, otherwise it impedes the conduct of business, and this will in part depend on the size and nature of the company. We have noted, however, that in some companies there are now fewer executive directors, which can happen when non-executives who exceed the nine year rule and no longer qualify as independent are retained on the board. Without increasing the size of the board but with a larger proportion of non-executives, only some of whom are independent, the number of executive directors falls.

- *Whether more guidance is needed, in the Code or elsewhere, on succession planning and the need to ensure that board composition is aligned with the present and future needs of the business.*

It may be helpful to provide further guidance on the need to ensure that board composition is aligned with the needs of the business.

Frequency of director re-election

Views are invited from companies and investors on whether changes to voting would increase accountability to shareholders and which, if any, of the following options they would support as recommendations for possible inclusion in the Code:

- *Annual re-election of the company chairman.*
- *Annual re-election of the chairs of the main board committees.*
- *Annual re-election of all directors.*

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We do not support the proposal to have annual re-elections of the company chairman, directors or chairmen of the main board committees. This would simply lead to uncertainty and short termism, with the chairmen and directors constantly mindful of their re-election. It invariably takes time to learn about a position and to gain the experience to undertake it effectively, and this would not be encouraged by annual elections. However, it is notable that shareholders often have little insight into why someone should be elected or re-elected and we consider that it would be useful if candidates were required to have a personal statement, indicating what they would bring to the position, individually and collectively.

- *Binding or advisory votes on specific issues, or on the corporate governance statement as a whole.*

We would support an advisory vote on the corporate governance statement in order to encourage more active input and oversight from shareholders. However, we would caution that there is a need to define the parameters of what the vote refers to as the material contained within the corporate governance statement is wide ranging in its nature.

Board information, development and support
Views are invited on whether it would be helpful to provide more guidance on some or all of the following issues, either in the Combined Code or in non-binding guidance.

Many commentators on the review highlighted the need for the non-executive directors individually and collectively to have sufficient knowledge of, and information about, the business to be able effectively and constructively to challenge the executive. This could be obtained in a number of ways:
- *Through prior relevant experience, which the sections of the Code dealing with board balance and composition should facilitate;*
- *Through the information they received, whether from the executive or from independent sources. Some commentators felt that the Code could encourage non-executive directors to make more use of independent sources of advice;*
- *Through greater contact with the operational activities of the company. Some commentators felt non-executive directors could be more proactive in this respect, and that it was the responsibility of the chairman and CEO to facilitate these contacts, while recognising the implications in terms of the overall time commitment required of non-executive directors; and*
- *Through induction and ongoing professional development.*

We commented on this topic in our earlier submission and believe that the key to understanding a business is through a comprehensive induction process and greater contact with the operational activities of the company. As discussed above, we would also support the principle that non-executive directors collectively have experience relevant to the current and future needs of the company.

The role of the company secretary
Again, we commented on the importance of the role of the company secretary in our previous submission; the company secretary may not occupy the most visible position in relation to corporate governance but is vital in facilitating effective board meetings and decision making. We believe there is already sufficient guidance on the role of the secretary and their effectiveness rests upon their softer skills and ability.

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Board evaluation

Specific issues for further consideration include:

- *Whether the Code should be amended to recommend that board evaluations should be externally facilitated at least every two or three years for some or all companies.*

We would encourage the adoption of this proposal on an advisory basis only, based on the Walker Recommendation number 12, which should lead to a more formal and rigorous evaluation, and with an emphasis on future improvements. We would suggest that this should be conducted, at most, every three years so that there is not an over-emphasis on evaluation. It may be that for the majority of companies applying the Combined Code, it would be more appropriate to have this on a five year basis. Many of our members have expressed concerns that externally facilitated board evaluations can be very costly and, whilst of value if conducted periodically, this is not necessarily the case if conducted on a regular basis.

- *Whether the recommendation that the effectiveness of all the main board committees should be evaluated every year should be relaxed in some way, for example to recommend a rolling cycle of committee reviews. Some commentators considered that after the initial evaluation there was limited value in subsequent annual reviews.*

We would concur with the latter sentiment and would be supportive of a rolling cycle of committee reviews.

- *How disclosures in the annual report might be made more informative, either in relation to the process that was followed and/or the outcomes of the effectiveness review.*

Any disclosure in the annual report should focus on the outcomes and any improvement measures. This should be in such a manner that it adds value and does not simply become exception reporting of weaknesses. In our view, information about process is unlikely to add value other than to justify the rigor of the process undertaken as a basis for the conclusions.

On the last issue, the FRC believes that the proposal for an "assurance statement" merits further consideration as it may provide a means of enabling investors to obtain more relevant information while allowing some other disclosure requirements in the Code to be rationalised, and would welcome views on what might be covered by such a statement.

We believe that an 'assurance statement' would be unnecessary and simply be a further layer of reporting without any significant benefits.

Risk management and internal control

Specific issues for further consideration include:

- *Whether the board's responsibility for strategic risks and setting risk appetite – as set out in the Turnbull Guidance - should be made more explicit in the Code, and whether the current balance between the Code and the Guidance is the right one.*

We believe the current balance between the Code and the Guidance is satisfactory. It may be that the setting of risk appetite, and its periodic evaluation, is an agenda item for discussion as part of the engagement between boards and shareholders but we have reservations about the need for further disclosure in the annual report.

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- *Whether there is a need for all or parts of the Turnbull Guidance to be reviewed.*

We believe that it might be helpful to review Turnbull in light of recent events with an emphasis on risks as well as the quality of implementation of controls.

- *To what extent the particular mechanisms recommended for banks and financial institutions would also be appropriate for other listed companies. For example, there were mixed views among commentators about whether separate risk committees were necessary for companies with less complex business models.*

We do not think it is necessary for separate risk committees in all companies. This is because we believe that risk identification and management are core responsibilities for all members of the board and therefore should not be delegated to a subsidiary committee. It may be that in larger companies it is board policy to set up a risk committee. If so, it is important that it is properly coordinated with the audit committee and the internal audit function, and without losing sight of the fact that responsibility for risk rests with the main board.

- *How reporting on risk might be improved, for example by rationalising existing disclosure requirements or providing guidance on good communications tools.*

We believe that risk reporting could be rationalised because at present there are a number of different requirements in the Business Review, IFRS requirements, and Turnbull. Rationalisation should clarify the disclosure by directors, presenting a more accessible, overall assessment of risks for shareholders.

Remuneration
Specific issues for further consideration include:

- *Whether to revise the Code to ensure consistency with the European Commission's Recommendations and, where appropriate, the FSA's proposed code of remuneration practice for financial institutions and the recommendations of the Walker Review.*

In general, we believe that the Walker recommendations should be contained in separate guidance for the banking and financial institutions but where specific recommendations can be demonstrated to be beneficial across the whole corporate sector, these could be included in a revised Code. For example, the Walker Recommendations number 28, 29 and 30 may have relevance and be useful in the Combined Code.

- *Whether any other changes to the Code, or additional guidance, are required to reflect developments in best practice.*

We believe that additional operational and focussed risk management guidance would be beneficial for the remuneration committee. This should interact with the risk management at board level and, in particular, non-executive directors need to understand how remuneration is tied to risk management and overall company objectives; they should be involved in approving policy and monitoring application of the policy.

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- *Whether shareholders should be given a more direct role in setting remuneration and, if so, how this might be achieved.*

To have effective involvement in setting remuneration policy, the shareholders would need to be involved in negotiations before policy is established and we do not agree with this. The shareholders may be expected to exercise oversight and ensure that the directors adopt suitable remuneration policies linked to the company's objectives but they should not be involved in the setting, reviewing or revising of policies. Once directors are appointed they should be trusted to run the company, without shareholder interference.

Section 2

The quality of disclosure by companies

Specific issues for further consideration include:
- *The extent to which it would be possible and desirable to rationalise the disclosure requirements set out in the Code. We would particularly welcome the views of investors on what information is of most value to them, and the views of companies on what information is most costly to produce.*

It would be useful to undertake a review of disclosure requirements with a view to establishing a reasonable level of meaningful disclosure.

- *Whether it would be appropriate for the FRC or the FSA to undertake greater monitoring and enforcement of "comply or explain" statements, and if so what form this might take.*

We do not believe it is an appropriate role for the FRC to undertake greater monitoring and enforcement of 'comply or explain', and that a successful feature of the existing Code is that companies may speak for themselves.

Views are invited on these issues, and on whether there are any other actions that the FRC might take to encourage more informative disclosure.

We believe that the nature of the Code is such that this should rest with the company and its shareholders. However, we recommend that the FRC should explore the benefits of the wording being changed to 'apply or explain', to take away the current emphasis on compliance and this may lead to more informed assessment of disclosures.

Engagement between boards and shareholders

Specific issues for further consideration include:
- *The framework proposed by Sir David Walker, and the appropriate role for the FRC.*

Walker puts forward a proposal that institutional investors should be subject to the 'Principles of Stewardship', encapsulating regular meetings with company directors and actively exercising an oversight role. We believe that this should have a wider reach than the banking and financial institutions and we would support such a principle in the Code. This should also dovetail with the recommendation in the draft AFGC.

- *What role, if any, it would be appropriate for the FRC to play in encouraging collective engagement.*

The FRC is not a shareholder body and so we are unsure of how it might consider defining or encouraging 'collective engagement'. In order to be effective, 'encouragement' would also need to be supported by a monitoring and enforcement procedure, which would require further input and have cost implications.

- *Whether further guidance on best practice for companies, investors or proxy voting services would be helpful, either in the Combined Code or elsewhere, and whether the practices currently recommended in Sections D and E of the Code continue to represent best practice.*
- *What other steps might be taken, by the FRC or others, to encourage both companies and investors to be more proactive about regular engagement and with a longer term focus than the annual results presentations.*

We suggest that the FRC consider commissioning a study of the relationships with different shareholders and the shareholders' time horizon and desire for more regular engagement. Each of the different groupings would need to be identified and their desire and ability to influence decision making analysed. The development of a good practice model for engagement would be helpful, which balances the needs of both parties and is mutually beneficial.

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