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Dear Sir

## Response to the FRC review of the Combined Code

- 1) City Group provides outsourced company secretarial services to smaller quoted companies. As such we have extensive practical experience of corporate governance issues, developed over many years.
- 2) We understand that the FRC's objective is to encourage shareholder regulation of companies in order to "facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term". We also consider that the FRC's recent consultation paper, "Louder than Words" sets out an appropriate approach for making corporate reports "less complex and more relevant".
- 3) For shareholder regulation to work, not only do we need shareholders who are prepared to engage with companies, but also companies need to provide sufficient, timely, information to enable those shareholders to engage constructively. Shareholders also need tools available to enable them to enforce change if management are reluctant to act in the manner requested by shareholders.
- 4) In our opinion the additional questions that the FRC needs to be asking itself are:  
How can we encourage more shareholders to engage effectively?  
How can we improve the provision of sufficient, timely, information to shareholders? and  
What tools do shareholders need to enforce change if dialogue fails?  
These questions are in addition to the previous challenge: how to encourage improvement in corporate governance?
- 5) Shareholders need to believe that by engaging, they can improve corporate governance, and that in turn will lead to better returns for investors. The FRC has a useful role to play in encouraging that belief, and encouraging the formation of structures that will facilitate

engagement. The current review process has started this debate, but it probably needs to be decoupled from the debate on what companies should be encouraged to do by way of corporate governance processes.

- 6) We believe that good corporate governance is founded on an understanding by directors of the stewardship role that they are undertaking. In particular the role of the chairman is key. Lip service by the chairman will lead to a system of corporate governance that just ticks the boxes. A chairman who believes in the primacy of shareholders will be more likely to promote a system of corporate governance that, while it may not tick all the boxes, will work in the interests of investors. The FRC has a useful role to play in reminding chairmen and directors of their stewardship role.
- 7) Sufficient and timely information, provided to shareholders by directors, is the cornerstone for any discussions on how well directors have fulfilled their stewardship role and what, if any, improvements are required. The FRC (in all its branches) needs to remain fully involved in this role.
- 8) To make assessments of how well directors have fulfilled their stewardship role, shareholders need to consider all aspects of the annual report including the Business Review and Annual Accounts, as well as the Directors' Report, Committee Reports and the Corporate Governance Report. The contents of these are determined by a number of different bodies including HMG, IASB and FRC. We would like improvements in all areas to focus reporting on being more outcome orientated.
- 9) We consider that most Corporate Governance Reports do not help shareholders assess how well directors are performing their stewardship role. Although the content of the Combined Code is world class, the way that it has evolved over the years, gradually increasing in length, has in turn led to Corporate Governance Reports that focus on addressing each of the main and supporting principles in turn, rather than explaining to shareholders how the business is organised in order to "facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term".
- 10) We consider that a fundamental re-drafting of the Code is required in order to promote a substantial re-drafting of Corporate Governance Reports, such that the reports will in future be useful to shareholders in assessing directors' stewardship. If the Code is changed simply by the insertion of additional Principles and Provisions, Corporate Governance Reports will remain substantially unchanged in structure, with additional words inserted to cover the new Principles and Provisions.
- 11) We think that the Combined Code should be a comprehensive document in and of itself. While we acknowledge there is a requirement for additional specialist guidance in certain areas (e.g. Turnbull and Smith), we do not generally support additional guidance outside the Code. The only areas in which we support additional guidance outside the Code are in relation to the role of the chairman (see 6 above) and remuneration. The Code is currently unbalanced with an excessive focus on remuneration, and the risk is that the additional recommendations in the Walker Review make this worse. We would like to see a more outcome orientated section of the Code dealing with remuneration, in proportion to the other areas dealt with by the Code.
- 12) Little consideration has been given to the timeliness of information provided to shareholders. All too often, the annual report is sent out with the notice of AGM. We would like to see a reasonable time delay between the posting of the annual report and the notice of AGM. This period should be long enough for shareholders to digest the content of

the annual report, discuss any areas of concern with companies, and, if necessary, propose additional resolutions to be put to the AGM. This would also go some way to reducing the “bunching” of AGMs following peak reporting dates. We do not consider the additional costs from separating the mailings would outweigh the benefits.

- 13) The Walker Review has introduced some suggestions for additional tools to be used by shareholders to enforce change, but we believe that a more fundamental debate is required to identify the complete suite of tools that should be available.
- 14) When considering the cost/benefit balance of the existing code requirements and of proposals for changes, the main benefits arise from (i) changing the behaviours of directors and (ii) from improving the manner in which companies explain to shareholders how their corporate governance systems “facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term”.

We set out below our comments on the specific matters raised in your second consultation.

#### Guiding principles

- 15) Please see comments above, in particular 9-11

#### Responsibilities of chairman & NEDs

- 16) More emphasis needs to be placed on directors’ stewardship responsibilities and in particular the chairman’s responsibility for corporate governance. We commend the suggestion by David Phillips and Professor Roger Steare for a chairmans group to promote best practice.
- 17) Time commitments are dependent on the nature and size of a company, so general guidance will need to be so broad that it is likely to be worthless and specific guidance will not be workable.

#### Board balance and composition

- 18) A4.2 could be updated to give more prominence to the need for a Board to include sufficient mix of skills and experience
- 19) Independence is a state of mind. The guidance in the code creates a problem because it is interpreted as a rule, and so should be deleted from the code and replaced by a challenge to explain clearly why companies consider certain directors to be independent.
- 20) This issue arises because the guidance in A3.2 is interpreted as a rule. The solution is to remind people that the code is guidance and that companies are entitled to explain why they have not followed the guidance.
- 21) Succession planning is an essential part of a corporate governance system and needs to be considered as part of considerations on Board composition. Even more important though is contingency planning for the loss of key personnel. Plans should be in place for the sudden loss of key personnel. This will strengthen the Remuneration Committee’s hand in pay negotiations and mitigate any loss of shareholder value if a key member of staff is suddenly unavailable for work.

#### Frequency of director re-election

- 22) It is only in totalitarian regimes that we should expect to see 100% votes in favour of a resolution or candidate, and it would be wrong for Boards to operate as totalitarian regimes. Directors should expect some shareholders to be unhappy with the way that some things are

done, and use that as an opportunity for the Board to initiate dialogue with the discontented shareholders and potentially identify improvements in what they are doing.

- 23) We do not believe that there are good arguments against all directors standing for re-election annually. This practice is wide spread in other countries and does not appear to lead to practical problems. As a protection against boards being thrown out by a minority of shareholders on a low turnout, if more than (say) 50% of directors standing for re-election are not re-appointed, and less than (say) 40% of shareholders voted against re-appointment, then a confirmatory vote could be required.
- 24) Whereas binding votes have their (limited) place, we believe that Board members should take responsibility for their actions and that instead of advisory votes, shareholders should be encouraged to vote against the re-election of specific directors whose actions they disapprove of. Since the Chairman has overall responsibility for corporate governance, rather than a vote on a corporate governance statement, we believe that shareholders should vote against re-appointment of the chairman if they consider there are failings in corporate governance.

#### Board information, development and support

- 25) We believe that Chairmen often do not understand their responsibility for corporate governance, or the importance of that responsibility. At present the supporting principles to A5 impose on the Chairman responsibility for providing information to directors and also for induction and development, but they then go on to state that the Company Secretary will normally perform these tasks under the supervision of the Chairman. We would like it to be made clearer that the provision of information and training is an important part of the Chairman's responsibilities, perhaps through the re-issue of the Higgs "Guidance for the Chairman", updated as necessary.
- 26) The Code assumes that there will be a Company Secretary working with the Chairman to help him fulfill his responsibilities, however (in most companies) we do not believe that it is possible for a Company Secretary to fulfill this role properly while still performing as an executive director. For example significant responsibility is placed on the Finance Directors as a result of that role and, particularly in smaller companies where resources are limited, there is a major risk that, if the FD is also the Company Secretary, company secretarial responsibilities receive lower priority. We would therefore like a revised code to include a new provision that the Company Secretary is not also an executive director. This would be subject to the normal "comply or explain" mechanism, so it would remain open for a company to explain why an executive director was also its company secretary.
- 27) In our experience of smaller companies, often the Chairman has not previously served on the board of a public company and benefits from the practical advice of those who do have public company experience. We strongly recommend that, where the Chairman has limited experience of serving on the boards of publicly quoted companies, he has available the services of a full or part time company secretary with relevant public company experience (or some other corporate governance adviser) to assist him in fulfilling these responsibilities. Such advice could be provided by a SID, but the Chairman should not be reliant on advice from, or channeled through, executive directors.

#### Board Evaluation

- 28) The Code provides a bias towards an annual review of Board performance, but we consider an ongoing process to be more relevant. Boards should be considering at every meeting whether there is anything to be learnt from past experience and applying any lessons learnt promptly.

- 29) A case can be made to support a thorough, externally facilitated, review every 3 years in order to confirm that the lessons from past experience have been learnt and to help improve the quality of the ongoing review process in future.
- 30) Much valuable work is performed at committee level and so we do not think that board committees should have their performance evaluated less frequently than the main board.
- 31) The quality of reporting reflects the seriousness with which a review process has been performed and the importance given to corporate governance. Any recommendations need to address the cause of the problem and not the symptoms.

#### Risk management and internal control

- 32) The supporting principles to A1 already cover the board's responsibility for setting strategy and identifying and managing strategic risks is fundamental to setting and monitoring execution of strategy. Given that risk management is so important to the generation of shareholder value, more emphasis could be given to this area.
- 33) If the code is re-drafted to be more outcome orientated, C" and C3 will need to be changed. The Turnbull guidance still remains relevant but depending on the changes to the code, it may need to be updated to be in line with the requirements of a revised code.
- 34) We do not think that a sound case can be made for risk committees outside of BOFIs and a limited number of other sectors. They should not be a general requirement in the code.
- 35) Any guidance on risk reporting is best given in the ASB's Reporting Statement "Operating and Financial Review" rather than in the Combined Code since risk reporting should be integral to the business review. The format and content of risk reporting should be specific to each company and so guidance is likely to be too detailed to fit into the code, or so general as to be of little use.

#### Remuneration

- 36) We are concerned about the potential overlap of regulation (c.f. "Louder than Words"). We would like the code to be redrafted to provide a focus on outcomes and consider that detailed guidance on best practice should be eliminated from the code. It might be appropriate to produce some remuneration guidance on application of the principles of the code, similar to the Turnbull and Smith Guidance.
- 37) Shareholders should be given the opportunity to vote on the re-appointment of every director, every year, so that they can take action on pay if they so desire.

#### Quality of disclosure

- 38) Whereas the fine details of corporate governance processes should be continually evolving, the core procedures usually remain fairly static. We therefore do not see the need for a corporate governance report to be included in the annual report and accounts and consider that an explanation of corporate governance practices should be published on a company's web site. Best practice would be to update this document at least once a year and have changes since the previous update highlighted. This would have the additional benefit of allowing any updates to this document to be made outside of peak periods.
- 39) The main issues that Board committees address are likely to vary every year and so their reports should be included in the annual report every year.

- 40) The principle behind Shareholder Regulation is that shareholders will take action if they feel it is required. Shareholders should not be relying on the FRC or FSA to take enforcement action on their behalf. We therefore do not believe that any monitoring or enforcement of “comply or explain” statements is required, but if any were to be introduced it should be limited to determining whether explanations were sufficient to enable shareholders to understand the issues and engage in informed debate.

#### Engagement between boards and shareholders

- 41) We are concerned about the risk of increasing the separation of investment decision making and corporate governance within fund managers and other institutional investors. Corporate Governance is about value creation, as well as value protection, and management behaviour is key to good governance. A vital part of any investment decision is whether you believe that the management team will deliver an increase in shareholder value. We are concerned that corporate governance teams may not get sufficient exposure to management to enable them to take a holistic view of management’s ability to deliver increases in shareholder value. There is a substantial risk that if separate corporate governance teams do not get sufficient exposure to management, they will focus on value protection to the detriment of value creation.
- 42) As we have stated in the introduction, shareholders need to believe that engagement on corporate governance will enhance shareholder value and is therefore worthwhile. The FRC could usefully examine how it can encourage such a belief by shareholders. This might include facilitating a review of the tools available to shareholders to enforce change, should dialogue fail.
- 43) Many Chairmen are failing in their responsibilities to discuss governance and strategy with shareholders (provision D1.1). For smaller companies, the normal opportunities to meet Shareholders are results presentations, and these are usually only attended by the chief executive and FD. Chairman need to be reminded of this responsibility and challenged to explain how they have fulfilled it if they have not attended results presentations.
- 44) Shareholders often complain about “bunching” of AGMs restricting their ability to give sufficient consideration to corporate governance reporting. The FSA should not allow listed companies to change their year end to be close to one of the popular year end dates and should require (subject to limited exceptions) new entrants to have year ends at less popular times of the year. Over time this will help to reduce the “bunching” of year ends. (See also 12 above.)

If you wish to discuss these issues with us, we will be pleased to attend a meeting.

Yours sincerely,

Edward Beale  
Chief Executive