From: Ian Butcher [ian.butcher@mwmconsulting.com]
Sent: 22 May 2009 17:12
To: Chris Hodge
Subject: Comments on the Combined Code

Dear Sirs

Please find below our comments on the Combined Code for the purposes of the review currently being conducted.

MWM Consulting is, we believe, the leading executive search firm in the UK acting for top company boards; for example we act for the boards of twelve of the top twenty five FTSE 100 companies. Additionally we conduct Board Reviews (Performance Evaluations) for the boards of some of the largest companies. We believe that our work in the boardroom gives us an informed insight into many aspects of the Code.

Generally we believe that the existing Code has worked well and requires evolutionary modification rather than substantial change. Moreover, we believe strongly that an overly prescriptive Code would create more problems than it solves; attempts to impose a 'one size fits all' regulation based straitjacket would be misguided. There is no simple 'boiler-plate' definition of the role a world-class board should play: each business and each board operates in a particular context with its own priorities and challenges to consider. Financial services boards typically require greater engagement and technical expertise; multinational and multi-product businesses require a different style of leadership from simpler national ones; companies requiring a turnaround warrant a different board approach from those with a more incremental agenda.

That said, it is clear that many Boards have not lived up to the expectations investors have of them. In this context, there are three areas that, from our experience, could be improved: ensuring the right Board balance; enhancing the impact of Board effectiveness reviews; and non-executive director engagement.

Board Balance

In the first Supporting Principle in section A3 on Board Balance and Independence, it states that "The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business…"

The subsequent Code Provisions of this section focus on the definitions of independence, the balance of independent and non independent directors and the appointment of a senior independent director. There is no elaboration as to the sort of criteria which might be used to judge what an appropriate balance of skills and experience might be.

In A.4 Appointments to the Board, code provision A.4.2 states that "The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment."

It seems likely that Sir David Walker's Review of bank governance will make quite specific recommendations as to the skills and experience that will be required for bank boards. Indeed the FSA has made its position quite clear on the requirement for more relevant experience and skills on bank boards and this process is already under way. We have in fact been directly involved in this shift, in another jurisdiction, having helped one of the large Swiss banks recruit a new chairman and eight non executive directors over the past year, all with specific banking, risk and audit backgrounds.

For non banking companies, we believe there would be merit in giving more guidance to boards as to the sort of criteria which should be applied when forming a judgement about an appropriate "balance of skills and experience" in the non executive director team, for example:

- A knowledge of particular geographies or overseas markets which are of significant importance
- Relevant sector background/ knowledge
- An ability to form a view on key risk factors specific to the company (which might be related to financial, technology or other factors)
- A current, or very recent, executive member of another board (particularly relevant insights into the challenges facing the executive directors)
- For a company very active in buying and selling businesses, relevant corporate transaction

experience

What is critical is for each Board to articulate and agree:

- Given its desired role and how it will add value, the balance of skills and experience required
- What gaps exist now or prospectively, given anticipated requirements
- Using this as a template against which the nominations committee can make decisions relating to further appointments, in terms of designing briefs and evaluating potential candidates. It would also be helpful when judgements are being made during the annual Performance Evaluation.

Performance Evaluation

In our experience, some Board Reviews that companies have conducted are little more than 'tick box' exercises, whilst many generate only incremental process improvements. This is due to two key issues: a lack of independence in the review and too narrow a focus in the thinking.

Firstly, it is our belief that allowing boards to determine whether they ever commission an externally mediated Performance Evaluation is a significant weakness of the Code. Our observation is that it is the strongest boards who do conduct evaluations through an outside adviser and the weakest who always conduct their own reviews. We do not advocate an externally mediated evaluation every year, but that they should be done at least every third year. Moreover, the Code requires that the boards should state how the performance evaluation has been conducted; we believe it should go further and also disclose a summary of the results of the evaluation. This will be part of the process required to help reassure investors that boards are taking on a higher degree of accountability.

Secondly, we believe that board reviews should – periodically at least – ask a broader and more fundamental set of questions than is typically in their scope today: taking a step back to ensure clarity and alignment on what the Board is trying to achieve, a structured plan to build the capabilities required and the identification of any fundamental changes to the way the Board operates to ensure it delivers what is expected of it.

- The starting point should be that boards – having engaged with their investors – define clearly how they will add value in the key areas of strategic leadership; performance management; management development and succession; risk assessment and management; and stakeholder management. This provides a platform for aligning the respective roles and time expectations of the chairman, non-executive directors and executive directors
- Next, it is critical to be clear on the skills needed, tailored to the role the board is seeking to play. Based on that, structured analysis will identify key gaps (either immediate or prospective), and hence enable effective succession planning to recruit the necessary capabilities
- Finally, reviews should examine whether the board is working in the most effective and efficient way possible to fulfil its objectives. This involves exploring a range of practical issues such as how board members allocate their time, collectively and individually; whether board meetings generate useful debate and clear actions; and the coverage, quality, relevance, presentation and timeliness of the information provided to the board. It also means considering how to optimise board dynamics such as the relationship between the chairman and the CEO and the degree of mutual trust, respect and openness between the non-executive and executive directors.

In addition, we observe that some members of the ABI seem to be coming to a view that the conduct of external Performance Evaluations should not, for perceived independence reasons, be conducted by executive search firms, or at least a search firm that conducts search work for the board in question. In contrast, we believe that a firm such as ours, with the unrivalled insights gained by the partners into boardrooms and directors over many years, is actually uniquely well qualified to conduct such evaluations. The critical issue for Boards should be to work with someone who will give honest, expert and objective advice.

Non-Executive Director Engagement

We conducted some research last year comparing the perceived effectiveness of plc Boards with the Boards of portfolio companies run by the most successful private equity firms (a copy is attached). Whilst the contexts clearly vary, it was striking that people with experience of operating in both

regimes felt strongly that PE Boards added much more value.
Our research suggested three key reasons for this:

- The strongly aligned focus on value creation in PE Boards
- The greater clarity of strategic and performance priorities
- The higher engagement and commitment of Board members

The first of these three reasons is hard for plc Boards to replicate; the second is a question of focus and leadership and shortcomings should be highlighted in well run Board reviews; the third is perhaps the most interesting. Not all Boards can or should respond the same way; it depends (see above) on their view of the role of the Board and how it will add value. But for those seeking to play more than just a high level governance role it raises three key implications:

- *Increasing the time expectation of Non-Executive Directors:* It is difficult to see how plc non-executive directors can ever hope to add real value to their businesses if they only have 20 days a year to spend on them – and if the vast majority of that time is spent on formal Boards and committee meetings. This is particularly true for the larger and more complex public companies, such as Banks. Plc Boards therefore face a stark choice: either to accept that their role remains a governance-centric one focused on avoiding surprises for investors, or significantly increasing the time expectation for some or all of their non-executives (and spending much more time in informal interactions with executives). The latter option would of course raise its own challenges, in particular how to attract serving executives onto Boards given the demands of their main job (and such executives are often highly valuable Board members) and how to make rewards for Board members consistent with the greater demands placed on them.
- *Transforming how Boards are educated and informed about the business:* Plc non-executives often have a much less detailed understanding of their businesses than the Board members in PE businesses. Addressing this may require four changes, beyond simply investing more time. Firstly, plc induction processes (which have greatly improved in recent years) need to be far more thorough: a fair expectation is that a new non-executive might need to devote five to ten days to induction, rather than the usual one or two, and spend them in engaging with a wider range of managers and in site visits, customer meetings, discussions with analysts/industry experts etc as well as in Head Office briefings. Secondly, plc Boards need to define with the same precision that is typical of PE Boards the regular information they require (including agreeing the KPIs that highlight priority value drivers, including cash) to stay fully up to date with business performance and trends. Thirdly, Boards should consider providing the Chairman and the non-executive directors with modest levels of further staff support, in addition to that already provided by the Company Secretary's office and through the key Committees, to provide the analytical resource that exists in PE houses and in activist investors. Finally, plc non-executives should ensure that (as is already the case in the best run Boards) they ask for and get detailed background briefings on technical issues or major themes as required.
- *Selectively modifying the remuneration model for Non-Executives:* The recommendations outlined above would significantly increase the burden on the non-executives: as time expectations increase then, at a minimum, the payments received by non-executives would need to increase proportionately if high calibre candidates are to be attracted to the role. It may also be worth considering alternatives to the flat fee system, including greater use of payment in shares to align non-executive directors interests with those of investors.

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