

PETER MAYNARD  
GROUP LEGAL SERVICES DIRECTOR



**PRUDENTIAL**

PRUDENTIAL PLC  
12 ARTHUR STREET  
LONDON EC4R 9AQ

TEL 020 7548 3737  
FAX 020 7548 3191  
[www.prudential.co.uk](http://www.prudential.co.uk)

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

1<sup>st</sup> June 2009

Dear Mr Hodge

We attach our response to your call for evidence. It has detailed comments on the points you have raised. However there is a critical big picture issue which must also be born in mind to ensure that any changes to the Code are both proportionate and focused.

The current financial crisis is not primarily a failure of corporate governance in the commercial world at large. There has been no repetition of the corporate governance failures of the early part of this decade. Nor has there been a corporate governance failure in the non-banking sectors of the financial services industry in UK. There is scope for legitimate criticism of the role played by the boards of some UK banks but even these must be set within a context of far more widespread failures arising from:

- a prolonged period of mis-pricing of risk and providing excess liquidity by central banks which led to excessive borrowing by consumers and excessive lending by banks;
- driven more by widespread policy failures; and
- compounded by sustained global failure in the regulation of banks, albeit with differing manifestations from one country to another.

Whilst some would gladly attribute the sole cause of the current financial crisis to a failure of corporate governance in our view that is driven by a mix of hindsight and self interest. None of HMT, TSC or FSA or their foreign equivalents were vocal before the event in warning (or acting) either to tighten mortgage lending criteria or to scale back open derivatives books to reflect downside counter party risk. This resulted in banks being able to indulge in excessive low quality lending unchecked (some would say actively encouraged to do so) by policymakers or regulators (or both). In too many countries, maintaining asset prices (and particularly house prices) at inflated levels had become a major - if not the unique policy objective, overriding the need to provide a sound macro-economic environment and financial stability.



**PRUDENTIAL**

Banks operating in this market environment have effectively faced a choice of either obtaining the returns available or being acquired by those following these lending practices which were unsustainable in the long term but highly profitable in the short term. This has resulted in the impact of their lapses in corporate governance being magnified hugely in terms of the effect on the financial system i.e. it has turned what might have been a single institution failure into a systemic failure.

We say this not to excuse the conduct of those institutions affected but to ensure that we do not over react on governance issues to fix a problem whose root causes are elsewhere.

Yours sincerely

Peter Maynard  
Group Legal Services Director and Company Secretary



PETER MAYNARD  
GROUP LEGAL SERVICES DIRECTOR



Sent by email to: [codereview@frc.org.uk](mailto:codereview@frc.org.uk)

PRUDENTIAL PLC  
12 ARTHUR STREET  
LONDON EC4R 9AQ

TEL 020 7548 3737  
FAX 020 7548 3191  
[www.prudential.co.uk](http://www.prudential.co.uk)

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

1<sup>st</sup> June 2009

Your ref  
Our ref

Dear Mr Hodge,

#### **Review of the effectiveness of the Combined Code - call for evidence**

Prudential welcomes the opportunity to comment on the above review. Prudential plc is a publicly traded company listed in London and New York and is an international retail financial services group with significant operations in the UK, Asia and the United States. Our purpose is to promote the financial well-being of our customers and their families, with a particular focus on saving for retirement and income in retirement. Prudential's portfolio of well-known and respected brands has attracted more than 21 million customers (and policy holders and unit holders) worldwide. M&G is Prudential's UK and European fund management business and has £141 billion of assets under management (as at 31 December 2008).

We set out below our comments, from the perspectives of both a listed FTSE 100 company and an investor, in relation to some of the issues raised in the review document. In doing so we have answered the questions following the order in your call for evidence document. However, there are some key themes that flow throughout our response as follows:

- the dangers of a "box ticking" approach;
- the practical limitations of codifying "appropriate behaviour" and "good judgement";
- the lack of a common understanding on the role of the non-executive director and the practicalities of what they can achieve;
- good governance does not by itself guarantee commercial success; and
- clarity that management has responsibility and accountability for the management of the company is critical

#### Specific comments

*Issues for  
comment*

*Which parts of the Code have worked well? Do any of them need further  
reinforcement?*

**Comment**

1. Overall Prudential considers that the Combined Code provides a sound 'guide to the components of good board practice' as described in paragraph 2 of the Preamble to the Code.

2. However there is an inconsistency between this view of the Code as a set of guidelines and their potential application as 'a set of rigid rules' with the expectation/demand that firms will comply 'wholly or substantially' with them regardless of circumstances. Such unwillingness to exercise judgement could devalue the 'comply or explain' approach that has been in operation since the Code's beginnings in 1992.
3. We believe that "apply or disclose" would lead to a more positive approach than "comply or explain".
4. The linkage between governance and commercial success can be overstated – if the judgements on strategy, resourcing and risk appetite prove to be wrong, then no amount of good governance will prevent corporate failure. It is not possible to codify behaviour or prescribe "good judgement".
5. It is critical that the compliance requirements of the Code are sufficiently flexible to enable different business models to function effectively.
6. We believe robust board evaluations could over time result in improved effectiveness of boards - but only if they are soundly based and focus on the success of executive management in capturing opportunities whilst avoiding risks and losses.
7. The outcome of the current reviews in relation to governance and remuneration matters in the UK banking sector should therefore distinguish between two potentially separate sets of causation; and any remedial recommendations and actions developed in response to these specific banking sector problems should not be applied to other parts of the financial sector or to corporate governance and remuneration across the entire UK corporate sector other than where an equivalent need is manifest.

*Issues for comment*

*Have any parts of the Code inadvertently reduced the effectiveness of the board?*

**Comment**

8. We see a real danger that the increasingly prescriptive approach in codes can give rise to a false and unwarranted sense of security that, if boxes are ticked to show compliance, "good governance" and commercial success will ensue automatically.
9. We support the unitary board structure, both from a corporate and an investor viewpoint. We also support the Code's principles relating to the need for a balance of executive and non-executive directors. The mixture of executive and non-executive directors adds to the quality of debate and decision-making.
10. Non-executive directors with a relevant sector background are generally able to provide greater challenge to the executive than non-executive directors from other sectors. Boards therefore need a certain number of non-executive directors with sector experience to complement the non-executive directors without sector experience.
11. The available pool of non-executive directors with sector experience, and thus the depth of understanding of the business available in non-executive director deliberations, could be strengthened considerably by relaxing the 'independence' requirement of the Combined Code to enable the recruitment of a small number of retired former employees and executive directors as non-executive directors after a shorter period than is currently prescribed.



12. The current practice of recruiting as non-executive directors only individuals who hold or have held other listed company directorships (even though not a Code requirement) is unnecessarily restrictive and the Code should be expanded to encourage the appointment of experienced and successful managers who have not been on listed holding company boards. These individuals have often managed bigger businesses than some listed companies.

13. Whilst recruitment of directors with business experience as directors is likely to be the norm, this is not in our view an essential qualification for a non-executive director. We do not believe that a successful business career necessarily makes a person a successful/effective non-executive director. An important competence of a non-executive director is the ability to think constructively, objectively and at a high level about how successfully a business is being managed without becoming immersed in day to day management of the business.

14. We believe that the "independence" definition for non-executive directors also needs to be relaxed in respect of the Code provision regarding the cessation of non-executive director independence after nine years on the board. "Independence" is a matter of substance, not form and rigid adherence to this provision may result in valuable members of the board having to step down at the end of this period.

*Issues for comment*

*Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?*

**Comment**

15. We feel that the emphasis in the Code on arrangements to secure the independence of non-executive directors results in too little emphasis on the role of executive directors. Given the UK unitary board framework there is a need for a clear statement in the Code that accountability for managing the business day to day rests with the executive and not the non-executive directors. This statement of the obvious to those familiar with listed company management is currently not given sufficient weight in the Code's main principle A2 and may be a cause of the evident confusion as to the role and responsibilities of the non-executive directors.

16. The notion of collective responsibility in the unitary board structure is fundamental. A non-executive director of necessity lacks involvement in depth in operational aspects of the business and for the unitary board model to work well, non-executive directors need to be able to rely on the information provided by management. This approach is critical to the viability of the non-executive role. Where trust between executive and non-executive directors does not exist it is the responsibility of the chairman to identify such measures as will re-establish trust, specific to the circumstances of the board.

17. We sense from media and political debate that there is currently too little understanding of the non-executive director role. It is essential that a better alignment is created between the practical opportunity for non-executive directors to influence events and the public, political and regulatory perception of what is expected of the role. Further prescription on the role of the non-executive director cannot deal with issues such as competence and expertise. We suggest revisions to the Higgs definition of the role of the non-executive director in Annex 1.

18. The current Code guidance on non-executive director liability is correct. We disagree with recent commentary on the financial crisis suggesting an extension of the liabilities of non-executive directors beyond the requirements of the Companies Act and the historic approach that non-executive director responsibilities are bounded by



expectations of normal care, skill and diligence. Suggestions to revisit judgements with the benefit of hindsight are also wrong. Personal liability, whether financial or criminal, for directors should not arise in the context of an honest commercial failure of the business.

19. We recognise that there is a potential issue with individuals taking on too many non-executive directorships given the increasing time commitment these roles require. This can have an adverse impact on the time that such non-executive directors are able to spend on individual companies.

20. However we would not support a "one size fits all" restriction on the number of non-executive appointments (e.g. imposing a limit of 2 or 3 positions). We would view such a requirement as a "box-ticking solution" which ignores the individual differences in ability and appetite to deal with a number of directorships. Other commitments of non-executive directors should be a key consideration on appointment.

21. Where a non-executive director is a member of or chairs a board committee, this should be taken into consideration in determining whether they have adequate time to assume other roles. It is noticeable that the complexity and time commitment required for committee work has increased dramatically in recent years.

22. We believe that increased share ownership by non-executive directors, subject to maintaining independence, would be welcomed by investors and we note that some companies already have voluntary schemes in place to achieve this. Consideration should be given to making this a requirement.

---

<i>Issues for comment</i>	<i>Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved? Views are invited on the usefulness of company disclosures and the quantity and quality of engagement by investors.</i>
---------------------------	---

<b>Comment</b>	<p>23. On the whole, and as described previously, we feel that the sound intention underlying the 'comply or explain' mechanism has been undermined by the increasing emphasis on prescriptive requirements and a tendency to focus on 'box-ticking' conformity rather than the quality of governance achieved. The current approach has come to mean that any explanation given by a company will be seen as non-compliance of the Code. This may lead to an incorrect assumption that the governance arrangements within the company are in some way flawed.</p>
----------------	--

24. We believe that a different emphasis in language will assist companies, investors and governance bodies including voting advisory services to establish a healthy dialogue regarding the explanations given. We therefore recommend that 'comply or explain' be changed to 'apply or disclose'. We believe that the flexibility provided by "apply or disclose" is a cornerstone of the Code and should encourage investors and those advising them to move away from box ticking and back to exercising judgement on the quality of both governance and corporate performance.

---

<i>Issues for comment</i>	<i>The composition and effectiveness of the board as a whole;</i>
---------------------------	---

<b>Comment</b>	<p>25. Consistent with our views as stated above we believe that prescription and inflexibility have become too prominent at the expense of good judgement. We identify effective performance of a unitary board as depending on a wider range of attributes than are, or should be, codified. In particular, it is reliant on:</p>
----------------	---



- (i) the presence of a strong and effective chairman;
- (ii) the depth and quality of executive board representation;
- (iii) clarity of information and support provided by management, in and out of board meetings;
- (iv) a board atmosphere embracing both executive and non-executive directors that permits constructive input of advice and constructive challenge;
- (v) non-executive directors' willingness and effectiveness in contributing to the board and in understanding and engaging with the company;
- (vi) non-executive directors' individual competence and expertise; and
- (vii) non-executive directors' time commitment.

Each company needs to work out their own way of dealing these points. They are not something that can be effectively prescribed or codified.

---

<i>Issues for comment</i>	<i>The respective roles of the chairman, the executive leadership of the company and the non-executive directors;</i>
---------------------------	---

**Comment** 26. The role of chairman is critical.

27. It is important not to blur accountability for management of the business between executive management and non-executive directors. It is management's role to manage and you cannot have non-executive directors in a "hybrid executive/non-executive" role. The concept of non-executive directors becoming "like full time Independent Directors" would only lead to major difficulties in that respect.

28. In respect of the effectiveness of non-executive directors, we do not believe that it is practical to attempt to prescribe or codify behaviour.

---

<i>Issues for comment</i>	<i>The board's role in relation to risk management;</i>
---------------------------	---

**Comment** We make the following comments:

29. Risk management systems do not necessarily mean well managed risk or an ability to foretell the future. We believe that the companies which recently failed because of mismanagement of risk would almost certainly have been perceived to have high quality risk systems in place together with regulatory approval for those systems. This did not prevent problems subsequently occurring once it turned out that the risks had been wrongly judged.

30. The assessment and control of commercial risk is a function of line management. Financial control and risk assessment specialists have an obvious and important role to play in recognising and highlighting areas of exposure.

31. It is not the role of non-executive directors to be involved in the day to day management of risk - that is the responsibility of executive management. We believe



the board's role in relation to risk management is properly recorded in the Higgs Report's definition of the role of the non-executive director in relation to risk, but could be enhanced by adding a requirement to understand the size and nature of risks run by the company – see Annex 1.

32. It is important not to allow gaps between separate audit and risk committees to occur.

33. It is up to individual companies to determine how and where their specialist risk management functions fit within their governance structures.

<i>Issues for comment</i>	<i>The role of the remuneration committee;</i>
<b>Comment</b>	34. We suggest that the Code provisions in respect of remuneration committees could be strengthened by requiring remuneration committees to be aware of how risk taking within the different business areas of the company impacts the profitability of the company and how risk appetite is influenced by remuneration plans and policies below director level.
<i>Issues for comment</i>	<i>The quality of support and information available to the board and its committees;</i>
<b>Comment</b>	35. We believe that each board must decide for itself whether the support and information provided to the board and its committees is adequate in its own circumstances. This is a key issue for any board evaluation. The chairman should be alert to this issue and the non-executive directors should make their views known.
<i>Issues for comment</i>	<i>The content and effectiveness of Section 2 of the Code, which is addressed to institutional shareholders and encourages them to enter into a dialogue with companies based on a mutual understanding of objectives and make considered use of their votes.</i>
<b>Comment</b>	<p>In addition to our comments above, we have the following comments:</p> <p>36. We believe that corporate governance is enhanced by effective dialogue between companies and institutional investors, and this needs to be a "two-way" process. Companies need to be more pro-active in organising meetings on governance issues between major institutional investors and the chairman, plus possibly the chairmen of board committees, on an annual basis.</p> <p>37. Institutional investors should ensure they have more contact with chairmen who should attend some, but not all, investor meetings with the CEO and CFO.</p> <p>38. There appears to be a disconnect between the buy and sell decision makers and those who review corporate governance and board competence.</p> <p>39. Investors need to make judgements about company disclosure of the company's application of the Code in the context of that company's circumstances. A "box-ticking" approach is not appropriate.</p> <p>40. The remuneration of fund managers should be designed to encourage sustained investment performance thereby being aligned with the investee companies' long term strategies, the objectives of company management and the principles of the Code.</p>



---

**Issues for comment**      *In order to be effective [the Code] requires boards to provide investors with the necessary information on which to make [a] judgement [about a company's governance arrangements], in particular where they have chosen not to follow the Combined Code; and it requires a sufficient number of investors to take a long-term view and to engage constructively with the companies in which they invest through dialogue and the use of their voting and other rights.*

*The 2007 review found that, while the 'comply or explain' approach was felt to be working reasonably well, there were some concerns on both counts. The FRC would be interested to know whether those concerns have increased or decreased in the intervening period and, if they still remain, whether there are steps that could be taken by the FRC or others to increase the usefulness of disclosures and the effectiveness of engagement.*

**Comment**      See our comments above.

---

Yours sincerely,



Peter Maynard  
Group Legal Services Director and Company Secretary

## Annex 1

### **Suggested amendments to the role of the Non-Executive Director defined in the Higgs Report**

**Strategy:** Strategy must be led by the Chief Executive and executive directors but non-executive directors should constructively challenge and contribute to the development of strategy.

**Performance:** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They are entitled to rely on the information provided by management and should not become involved in the day to day management of the business.

**Risk:** Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible. Non-executive directors should understand the size and nature of risks being run, but should not become involved in day to day management of risk.

**People:** Non-executive directors are responsible for determining appropriate levels and bases of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.