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(Submitted by email to codereview@frc.org.uk)

9th October 2009

Dear Mr Hodge

Response to Review of the Effectiveness of the Combined Code Progress Report and Second Consultation

We are pleased to have the opportunity to provide comments on the current review of the effectiveness of the Combined Code, on the matters identified for consideration in the Progress Report and Second Consultation.

It is assuring that the FRC has been able to confirm the widespread support that exists for the Code with its 'comply or explain' principles-based approach, rather than for rules-based regulation. We are similarly encouraged to see that the FRC shares the widely held view that the Code continues to provide the most responsive and adaptable mechanism for translating into practice the principles of sound corporate governance.

We believe the governance issues that have been faced recently within the banking and finance spheres have generally been specific to the unique complexities of the business models adopted within those sectors. We therefore strongly believe that, in the main, the recommendations and Code changes proposed by the Walker Review in respect of banks and other financial institutions ("BOFIs") are only pertinent to and should remain confined to those entities.

Please find attached our views and comments on the issues identified in the report, together with our detailed comments on the extent, albeit limited, to which Sir David Walker's recommendations and his proposed Code changes could also be applicable in respect of non-BOFIs.

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Finally, to the extent that the Walker Review implements the additional, more exacting, requirements and Code changes for BOFIs, these should be set out in a separate addendum and guidance to the Code issued by the Financial Services Authority, rather than being amalgamated as BOFI-specific sections within the Financial Reporting Council's main Code and guidance for all other listed companies.

Should you have any queries please do not hesitate to contact either me or Victoria Whyte, (Deputy Company Secretary) (020 8047 4509).

Yours faithfully

pp V Whyte

Simon Bicknell
Company Secretary

Section 1: The Content of the Combined Code

Introduction

We fully support and endorse the three guiding principles that the FRC intends to adopt when assessing the lessons to be learnt from the financial crisis and the case for changes to the Code and its associated guidance.

We also believe that, wherever practicable, any guidance concerning the implementation of the Code should either be included in or annexed to the main body of the Code. This will ensure that full prominence is given to the relevant issues and avoid the proliferation of separate, potentially unwieldy, ancillary guidance documentation.

The FRC could also helpfully make more use of the preamble to the Code to set out its expectations, in terms of high level principles, for the key tasks and behaviours required of well performing boards. We would expect these high level principles to include as a minimum:

- the board's role is to govern and not to manage.
- the board is ultimately responsible for setting the company's risk appetite and profile
- the importance of the unitary board.
- the board should regularly review the matters reserved to it and the level of authority delegated to the executive.

The type of tasks which a board should be engaged in could include:

- reviewing and where appropriate determining strategy
- performance monitoring
- succession
- setting the "tone from the top".

It should be clear that the preamble sets the framework against which compliance with the Code principles should be judged.

Provisions which apply purely to BOFIs should not be included in the Code per se, but in a separate Code overseen by the FRC or another regulator.

The responsibilities of the Chairman and the Non-Executive Directors

We agree with market participants' belief that the quality of governance ultimately depends on behaviour and not process. Further clarification of the expected boardroom behaviours and responsibilities of the Chairman, the Senior Independent Director ("SID") and the non-executives could therefore usefully be made for all companies in the Code, or in a specific annex to the Code. This might also encapsulate Walker Recommendations ("WR") 6, 9 and 11 (to the extent that 11 is not already covered by existing provision A.3.3 or elsewhere in the Code), and in the case of the Chairman the 'leadership' element (only) of WR 8.

It may also be helpful to provide indicative guidance on the likely time commitment which may be expected of the role of a 'typical' Chairman, SID and non-executive director. However, beyond the rather specialised financial services sector, we believe that specifying a minimum expected time commitment (for example, as set out in WR

3 and 7) is too prescriptive for most companies. Directors are increasingly aware that their role can no longer be described in terms of a notional number of days per year. In the event that a director is perceived to spend an inadequate amount of time on their role, the issue should be addressed through the board evaluation process, enabling directors to provide feedback on their perception of the adequacy of the general time commitment required. The Chairman could then take action to address any issues identified.

Board balance and composition

As stated in our initial response to the review we do believe that it is important for boards to include members who have relevant sector or industry experience. The benefit of relevant experience should be identified as part of the board's determination that it is of sufficient size that the balance of skills and experience is appropriate for the requirements of the business. If it is widely felt that an explicit reference to relevant experience would be a useful addition at A.3, we do not see any downside to its inclusion, provided that any new Code wording were to be tempered by the recognition of the availability of people with appropriate experience and available to carry out the roles.

The preamble to the current version of the Code makes clear that the Code is not intended to be a rigid set of rules. It recognises that non-compliance may on occasion be justified if good governance can be achieved by other means and the reasons for it explained to shareholders. In keeping with the spirit of 'comply or explain' shareholders should be taking a pragmatic view of companies' individual circumstances. The preamble obviously goes on to confirm that in challenging any explanation regarding divergence from the Code, non-compliance should not be evaluated in a mechanistic way and automatically treated as a breach. Provided, therefore, that an open and frank dialogue is taking place between both sides, we believe that the existing independence criteria in the Code should not act to significantly restrict the pool of non-executive directors. Nevertheless, we would recommend the withdrawal of the so-called and rather arbitrary 'nine year rule' which (if not explained sufficiently clearly to shareholders) has the potential to force an individual to step down from the board when he or she is otherwise continuing to make a strong contribution.

In our view, the recommendation that boards of FTSE 350 companies should comprise at least 50 per cent independent non-executives is likely to result in boards themselves becoming larger to help maintain the requisite composition. This would then pose a drain on the currently limited pool of available non-executive directors.

We believe that the Code already gives sufficient emphasis to the requirements for succession planning and the need to ensure that board composition remains aligned with the needs of the business.

With regard to WR 4, we would reiterate the view expressed in our initial response that ultimately boardroom behaviour will stem from the personal integrity of the individuals on a board. Whilst the general content of that recommendation is not applicable to extend to non-BOFIs, the issue it raises regarding the consideration of individual directors' 'other qualities' is therefore something that could potentially be built upon in the context of the appointment provisions of the Code and the further clarification of boardroom behaviours.

We do not believe that WR 5 has any practical application beyond BOFIs.

Frequency of director re-election

Beyond the finance industry, changes to the frequency of director re-election or other changes to voting are not necessary. Whilst governance failures within BOFIs have been found to have contributed to the financial crisis, we do not believe that this is reflective of UK listed companies generally. Accordingly, WR 10 and WR 36 should not be extended to non-BOFIs. Given the strong principle of the unitary board we do not support the proposal to:

- link the outcome of the resolutions (such as the approval of the directors' remuneration report) to the re-election of certain directors.

- establish a different practice of re-election for the Chairman of the Board and Committee Chairman compared to other directors.

These changes would inappropriately target individual directors rather than maintaining the focus on the board as a whole.

We do not believe that it is appropriate to introduce a binding or advisory vote on specific issues or the corporate governance statement. This would add further prescription and bureaucracy to the AGM process.

Shareholders already have, and currently do, express their satisfaction with the governance and commercial performance of a company with the annual votes on a company's annual report, directors' remuneration report and the re-appointment of auditors. Adding a specific vote on a governance statement could not only lead to an increased level of boilerplate disclosure, but to a box ticking mentality. Adding more prescription to disclosure will only serve to constrain the way in which companies communicate with shareholders.

Board information, development and support

Our view remains as set out in sections 5. (final paragraph) and 9. of our initial response to the review.

Most companies outside the banking and finance sectors will already be meeting the requirements of WR 1 through their compliance with A.5 of the existing Code. The requirements of WR 2 will be met by adherence to the principles and provisions of A.5, and WR 9 is also already clearly stated through a combination of that section and A.2.

Whilst non-executive directors of BOFIs may well need extra support, the reference, in recommendation 2, to 'dedicated' support appears to perhaps imply a separate or discreet support function, which has the potential to undermine the unitary nature of the UK board model. Secretariats should provide an effective and appropriate resource to enable all directors, both non-executive and executive, to carry out their roles.

Board evaluation

We believe that the extent to which board evaluations are conducted externally or otherwise should be left for individual boards to determine, in conjunction with their ongoing dialogue with the company's shareholders. Consequently for non-BOFIs there is no need to include a recommendation about the frequency of external evaluations in the Code.

Since the annual board and committee evaluation process is now well established within most listed companies, we see no merit in relaxing the requirement for committees at this time. Indeed, with the current heightened focus on the workings and effectiveness of boards and their committees (which perform a key and integral part of the effective functioning of the board process), this would be a regressive step. WR 12 is therefore not applicable to non-financial institutions. Where an external facilitator is used, existing Code provision A.6.1 would prompt disclosure of this fact in the board evaluation statement. The evaluation statement itself should already be in a clearly defined section (with its own distinct sub-heading) in the corporate governance report within the annual report. In our view, it would serve little purpose for the statement to appear as a distinct separate section of the annual report.

Under the existing Code the evaluation disclosure in the annual report should be providing 'meaningful, high-level information' to enable shareholders to understand the main features of the process, as referred to in WR 13. Transparency is vital, so that shareholders are able to gauge both the integrity and effectiveness of the process, including the ability to see the fruits of the exercise. If the outcome of the review results in any material shortfalls being identified these should be disclosed, together with any remedial steps taken or to be taken.

It is obviously crucial for shareholders to also be provided with a level of comfort as to the objectivity of any external facilitator (in keeping with the spirit of the second part of the final sentence of recommendation 12). From our perspective, the provision to shareholders of an indication of the nature and extent of communication by the Chairman with major shareholders (the final sentence of WR 13) more appropriately flows from and is already covered by existing Code provision D.1.2.

We recognise that currently there is demand from investors for a more open and frank approach to corporate reporting generally to counteract the market uncertainties that exist. However, we are not supportive of the term 'assurance statement' with its legal overtones and we believe that simply clustering together certain items of the existing governance statement into such a statement would be of limited practical benefit to investors. Additionally, a legislative and regulatory requirement already exists for the inclusion of a formal directors' responsibilities statement in connection with the annual report. UK listed companies with secondary listings already face a variety of demands from Regulators and shareholders as to what, where and how information should be provided and how it should be formatted in a company's annual report. Issuing yet another contradictory format would not help issuers or shareholders. Companies should be free to report specific information using a format that best explains the way their business operates.

Risk management and internal control

We would refer you to our comments on risk management in our initial response, and to our ancillary comment regarding guidance generally.

Since the Turnbull Guidance was last updated in 2005, and having been first issued in 1999, it would seem appropriate and timely, four years on, for a second periodic review to be embarked upon once the Walker Review and the FRC's own review of the Code are completed. It may however be wiser to wait until the dust settles further following the credit crisis. This should avoid the dangers of overreaction as a reflex to the current crisis.

Our comments regarding the extent to which the particular risk management mechanisms recommended for BOFIs would be appropriate for other listed companies are given below.

We do not believe that separate risk committees are necessary for companies outside the financial services sector with less complex business models (WR 23), although the committee/entity which has responsibility for risk management should as a matter of course have responsibility for oversight and advice to the board on the current risk exposures of the organisation and its future risk strategy.

Many companies, including GSK, now have both an individual and a department or forum with specific executive responsibility for the oversight and management of risk. Indeed, we have also seen it argued that in reality a company's CEO can be regarded as the organisation's 'de facto' CRO, since he/she is responsible for implementing the company's business strategy which will only be achieved successfully if the risks associated with the business are properly managed. Non-BOFIs should be left to decide how to structure their risk management model and whether to appoint a CRO on the basis of how they manage risk to reflect their structure.

Ultimately it is for the board as a whole to be responsible for determining the risk appetite and for articulating the risk profile of the company. Management are responsible for the management of risk and internal controls within the parameters set by the board.

It is sensible that the relevant board committee/entity should be in a position to operate in the way envisaged by WR 25 and WR 26. In the case of the latter, the practicalities of being able to effect such transactions in an efficient and responsive manner may dictate that it is necessary, at least in the case of non-BOFIs, for the recommendation to be limited to individual acquisitions/disposals which are regarded as being material or significant in relation to the current size or nature of the company.

Boards already effectively produce what amounts to a separate risk report (WR 27), albeit through clear cross-referencing between the corporate governance internal controls statement and the business review disclosures regarding the principal risks and uncertainties faced by the business. In light of WR 25, the corresponding disclosure under the Code could be widened slightly for all companies to provide an indication of whether external advice was taken during the year and, if so, its source.

The FRC should seek the rationalisation of the various underlying disclosure requirements relating to risk management and internal controls to assist companies in compiling a comprehensive, risk report which enables readers of the annual report to gain a clear, meaningful and company-specific understanding of the key risks faced by the business, the process used to identify and control those risks, and the tangible benefits of that process for the business, with the emphasis on providing a level of assurance to shareholders to counteract any prevailing market uncertainties.

Remuneration

The remuneration-related elements of the Code should naturally be updated from time to time to ensure that they are kept in line with developments in best practice. However, whilst consistency in some aspects may be desirable over time, as stated in our initial response, the recommendations of the European Commission should be thoroughly considered and evaluated before any change is made to the Code. We do not believe that, at this stage, it is appropriate for the Code to be amended to reflect the FSA's newly published code of remuneration practice, since its application has been deliberately limited currently to 26 large banks and financial institutions.

BOFI remuneration structures tend to be very different from those of other listed companies. Very few (if any) other listed companies remunerate as many employees as highly as the banks even at the board and senior executive team level.

In our view the applicability of the Walker Review recommendations on remuneration for other listed companies varies. We believe that WR 35 (in relation to the relevant board committee/entity that oversees risk management), 38 and 39 could potentially be extended to non-BOFIs, whereas WR 28, 29, 30, 31, 33, 34 and 37 should not be extended beyond the financial services sector. Similarly we do not believe that recommendation 32 has any practical application beyond FSA-authorised BOFIs. Please note, however, that we believe it is imperative that the professional body for remuneration consultants formed in accordance with recommendation 38 should also include independent, non-'remuneration consultant' representation within its membership, such as an FRC member.

When companies are considering significant changes to their board remuneration policies it is customary and best practice for the proposals to be discussed with their major shareholders. Their views are then factored into the remuneration committee's decision making process. Whilst we continue to follow the 'say on pay' debate that is taking place in a number of jurisdictions, we believe that, provided shareholders are always given a clear and full description of a company's board and senior executive remuneration policy, and that both the board and shareholders maintain a healthy dialogue, the existing mechanisms of the Code will, for non-BOFIs, enable all shareholders to play a full and thorough role in setting executive remuneration.

Section 2: The Implementation of the Combined Code

In our view the debate surrounding the terminology of 'comply or explain' versus 'apply or explain' is largely semantic and risks distracting market participants from the more pressing issues arising from the review.

It is possible that some companies become so immersed during the year-end process in ensuring that the annual report that they produce is compliant with the minutiae of the increasingly (and over-) complex corporate reporting requirements and that their governance statements contain the full range of specific reporting items, that they may be unable to make the extra time at that point to take a step back to consider substance over form and the overall effectiveness of their governance statements. In this context, we welcome the FRC's stated intention to seek to rationalise governance disclosures and your ongoing *Complexity in Corporate Reporting* project to investigate the scope for the shortening and simplification of reports and accounts generally.

We believe an aim of the review of governance disclosures should be to make governance reporting more integral with corporate reporting generally. Recent research by corporate reporting agency Black Sun suggests that investors and their fund managers do not always regard governance statements with significance when considering annual reports. This may be partly attributable to the fact that corporate analysts can view such statements as having been produced merely as a box ticking exercise. The more that the FRC is able to encourage boards to add value to their corporate reporting through high quality, meaningful and integrated governance reporting the more the perception of investors and their advisers will change, as they come to recognise the very tangible benefits that can flow from it and that sound governance can deliver real shareholder value over the long-term. They in turn will then start to demand clear and more effective reporting in this area. This has the potential to create a 'virtuous reporting circle' which would also have the effect of drawing boards and their investors closer together on governance matters. The process could be further supported, as part of current efforts to encourage shareholders and boards to engage more fully with one another, by making it clear to shareholders in the Code that there is also a very real onus on them as the owners of the businesses in which they are invested to demand useful and relevant governance information.

Research published recently by UBS confirmed that companies with higher corporate governance ratings tended to outperform low-rated companies on an annualised basis for holding periods of one year or longer. A second study quoted within their report suggested that share prices of companies with better governance tended to outperform both in bull and bear markets. It may therefore be helpful if the FRC, FSA and/or one of the investment management trade bodies were to initiate some form of campaign to 'sell' the investment benefits of good governance within the investment community.

Against this backdrop, the inauguration of the ICSA Hermes Transparency in Governance Awards is also a welcome development, seeking to identify and reward high standards of disclosure, with the aim of encouraging improvements both in the disclosure process and in governance performance itself.

With regard to the scope for rationalisation of disclosures, are there lessons that the FRC is able to learn from other jurisdictions which operate a 'comply or explain' regime but which may adopt a slightly different approach to disclosure, particularly with regard to the range of specific disclosure requirements under the Code? Additionally, it will be interesting to see how over time the encouraging move to slightly less prescription in the 2008 version of the Code through the requirement to state how a company has applied the Code's main principles (rather than both the main and supporting principles, as was the case for the 2006 Code) results in more concise and company-specific disclosure.

In our opinion, the most 'costly' Code disclosure - purely at least in terms of the underlying time and resources needed for the board to be able to make the statement - is the annual confirmation of the review of the effectiveness of the group's system of internal controls. Whilst the statement itself is succinct, the sound internal controls processes that all board's should have in place to safeguard shareholders' investment and the company's assets (irrespective of any disclosure requirement) quite rightly involve the expending of a significant amount of effort and resources on the issue. Whilst the inclusion in the Code of the requirement to make such a statement was for most companies simply the natural culmination of this vital business discipline, it has obviously brought to the fore for all companies the need for effective internal controls.

However, the effectiveness of the existing internal controls reporting requirement under the Code has been called into question in respect of the unique complexities of the business models within the finance industry, where it is apparent from the financial crisis that internal controls failures arose stemming from those complexities, despite the boards of certain listed BOFIs having been able to make their annual internal controls review statements in the run up to the crisis. The relevant Code disclosure requirement nevertheless remains appropriate in its existing form for companies outside the finance sector.

We also wish to take this opportunity to comment that, in our view, the rigidity of the new disclosure requirements under the DTRs relating to corporate governance statements and audit committees, in comparison with the more flexible provisions of the Code in the areas in which they overlap now, has the potential to confuse and rather negates some of the benefits which might otherwise be gained from 'comply or explain'.

It is probably necessary, in view of the magnitude of the crisis that has engulfed the banking industry and in respect of amended provisions for BOFIs, for there to be an explicit and dedicated Combined Code review and monitoring process beyond that currently undertaken by the FRC. However, this is not necessary for other listed companies outside of the financial sector, particularly given the measures which are likely to be taken to encourage greater engagement and dialogue between companies and shareholders. A potential risk of the FRC or FSA undertaking more monitoring or enforcement of 'comply or explain' is that shareholders become more complacent and engage less, taking the view erroneously that the regulators are somehow discharging their own responsibilities to identify instances where no explanation was given for a departure from the Code or to challenge unsatisfactory explanations for any non-compliance.

Engagement between boards and shareholders

In all well run companies the steps set out in WR 14 should already be taking place as a matter of routine board best practice. We also broadly agree with the proposals (which should be applicable in respect of all listed companies) of WR 16 to 18, subject to our comment in our initial response concerning our preference for broader content of the International Corporate Governance Network's (ICGN) Statement of Principles on Institutional Shareholder Responsibilities (an updated version of which is expected to be published shortly) over the current ISC Statement of Principles. We are also supportive of the remainder of the framework for enhanced engagement by shareholders proposed by Sir David Walker in WR 19 to 22, and for its application in respect of investments in all UK listed companies. We do not believe that recommendation 15 is applicable to extend beyond the banking and finance sectors. We also believe that consideration should be given to the development of best practice guidelines for the highly influential, yet unregulated, proxy voting services.

It would also be helpful for the FRC to play a supporting role to encourage broader participation, through the endorsement of any specific mechanisms for engagement that are developed by the investment community itself, as well as by working with all interested parties to further change behaviours of both investors and companies over time, for example, through the active promotion of the potential best practice research findings of the JCA Group for boards and investors regarding effective shareholder engagement, as referred to in the consultation document.

As part of the regular scheduled periodic reviews of the Code, the FRC should ensure that Sections D and E of the Code are kept abreast of best practice developments, so that the Code provides an effective and robust framework for encouraging dialogue and engagement. Best practice developments (arising from refinements and enhancements devised by market practitioners, or from salient research and the like) should be distilled into embellished Code principles or provisions or annexed to the Code as practical guidance. Similar guidance should also form an integral element of the Principles of Stewardship.

However, we agree with Sir David that the FSA should assume a meaningful role in the process of encouraging shareholder engagement in respect of equity investments in all UK listed companies through its oversight of fund managers and other financial institutions and their corporate governance departments. In this regard, the FSA's recent clarification of its rules around collective shareholder dialogue and engagement represents a positive initial step.