

By email: codereview@frc.org.uk

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
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12 October 2009

Dear Mr Hodge,

Smith & Nephew plc welcome the opportunity to comment on the Financial Reporting Council's Review of the Effectiveness of the Combined Code – Progress Report and Second Consultation. Smith & Nephew plc is a UK FTSE 100 company, with a secondary listing on the New York Stock Exchange. We have around 23,000 registered shareholders and operate in over 30 countries across the world.

Before commenting in detail on the specifics of your consultation, we would like to make the following observations:

- 1) We welcome the analysis in your review and in particular noting that account has been taken of the submissions by the Institute of Chartered Secretaries and Administrators and the GC100 Group and also the ICSA publication on Boardroom Behaviours.
- 2) We also welcome the continued support for the “comply or explain” regime, although we would also support a change in terminology from “comply” to “apply” because of the negative connotations of “comply”.
- 3) Whilst we broadly support the sentiments expressed in the Walker Report, we would also note that the proposals are focused primarily on banking and other financial institutions (BOFIs) and are not necessarily relevant to other sectors. Whilst supporting the Walker arguments, we believe that some of the proposals are overly prescriptive which is contrary to the principles based approach of the Code itself. Whilst Walker focussed on BOFIs, where a uniform regime may or not be appropriate, we would caution against such uniformity

being adopted for the wider range of companies of varying sizes, operating in a range of different sectors.

We shall respond to your specific questions following the 7 key areas highlighted in your review:

Responsibilities of the Chairman and the Non-Executive Directors

We agree that further clarification of the roles of the Chairman, Non-Executive Directors and the Senior Independent Director would be desirable recognising the importance of an effective chairman for the efficient running of the Board. However, we believe that care should be taken that Code provisions do not become overly prescriptive.

This applies particularly to the time commitment required of the Chairman and the Non-Executive Directors and the number of directorships or chairmanships permitted. Different companies will have different requirements, which may well vary over time depending on what is happening in the company. Requiring a time commitment of 30 days per year is excessive particularly for smaller companies, whilst in some cases, a company with a number of issues may require an even heavier time commitment. Such a time commitment would limit the ability of executives to take up external Non-Executive Directorships, so continuing to limit the pool of available Non-Executives. Individual directors also have different capacities and appetites, which need to be taken into account. We would therefore suggest that it is appropriate for each company to determine the time commitment required of its Chairman and Non-Executives which would be appropriate for the particular company, recognising the capacity of the individuals concerned.

Board Balance and Composition

We believe that the current criteria for independence work well, although the 9 year modus is arbitrary and we would suggest that this is another area where companies should be encouraged to consider what is appropriate for them. Depending on the industry, it can be a year or two before a Non Executive Director is fully effective, as he or she takes time to become fully familiar with the business and culture of the new company.

In times of change and transition, continuity may be more important for a Board than following a strict definition of independence. Companies should be looking for independence of judgment and the ability to challenge rather than whether a list of independence criteria is met.

Frequency of Director Re-Election

We are neutral on this issue having seen it work well in either mode. However, the proposal that the Chairman of the Remuneration Committee be subject to re-election in the event that the Directors' Remuneration Report receives fewer than

75% votes in the previous year seems less well considered. This would mean that investors effectively have to wait for a whole year before they see any result of their negative vote, by which time there could well be a different Remuneration Committee Chairman or a different policy. Investors should want to be voting for the future management rather than looking back to the previous year, since when circumstances may have changed.

Board Information, Development and Support

We support the comments made in the preliminary submission by the ICSA and in their Boardroom Behaviours publication.

We would also suggest that most Non Executive Directors are looking for help in understanding the particular business, its markets, challenges, culture and ways of working rather than for training as a director per se, which could be irrelevant or repetitive particularly for those with multiple board experience.

Board Evaluation

We support the proposals on Board Evaluation, recognising the benefits of using an external facilitator at least every two or three years. We also support the disclosure of the results of such evaluations, recognising that full disclosure may have negative consequences in case where weaknesses have been identified and are in the process of being addressed. For this reason, we would wish to consider carefully the proposed elements of an "assurance statement" before being able to comment.

Risk Management and Internal Control

We welcome the increased focus on risk and would emphasise the distinction between the Board being responsible for setting the risk appetite and executive management responsible for the day to day operational risks. We feel however that the Walker proposals relate specifically to BOFIs and should not automatically translate to other companies. In particular, we would not support the compulsory requirement to have a Risk Committee or a Chief Risk Officer. The responsibility for risk lies with the Board as a whole and should not be delegated to a separate committee except for a preliminary review function.

Remuneration

There have been a number of different recommendations and proposals on remuneration and we would support the broad sentiment that there should be no reward for failure and that reward should be proportionate and should not encourage excessive risk taking.

However, a number of the proposals relate specifically to BOFIs and would not translate easily across to other sectors. In particular, we would note the Walker focus on high paid earners outside the Board, which is less likely to be such a significant feature outside the BOFIs.

Some of the proposals are highly prescriptive and whilst supporting the principles, we would caution against such prescription for example defining precise multiples for director shareholdings or precise periods of deferral of bonuses or the vesting of long term incentive arrangements. The function of a Remuneration Committee is to determine the correct level of reward and the balance between fixed and variable pay and between long term and short term incentives. The Remuneration Committee needs to consider the appropriate level and balance for that particular company Board at that particular time considering pay levels across the whole organisation and the behaviours they wish to encourage through incentives. When considering behaviours, the Remuneration Committee should consider appropriate levels of risk. The correct balance between these elements will necessarily differ between companies and it therefore makes little sense to be overly prescriptive in these matters, as Walker and the EU proposals advocate. We would suggest that the Code should reiterate the principles and avoid over prescription.

We would suggest that whilst the principle of clawback in the case of serious misstatement seems laudable, in practice, this would be difficult to operate. Many companies are now adopting "holdback" policies whereby some proportion of a bonus is deferred subject to further performance conditions. We would suggest that the principle of holdback rather than clawback be operated.

The EU proposal that at least one member of the Remuneration Committee should understand and be experienced in remuneration policy seems to mirror the Audit Committee requirement for someone with recent and relevant financial experience. It is however unclear as to what might constitute such experience and we would suggest that this could be clarified by confirming that anyone with Board level experience in an executive capacity is likely to qualify.

Implementation Issues

We note the comments in the implementation section of the Review and would have the following comments:

We do not believe that it is necessary for the FRC or the FSA to undertake greater monitoring of "comply or explain" statements. It is up to the market to review the information it receives from companies in their publications and decide whether or not to invest or to engage with the company. This is a market matter and requires no further enforcement.

We support the proposal that fund managers and other institutions be required to sign up the Statement of Principles and to disclose against them on a "comply or explain" basis. This would increase transparency in the market. In particular, investors should be required to disclose the measures they take to ensure that

the votes they cast are effectively transmitted through the voting system to the company. Very few investors check that their votes are actually received and rely on voting agencies and nominees to process their voting instructions accurately.

Yours sincerely,

Susan M. Henderson

**Susan Henderson
Company Secretary**