KPMG LLP
1-2 Dorset Rise
London EC4Y 8EN
United Kingdom

Tel +44 (0) 20 7694 8082
Fax +44 (0) 20 7694 8096
DX 38050 Blackfriars

Chris Hodge Esq
Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

Our ref tc/815

22 October 2009

Dear Sir

Review on the effectiveness of the Combined Code: Second consultation

We welcome the opportunity to respond to the consultation paper *Review of the effectiveness of the Combined Code: Progress report and second consultation*.

Whatever the role of corporate governance in the financial crisis, it is clear that companies operating under different governance regimes and having different governance structures have been affected. There has not been a systemic failure of any one corporate governance system and no single governance model has emerged as being 'better' or more capable of dealing with the issues leading to the crisis than the others. Therefore we see no compelling reason to radically change the UK governance model to a different system such as the two tier board system.

What we have seen, however, is the marked difference in behaviours employed by different companies. This should come as no surprise as good governance has never been about regulation; but about people, behaviour and instilling ethical and moral probity throughout an organisation – including, but not limited to, the board of directors. Simply complying with statute, regulation and codes of best practice is not enough. Companies need to consider how they behave in practice and recognise that their 'tone at the top' and culture pose critical risks to their corporate reputation and possibly survival. In short, the behavioural aspects of governance are paramount.

Furthermore, there is a limit to which any regulatory framework can deliver good governance, but this is not an excuse for complacency. All parties should strive to eradicate, or at least minimise, governance failure. In our view the solution does not lie in an overly prescriptive regulatory response but renewed focus on how the board discharges its responsibility. The behavioural aspects of corporate governance are more important than the architecture. For this reason we support any steps that might 'encourage' ethical and moral probity and change 'behaviour' such that companies are better placed to face future crises. Risk committees, a fresh look at the Turnbull Guidance on internal control and more guidance and disclosure around board evaluation are all areas worth exploring in the quest to improve the effectiveness of the UK governance regime.

We are also concerned that, over time, full compliance with the Combined Code has become the expected norm – and that this position has been encouraged both by successive relaxations of the Code in those areas where non-compliance was most apparent and by 'special rules' for smaller listed companies. Whilst we recognise that an effective corporate governance code must have the buy-in of both preparers and investors, we think too many steps have been taken to maximise compliance levels and ultimately this has weakened the 'comply or explain' framework and encouraged a compliance mentality rather than focus on what governance actions are in the best interests of the company.

If the Code is to be effective in offering flexibility rather than the brittleness and rigidity of legislation, then surely some, albeit not too many, rational and properly explained deviations from the Code should be commonplace. Yet the number of provisions not complied with is in fact very low. Is it really reasonable to expect all companies, or even most companies, to comply with all 47 provisions? Is wholesale compliance necessarily a good thing? Perhaps the investor community should be reassured by companies choosing not to comply with certain provisions providing it is done in the best interests of the company and explained in such a way that investors can evaluate non-compliance objectively.

* * *

Our comments on some of the specific recommendations within the review are set out in the attached appendix. We hope that our comments prove to be useful and we welcome on-going dialogue. Please do not hesitate to contact me should you wish to discuss any of the points raised in this response.

Yours faithfully

John Griffith-Jones
Joint Chairman
KPMG Europe LLP

Enclosures:

APPENDIX 1

The responsibilities of the chairman and the non-executive directors

Would it be helpful to further clarify 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?

We are not convinced of the need for further clarification as practice continues to develop and there are already many other sources of such guidance. If the FRC were to develop guidance on these issues, we would expect it to sit outside the Combined Code.

Notwithstanding the above, it may be appropriate to make reference to the legal duties of directors within the preamble to the Code. The Code addresses the role of non-executive directors in some detail, but doesn't really address the role of executive directors. In our view it would be appropriate to draw out the board responsibilities of executives and distinguish these from their management responsibilities. This would serve to strengthen the unitary board concept.

Would it be helpful to provide further guidance on the time commitment expected of the chairman, senior independent director and / or non-executive directors?

We do not believe it is necessary to provide further guidance on the time commitment expected of the chairman, senior independent director and / or non-executive directors. Time commitments may vary dramatically according to the complexity of the organisation, the issues faced and even the economic cycle. The important thing is that the directors carry out their role in a diligent and effective manner rather than fulfil a minimum time commitment – and this means investing time in understanding and deliberating the issues and making the necessary challenge. In some circumstances this could take considerably longer than the 36 days recommends by Sir David Walker.

Some non-executive directors have, during our Audit Committee Institute sessions, suggested that 36 days is not unreasonable for a non-executive director of a moderately sized company while others have suggested that executives aren't doing their job properly if non-executive directors of companies outside the financial sector have to spend more than 36 days. In any event, we believe that too specific a recommendation such as '36 days' is likely to act as a target and would prefer any additional guidance to be focussed on the broader issue of directors committing the time necessary to fulfil the role in the specific circumstances of the company.

In our view, to achieve the behavioural shift that might be necessary in some organisations, consideration should be given to whether the non-executive role could for extended periods require a 100% commitment of an individual's working time. This idea is not without its problems as such a commitment might possibly impair, or appear to impair, a non-executive's independence and their ability to exercise the 'nuclear option' of resigning if their concerns go unheeded by their executive colleagues. Nevertheless, we believe the guidance should note that where conditions are complex the more time spent understanding a company's issues and the market in which it operates would enable a non-executive director to better contribute to both strategy and oversight - without necessarily impeding independent judgement.

Board balance and composition

Does the Combined Code give sufficient emphasis to the need for relevant experience among the non-executive directors collectively?

We believe that the Combined Code does give sufficient weight to the need for relevant experience among the non-executive directors. Nevertheless, it is important that boards specifically address the experience of board members during the board evaluation process and consider both their current requirements and how those requirements might change in line with the company's strategy.

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

We believe there is merit in looking afresh at provision A.3.1 and a re-write might cause both corporates and investors to think differently when interpreting code compliance (or otherwise). The current provision does not, in our opinion, seek to establish independence criteria as such; but identify a number of circumstances which *may* appear relevant to the determination of independence. This is not well understood and as a result a 'box ticking' approach to this provision is common place.

Furthermore, some thought should be given to differentiating the concept of independence used in the Combined Code with that used in the Companies Act. As currently drafted, the Code recommends that boards should include a significant cadre of non-executive directors who are considered by the board to be 'independent in character and judgement'. Yet the Companies Act (s.173) requires *all* directors (both executive and non-executive) to exercise 'independent judgement'. Are non-independent non-executive directors therefore unlawful?

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

In our view the recommendation that boards should comprise at least 50% independent directors along with the increased focus on non-executive board committees has resulted in fewer executive board members.

Data from Spencer Stuart's 2008 Board Index reports covering 150 of the UK's largest companies by market value at the end of April 2008 (excluding investment trusts) suggests that while board size has remained relatively stable over the past five years, the ratio of executive to non-executive directors has changed dramatically and we are now seeing fewer executive directors sitting on boards. We also note that the research supporting the 2003 Higgs review concluded that non-executives comprised, on average, around half a FTSE 100 board.

	2008	**2003**
Average board size	10.5	10.8
Executive Directors	35%	48%
Non-executive directors	65%	52%

An average board size of around 10 does seem reasonable – not so large as to stifle debate, but large enough to ensure diverse views and experience are represented around the board room table. However, the reduction in executive representation to what is likely to be the CEO, finance director and one other is worrying as there is a greater risk of distortion or withholding of information, or lack of balance in the management contribution to the boardroom debate, when there are only a small number of executive directors on the board.

We do recognise that there is a Combined Code (Supporting) Principle that there should be a strong presence on the board of both executive and non-executive directors; however the different weight given to Provisions, Principles and Supporting Principles (in that order) has perhaps contributed towards the shift in board composition. There is no easy solution as greater executive representation would most likely come at the cost of larger and arguably more unwieldy boards – an issue that can only be exacerbated by the introduction of board risk committees.

Is more guidance 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?

We are not convinced of the need for additional guidance on succession planning, however, we believe that the disclosure obligations contained in Combined Code provision A.4.6 could be amended to encourage a more comprehensive description of the nomination committee's work and address the organisation's succession planning policy.

Frequency of director re-election

Would changes to voting increase accountability to shareholders and which, if any, of the following options should be considered for 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; Binding or advisory votes on specific issues, or on the corporate governance statement as a whole?

We believe that the annual re-election of the Chairman and/or other directors would weaken the UK corporate governance framework as such a practice will create greater uncertainty, undermine the unitary board concept and reinforce short-term behaviours.

Annual re-election is not conducive to long-term succession planning across the whole board or stable stewardship. In practice, activist users of shareholder rights can be primarily driven by short term objectives whereas longer-term shareholders are often passive. What this means for shareholder enforcement as a driver of good governance is an important question in a world increasingly dominated by hedge funds.

Furthermore, we do not believe that advisory votes on specific issues are necessary as the existing vote to receive the report and accounts is a useful and efficient mechanism to hold boards to account.

Board information, development and support

Would it be helpful to provide more guidance on the information and development needs of non-executive directors, either in the Combined Code or in non-binding guidance?

We do not believe the Code needs amending to include specific guidance on the information and development needs of non-executive directors. We are, however, fully committed to helping non-executive directors refine the skills and expertise they need to fulfil their role effectively; but it should be for boards to decide how this is best delivered.

If the Code were to be amended, we would support some additional emphasis on the development needs of executive as well as non-executive directors. This might encourage a behavioural change whereby executive directors better understand their responsibilities as directors and distinguish that role from their executive management role.

Would it be helpful to provide more guidance on the support mechanisms that should be made available to boards, either in the Combined Code or in non-binding guidance?

We agree that *all* board members should have access to dedicated support and external advice; however, it should be for boards to decide how this is best delivered. We do not believe that separate secretariats for non-executive directors will be appropriate in all circumstances and if Code Provision A.5.2 is extended in any way, we would hope that independent secretariats are not considered the baseline against which well governed companies are benchmarked.

Board evaluation

Should the Code be amended to recommend that board evaluation should be externally facilitated at least every two or three years for some or all companies?

We welcome the suggestion that board evaluation should be externally facilitated at least every two or three years as this is one of the measures that might get to the heart of many of the 'behavioural' and 'cultural' issues raised by the recent crisis.

Whilst the Code currently recommends annual evaluation of the board, board committees and individual directors; questions have to be asked about the thoroughness of such reviews. Externally facilitated evaluation can bring rigour to the process and provide a good baseline for subsequent internal reviews which one would hope would naturally become more robust over time. Other advantages include the ability of 'outsiders' to bring out tensions in a non critical way and engender a willingness to listen. In contrast, it can be argued that external facilitators use standard processes that are not always appropriate to the company, board and individuals involved.

On balance we believe that evaluation is hard to get right and even good processes can become stagnant over time. A mixture of approaches - for example involving an external facilitator every two to three years - would therefore be very beneficial.

Furthermore, if revisions to the Combined Code are to encourage the behavioural shift that might be necessary in some organisations, consideration should be given to establishing certain 'ground rules' for carrying out board evaluation – whether internally or externally facilitated. For example, perhaps boards should solicit feedback from major investors – say those owning more than 5% of the company? This would certainly test the appetite of institutional investors to actively engage with those companies in which they invest.

Should the recommendation that the effectiveness of all the main board committees be evaluated every year be relaxed in some way, for example to recommend a rolling cycle of committee reviews? Is there any value in subsequent annual reviews after the initial evaluation?

We believe that annual rigorous evaluation of board committee performance is an important tool in achieving and maintaining committee effectiveness. Companies can, of course, already choose to adopt a rolling cycle providing they explain their reasons – and this is appropriate. Relaxing the Code Provision at this time would not send the right signal and could potentially undermine the importance of evaluation at a time when boards and board committees should be seeking to maximise their effectiveness.

In our experience there is a clear benefit in subsequent annual reviews after the initial evaluation. Initial evaluations have, for many companies, been little more than a run through the various responsibilities referred to in the committee's terms of reference, Combined Code and associated guidance to make sure everything has been covered. A simple process, but often unable to provide any comfort as to the effectiveness of the committee let alone raise performance. Thinking in terms of 'passing' or 'failing' oversimplifies the situation – but is often the starting point. Subsequent reviews could then focus on the value added by the board committees. This could be established by asking probing questions such as: how well did the committee do this; could the committee have done better; and how could the committee made a difference?

How could the disclosures in the annual report be made more informative, either in relation to the evaluation process or the outcomes of the effectiveness review?

We support greater disclosure around board and committee evaluation. Clearly there are practical issues to be overcome, however, there are sufficient good examples from both the financial and non-financial sectors that serve to illustrate that useful information can be disclosed without straying into the realms of seriously prejudicial information.

Consideration could be given to enhancing the current best practice suggestions appended to the Combined Code to encourage:

- board performance evaluations to address intra alia:
  - behavioural issues and corporate culture
  - outcomes not activities
  - benchmarking against aspirations, identified shortcomings and best practice
  - soliciting feedback from the major investors, management and other stakeholders
  - the effectiveness of and the time given to the induction of directors
  - learning and development activity undertaken by board members (both executive and non-executive directors)
  - how the board ensures directors have access to the 'right' information on a timely basis
  - feedback mechanisms

- reporting of board evaluation to address:
  - who conducted the evaluation
  - what other services that organisation supplied to the company
  - how it was conducted
  - Whether feedback was sought from major investors
  - what it concluded
  - what would the company be doing differently as a result.

Risk management and internal control

Should the board's responsibility for strategic risks and setting risk appetite be made more explicit in the Code? Is the current balance between the Code and the Turnbull Guidance on Internal Control the right one?

We believe that the current balance between what is included in the Code and what is included in the supplementary Turnbull Guidance on Internal Control is about right. However, because of the concerns that some boards have had insufficient visibility of risk, we think it is appropriate to draw specific attention to the board's responsibility for strategic risk and setting risk appetite in the Code itself.

Is there is a need for all or parts of the Turnbull Guidance on Internal Control to be reviewed?

Whilst we think the Turnbull Guidance remains as relevant today as it ever was – the flexibility inherent in its principles-based approach has, by its very nature, enabled companies to apply the guidance to varying degrees. Of particular concern are those companies that have reached a 'comfort zone' of reviewing the same 'Top 10' risks without questioning whether these remain relevant, or whether they have been accurately aligned with the key business objectives. Furthermore, it is increasingly clear that some board visibility of risk is not all that it might be in some companies and that there are clear issues around the asymmetry of information provided to non-executive directors and the ability of those non-executive directors to effectively challenge strategy and the associated risks.

For this reason we recommend that the Turnbull guidance is refreshed with a view to articulating the board's role with respect to strategic risk and risk appetite; and in the hope of encouraging boards to regularly reassess their risk governance framework and to re-establish the momentum that was evident when the guidance was first issued. We see this as a real opportunity to re–invigorate risk governance and address some of the behavioral aspects of governance without imposing a prescriptive solution.

Revised Turnbull Guidance could also address the role played by risk and audit committees within the governance framework (see next question).

To what extent are the Walker Review recommendations for banks and financial institutions also appropriate for other listed companies? For example, are separate board-level risk committees necessary for companies other than banks and financial institutions?

The extent to which Sir David Walker's recommendations will be applicable beyond banks and other financial institutions (BOFI) is by no means clear. Each recommendation needs to be considered on its merits and whether it will bring about positive behavioural change. In any event we support a principles-based approach rather than one that is too prescriptive.

In principle we are supportive of board risk committees as a way of demonstrating that sufficient time and focus is given to the governance of risk. The full board is, of course, fully responsible for risk and should set a tone and culture. However, for many companies there are significant practical issues surrounding the ability of non-executive directors to gain a full appreciation of risk strategy, the associated risk appetite and the actual extent of risk bearing activities.

Risk committees may be a solution for some companies – and for some, even the consideration of their current arrangements in the light of a recommendation to explore such committees might bring about sufficient behavioural change to ensure risk is properly managed. However, it is important that there is a common understanding of the typical responsibilities of such a committee to ensure there is complete clarity over risk management and risk governance. To draw a parallel, there is a wealth of guidance on audit committee responsibilities and associated best practice and it would, in our view be helpful, if similar information could be developed for those charged with risk governance. Provided the risk governance responsibilities are clear, it should be for each company to decide how best these as discharged through the corporate governance process between the Board and either a risk committee or an audit and risk committee.

Could reporting on risk be improved by rationalising existing disclosure requirements or by providing guidance on good communications tools?

Consideration of the existing disclosure requirements should be judged by the yardstick of what is in the best interests of shareholders - what do shareholders want to know about the risks facing a company and the quality of the company's internal control system. The answer is probably something like "what's the company's appetite for risk and is it being exceeded?"

Articulating risk appetite in a meaningful way is clearly a difficult task, but we believe the current framework is capable of providing a base level of disclosure that will be of interest to investors. This is:

- the principal risks and uncertainties facing the company (as required by the Companies Act);
- the high-level internal control procedures put in place to mitigate those risks (as required by the FSA's Disclosure and Transparency Rules in response to the recent amendments to the European Union's 4^{th} and 7^{th} Company Law Directives); and

- how the board have reviewed the effectiveness of that system of internal control (the current Turnbull recommendation).

In effect a three part statement setting out the company's *risks*, it's *controls* and how that system of controls has been *reviewed* by the board – rather than three unlinked and unrelated statements as is often the practice at present. Not only would this provide users with an understanding of how risk is linked to the company's strategy and the process for achieving a sound system of internal control, but it would also offer an insight into the group's control environment and overall attitude towards control and risk management.

Remuneration

Should the Code be revised to ensure consistency, where appropriate, with the European Commission's recommendations on remuneration, the Financial Services Authority's (FSA's) proposed code of remuneration practice for financial institutions and the recommendations of the Walker Review?

Yes. This would ensure consistency and avoid overlapping disclosure requirements which would only add additional complexity for both listed entities and users of accounts.

Should shareholders be given a more direct role in setting remuneration and, if so, how this might be achieved?

We do not believe that shareholders should be given a more direct role in setting remuneration. There are various existing mechanisms available to shareholders and we are not convinced that adding additional mechanisms will assist in this area.

"Comply or explain"

Should the term "comply or explain" be replaced by "apply or explain"? Would such a change encourage: companies to explain where it was appropriate to do so, rather than feeling compelled to comply in all circumstances; or/and investors and proxy voting services to take less of a box-ticking approach?

Replacing the 'comply or explain' terminology with 'apply or explain' will not, in our view, encourage companies to explain rather than feeling compelled to comply in all circumstances; nor encourage investors and proxy voting services to take less of a 'box-ticking approach. Perhaps 'apply' rather than 'comply' should have been adopted in the early 1990's when the 'comply or explain' framework was introduced, but after 17 or so years the concerns about box-ticking and the generally perceived negative reaction to non-compliance (or should that be non-appliance) will persist whatever word is used.

Such a change may also create confusion between the Principles and Supporting Principles which should be applied in all circumstances and the detailed Provisions. As an aside, we believe that far too little emphasis is given to the narrative statements in which companies discuss their compliance with the various Code Principles. Perhaps there is scope for an FRC/FRRP review similar to that carried out with respect to the recently introduced Business Review disclosures; or even an award / prize to encourage good disclosure.

The quality of disclosure by companies

Is it possible and / or desirable to rationalise the disclosure requirements set out in the Code? What information is of most use to investors and what information is most costly to produce?

In our view the disclosure 'recommendations' set out within the Combined Code remain relevant however it could be argued that disclosure has not always been as good as it might. In particular, many non-compliance 'explanations' have amounted to little more than statements of the obvious which has perhaps encouraged investors to interpret non-compliance as failure.

For example, how often do we read that a company has not appointed a senior independent director because the board believes such a role to be inappropriate to the company's circumstances? There might be many sensible reasons why a company should not appoint a senior independent director, but these should be properly be explained - after all, if boards make conscious decisions in the interests of the company's shareholders, then they should not be afraid to articulate their reasoning to those very same shareholders. Given that few companies fail to comply with more than a handful of Code provisions, full and transparent disclosure should not be too much of a burden.

Similarly, 'Comply or explain' will not work in an environment where investor bodies and corporate governance 'specialists' are seeking compliance at any cost. The principle requires the commitment of institutional shareholders and, in particular, their compliance officers to devote the time necessary to assess each company's corporate governance statement – and in particular any explanation surrounding non-compliance.

Just as non-executive directors should act in an objective, diligent and informed manner, those responsible for interpreting corporate governance statements should be equally accountable and apply intelligent discretion in an enlightened manner.

Would it be appropriate for the FRC or the FSA to undertake greater monitoring and enforcement of "comply or explain" statements, and if so what form might this take?

We believe that it is appropriate to undertake monitoring and enforcement of "comply or explain" statements but would caution against the regulator making judgements as to whether explanations are acceptable or not.