CAPITA
COMPANY SECRETARIAL SERVICES

Chris Hodge
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Capita Company Secretarial Services Response to FRC Review of the Combined Code (the "Code")

29 May 2009

Dear Chris:

Capita Company Secretarial Services ("Capita Co-Sec") provides specialist outsourced support and advice on all company secretarial and corporate governance matters to a wide range of clients ranging FTSE 100 and AIM listed companies to investment trusts covering all industry sectors. In particular, we are responsible for providing advice to our clients in the application of and compliance with the Combined Code ("the Code") in a manner that best promotes good corporate governance for each individual company.

Below are our thoughts on the FRC Review of the Code. In particular we have focussed on responding to the following questions:

- Which parts of the Code have worked well? Do any of them need further enforcement?
- Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?
- Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved?

We also provide our views on the content of the Code including:

- The composition and effectiveness of the board as a whole;
- The board's role in relation to risk management;
- The role of the remuneration committee;
- The quality of support and information available to the board and its committees;
- The content and effectiveness of section 2 of the Code.

Pease note that these are the views of Capita Co-Sec and are neither representative of Capita Group Plc nor our clients; we do not as a rule consult with these for such a response.

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Introduction

In general we feel that the Code is well respected and is serving its purpose. Whilst understandable there is a lot of attention focussed on the financial crisis, the woes many companies are currently experiencing can be put down to lack of judgment rather than regulatory failure. However there are several areas of the Code that we feel need amendment or reinforcement. These include:

- Comply or explain;
- Composition of boards;
- Risk analysis;
- Definition of "going concern";
- Directors' induction and Training ;
- Definition of 'boardroom success';
- The development of a formal link between the Combined Code and regulation; and
- Institutional investors.

Our views on these areas are explained in detail below.

Comply or Explain

Capita Co-Sec supports the 'comply or explain' regime and does not wish to see a more rigid model of the Code. In general, when applied within the spirit of the Code, this approach provides companies with enough flexibility, allowing them to explain non-compliance and the reasons why this is in the best interest of the company and its shareholders. However, it has been our experience that companies are often reluctant to do this and are unsuccessful in convincing their management - instead preferring to tick all the right boxes in order to meet investor expectations.

We believe that the Code needs to do more to encourage the appropriate boardroom behaviours rather than greater compliance with it. Boards should not feel obliged to appear to comply with all of the Code's provisions. Instead, disclosure should provide an accurate, honest picture of boardroom practices and procedures. Indeed an '*apply or explain*' approach would be a more effective way of achieving this. In pursuit of true transparency, we would support a requirement that companies explain regardless of whether or not they have chosen to apply the Code. We recommend that the wording in paragraph 2 of the Preamble be amended to read:

"Whilst it is expected that companies will apply its provisions wholly or substantially, it is recognised that not applying these may be justified in particular circumstances if good corporate governance can be more effectively achieved by other means. A company's reasons for choosing either to apply or not to apply the Code should be explained to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result."

We believe that encouraging companies to explain their reasons for choosing their particular approach, in the same way that companies are currently required to explain divergences from the Code, would provide greater transparency and allow shareholders to be better informed and more involved. The quid pro quo is that the Code should strongly encourage institutional investors to accept explanations as a perfectly satisfactory alternative to compliance/application. There are many circumstances, particularly in the current economic climate, where companies are

being forced to re-evaluate their strategy. We believe that explanation will therefore become a more common feature of the reporting cycle.

Composition of boards

We believe that there is a great lack of diversity on boards and in some cases this has resulted in "group think". Hence the boardroom lacks the appropriate challenge from non-executive directors.

Derek Higgs, in his 2003 Review of the role and effectiveness of non-executive directors said, "The composition of a board sends important signals about the values of the company. A commitment to equal opportunities which can be of motivational as well as reputational importance is inevitably undermined if the board itself does not follow the same guiding principles." He goes on to say, "My research shows that non-executives are typically white males nearing retirement age with previous PLC director experience. There are less than 20 non-executive directors on FTSE 100 boards under the age of 45. In the telephone survey for the Review, seven per cent of non-executive directors were not British, and one per cent were from black and ethnic minority groups. The very low number of female non-executive directors is striking in comparison with other professions and with the population of managers in UK companies overall."

In essence, not much has changed with regard to the composition of boards in the six years since Higgs made these remarks. Many companies are currently seeking to regain the trust of their investors in the wake of the financial crisis, and it is our opinion that an effective way of achieving this would be to build boards which better reflect a company, its investors and the community at large. However many companies are still prone to seeking out certain types of candidates. Boards comprised of members from a similar social range are less able to make balanced decisions which are in investors' best interests. We are in agreement with the comment of the newly nominated president of CBI, Helen Alexander, that the severe lack of women in the boardroom is "a loss of real talent". The Chairman is crucial to setting the tone of the board and a good leader in the chair will ensure a diverse and effective board that includes more women, minorities and a wider age range.

The publication of the Higgs review coincided with a report by Professor Laura Tyson that looked at this issue, but it was ineffective is infrequently referred to. The only way to deliver the change that we believe is needed is to push for the commencement of a formal non-executive shadowing program under confidentiality agreements, with potential non-executive directors completing an unpaid 'shadow year' without liability. Our belief is that that this would encourage more highly skilled and diverse candidates to join the gene pool and this would present boards with an opportunity to see potential candidates that reflect the culture and values of the company.

Risk analysis

Many of the failures that led to the market crisis were due to poor judgment resulting in bad decisions rather than failures of the Code, and we feel that it is not possible to

judge poor judgment. However, the decisions taken by some boards may have been due in part to ineffective, historic risk analysis and vague perceptions of risk.

The historic information and data contained in many typical quarterly risk reports is neither sufficiently detailed nor forward-looking enough to enable boards to make informed decisions. To be effective, risk management needs to be embedded into the everyday decision-making processes of the company and the board should be collectively responsible for identifying past, present and future risks that might affect the company.

In particular negative stress testing will help, but the novelty of this type of test should not be underestimated - companies and their shareholders are not yet accustomed to this way of measuring risk. Therefore we feel that it should not overshadow other methods of risk management.

While the Turnbull guidance for directors relating to risk management continues to be relevant, we suggest that supplementary interim guidance relating to the current market would be very helpful, as would a recommendation that the new accounting disclosures that require sensitivity analysis be considered in conjunction with the risk management process.

Board evaluation

The company secretary is uniquely placed to act as an overseer of the conduct of the board and the business of it and its committees. The current economic crisis may well point to instances where this role was either not carried out or where the board ignored the concerns of the company secretary. We believe that this oversight role should be formalised within the descriptions of the company secretary in the Code.

There is a need to ensure a broader common sense approach to risk and to include the consideration of more external factors, more frequently. Therefore we strongly feel that in addition to regular internal audit, external board evaluation should be made compulsory and performed biannually. Although we accept the difficulties many smaller listed companies would encounter in adhering to this due to potential economic/resource issues, we feel that the 'apply or explain' regime would provide them with the flexibility to choose the approach that is best suited to their individual circumstances.

We also feel that there should be a stronger role in Section 2 of the Code for investors to communicate their criteria against which the board should evaluate its performance. This would allow institutional investors the opportunity to assess the board's performance and engage with the company if they find it is not satisfactory.

Directors' induction/ training and the role of the company secretary

It is our opinion that in order to fully understand the risks facing the company, and to effectively challenge executive decisions relating to these, non-executive directors require more comprehensive briefings and access to induction and training programs coupled with greater engagement with middle management. A good induction and training program should give non-executives a comprehensive view of the culture of the company, its business model and the types of risk a company faces. They should be given the opportunity to go out, interact with the business and ask questions. Companies should be further encouraged to implement formal and transparent

policies with regard to briefing, induction and training programs with the details of these disclosed in the annual report.

We believe that sometimes directors feel that they can rely on the board's sources of knowledge to keep themselves up to date and therefore do little themselves. This vital function is underestimated in the Code as it is currently set out and we believe that there should be formal reference to the company secretary to deliver information and training throughout their tenure. A diligent, knowledgeable and proactive company secretary plays a key role in supporting the board in respect of training, providing information required to support decision-making and summarising the output of each committee to the board. Company secretaries need to remind directors of their personal responsibility to keep themselves informed in order that they can fulfil their obligations and duties.

<u>The non-executive portfolio</u>

Often a director will hold several non-executive directorships, each requiring the significant commitment of over twenty days per year. When holding a large number of directorships, it is very difficult to achieve the level of depth and understanding that each business requires. Although we do not think that there should be a limit on the number of directorships held, we do feel that there should be more guidance on the time commitment involved in each non-executive directorship and the number of directorships held, especially with regard to FTSE 100. We also believe that the Companies Act 2006 requirement for directors to avoid conflicts of interest places a more onerous burden on the portfolio of the non-executive director, making it more difficult for multiple FTSE directorships to be held.

The board should assess whether the number of directorships held by a director might inhibit their capacity to perform. When a board nominates a new non-executive director who holds other directorships, it should provide a statement on capacity to perform the role, explaining why the board feels that this person is fit to take on another non-executive role and how their time commitments will be balanced. Where a board feels that a director's other time commitments are negatively impacting his or her performance, the chairman should intervene and provide clear guidance.

<u>Boardroom success</u>

We feel that the Code should provide a clear definition of boardroom success– what does it mean? For example, is it based on the share price, growth etc? Punishment and reward should not be the only incentives for directors. More importantly, we believe that a balanced mix of knowledge and understanding of effective boardroom practices will contribute to the success of the company – if directors appreciate this, this will be an incentive in itself.

<u>The development of a formal link between the Combined Code and regulation</u>

We believe that there should be a formal link between the Listing Rules, the Disclosure and Transparency Rules and the Companies Act 2006, with references to these in the Combined Code along with explanations, if necessary. This is due to the many areas of overlap which, at present, can prove confusing to directors and advisers alike. For example, how do the Code's provisions on independence relate to the new Companies Act provisions on Conflicts of Interest?

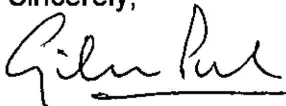
Responsibilities of institutional investors

It is our opinion that there is still room for improvement in Section 2 of the Code. Institutional investors already do play a large role in influencing boardroom behaviours, albeit in non-transparent communications/relations. However, it is our belief that they should get involved in a more coherent and constructive way by increasing their dialogue with the board and clearly communicating the governance arrangements and boardroom practices that they wish to see, in a more structured and transparent form. In particular, the practice of institutional investors communicating with companies in two distinct channels (with the CEO/FD and with the chairman/company secretary), often in different time scales, is a frequent cause of confusion and miscommunication. We feel that institutional investors should retain a flexible approach to the individual governance arrangements of different types of companies, however, where their investment criteria strictly prohibit them from investing in a company if this is not met, this should be clearly communicated to the board in order that they can review their practices.

Conclusion

We would like to thank the FRC for this opportunity to express our views on the effectiveness of the Combined Code. As there is much to debate, we would be happy to discuss any of the above in further detail.

Sincerely,



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