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Dear Sir

Review of the effectiveness of the Combined Code – Call for evidence

We write in response to the above invitation to provide our views on the Combined Code.

In summary, our views are that:

- the principles in the present Combined Code remain fit for purpose for UK corporates and that the current economic conditions have not demonstrated that the Code is fundamentally flawed (see paragraphs 1 to 6 below);

- three areas are worthy of further investigation at this time to determine whether the Code's provisions and related guidance should be amended. These areas are:

    i. the role of investors (see paragraph 7 below);
    ii. the Code provisions on remuneration (see paragraph 8 below); and
    iii. the topic of risk and whether the supporting guidance on internal financial control should be reviewed to determine whether risk may be handled better therein (see paragraphs 9 to 11 below);

- any potential changes to the Code should be tested to determine if they are codifying existing best practice which is valued by market participants. If they do not pass this test, there should be extremely strong evidence that such changes are essential to sound corporate governance in the UK (see paragraphs 12 to 13 below); and

- there should be no change to the Code's "comply or explain" approach or to setting out clearly the principles of corporate governance. Removal of unnecessary, perceived as box-ticking, detailed provisions is encouraged (see paragraphs 14 to 17 below).

We discuss in further detail below our views.

The current Code

1. The Combined Code, as issued in June 2008, is a well crafted document in which the main principles of good corporate governance are set out very clearly and command support. While the recent months have seen business failures and have exposed possible shortcomings in the governance arrangements within certain companies, we believe that the issues have been around application of the Code's principles, not with the principles themselves. An excellent example of this is the Code's main principles on the level and makeup of remuneration. The current Code reads:

   "Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant portion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance".

   While these principles continue to be valid, we are aware that, in the application of the second sentence above, in some cases "a significant portion" linked to performance has led to escalation of overall remuneration and too much emphasis on the incentive element. We note at paragraph 8 below the need for further work in this area and it may be that "significant" should be changed to "appropriate" in the principle.

2. In reviewing the effectiveness of the Code, the FRC will of course be taking into account other studies being carried out at this time, including the Walker Review. As well documented elsewhere, the current economic issues began in the so called Wall Street and then moved to Main Street. We recommend that the FRC discusses with regulators, particularly in the financial services sector, how the application of the Code's principles may be monitored more effectively in future.

3. This need to differentiate between application of the Code and the Code provisions themselves is very important. The Code is applicable to all listed companies in the UK and may be considered best practice by other entities such as AIM companies and public corporations. In the Deloitte research report "Write from the start" published in October 2008, 30% of companies complied in full with all of the

provisions, with the remaining 70% partially complying. Half of the top 350 companies by market capitalisation complied in full, compared to 27% of the middle group and 12% of the smallest 350 companies by market capitalisation. These findings are in respect of the application of the Code's detailed provisions, not adherence to the principles therein. They illustrate the relative burden on businesses of complying with all of the detailed provisions of the existing Code. The competitiveness of UK Plc is a critical issue for all. Thus any changes to the Code should pass the test of being fit for purpose for all businesses and not merely to serve a particular need identified in a specific sector.

4. In recent months we have been reviewing announcements by listed and AIM companies. Our analysis indicates that the current economic environment is impacting significantly on many businesses. Our surveys show that, on reporting uncertainties over the application of the going concern basis, the sectors with the higher numbers of companies affected include biotechnology and drugs, business services, medical equipment and supplies, real estate, retail, software and programming, printing and publishing. Other sectors affected include casinos and gaming, computer services, food processing, market research, mining, oil and gas, construction and miscellaneous financial services. Perhaps not unsurprisingly, small cap and AIM companies are reporting more uncertainties than larger listed companies. These findings again stress the need to consider the resource constraints in such businesses.

5. The Turner Report sets out very clearly the global nature of the current economic conditions. While there are many areas in which we support developing global solutions, we believe that the need for a UK Combined Code firmly remains. Board structures vary from country to country. A recent Corporate Governance event held at Deloitte Academy and with Yale School of Management reminded us once again of the differences internationally. These have developed from different legal and regulatory frameworks and different cultural and ethical viewpoints. While it is important that experiences are shared internationally, we continue to believe there is a strong need for a UK Code on corporate governance.

6. Recent discussions have prompted us to suggest that the FRC considers whether the Code should discuss at the beginning the values which Boards should have. These values would be accountability, transparency, objectivity and considering long term interests. These would assist in evaluating board performance. Two arguments against adding these values to the Code are first that it would introduce another element to the hierarchy of main principles, supporting principles, provisions and supporting guidance. The second argument is that it would cause potential confusion with the directors' duties as now set out in company law. On that last point, the FRC may wish to include in the Code reference to the general duties of directors as set out in sections 171 to 177 of the 2006 Companies Act.

The role of investors

7. The Preamble to the Code, together with section 2, contain wise words on the role of shareholders in supporting good corporate governance in the UK. However, because the Code is applied by corporates and there is no mechanism for its application by shareholders, section 2 is relatively short. But shareholders have the role of determining whether companies have applied appropriately the principles in the Code. If shareholders believe that the company is not being headed by an effective Board, that the remuneration structure is not rewarding corporate and individual performance or that the Board is not presenting a balanced and understandable assessment of the position and prospects and so on, then the shareholders should set out their views clearly to companies in the various dialogues. While we do not have a simple solution to offer in this area at this time, we recommend that the FRC asks the Institutional Shareholders' Committee to review its principles and how they are being applied in practice, to determine if any improvements can be made to assist shareholders in evaluating how the Code's principles have been applied by corporates.

The Code provisions on remuneration

8. At paragraph 1 above the main principles from the Code on the level and makeup of remuneration are stated. The Code, at paragraph B.2, also contains the principles that "there should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No directors should be involved in deciding his/her remuneration." In addition to the Code's principles and provisions, company law sets out detailed requirements on remuneration reports and listed companies are required to ask their shareholders to vote annually on that report. We believe that there is a need for further study in this area and in particular to look at:

- how directors' remuneration links to the business strategy and the wider remuneration policy in the organisation including the extent to which pay and conditions elsewhere in the group are considered in setting directors' pay and what will be reported under the disclosure requirement in paragraph 4 of Schedule 8 of SI 2008/410;
- whether the remuneration structures adequately balance the fixed and variable elements of the package and encourage long term sustainable performance;
- whether incentive plans have inadvertently encouraged excessive risk taking by incentivising the wrong behaviour;
- whether there is sufficient focus on the totality of remuneration rather than the individual elements to test how these interact with each other, particularly with reference to pension provision and whether the pension is given adequate consideration when reviewing the elements of the package;
- whether there is sufficient clarity and guidance on compensation for loss of office packages;

- the role, time and skill requirements and contribution of the non-executive directors on the remuneration committee, particularly focusing on the extent to which the directors are encouraged to question and challenge proposals, and the timing and quality of information given to them;
- whether there is a sufficiently strong link between the remuneration, audit and risk committees to ensure that the financial measures used in incentive plans are appropriate, that targets are sufficiently challenging and that risk is built into these measures where relevant; and
- whether there is sufficient clarity about the role of the remuneration advisers, transparency around the appointment process and the potential introduction of a code of conduct.

Risk and internal control

9. Consistent with our comments above, we note that the Code currently contains an excellent principle that "the Board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets."

10. Recent events have highlighted that shareholders have not apparently been fully aware of risks in particular businesses and that both shareholders and perhaps some Boards have not been fully aware of the risks associated particularly with acquisitions and certain financial instruments. The Code provision, C.2.1, notes that the Board should, at least annually, conduct a review of the effectiveness of internal controls and should report to shareholders. The Code is then backed up by the Turnbull guidance which suggests means of applying this part of the Code. While C.2.1 refers to risk management systems, the topic is handled relatively lightly in the Turnbull guidance.

11. In our opinion, there is a need for a review of the Turnbull guidance, as issued in 2005, to determine if it adequately handles areas such as an assessment of a company's exposure to systemic risk, procedures for risk escalation situations, recovery strategies, the adequate testing of business models and strategies, and the proper consideration of risk in major transactions such as business acquisitions and in complex financial instruments. Furthermore, the FRC may wish to consider the role of risk committees and whether companies can meaningfully communicate their appetite for risk to their shareholders.

Testing any potential changes to the Code

12. Paragraph 2 of the Code's Preamble notes that it is a guide to the components of good Board practice distilled from consultation and widespread experience over many years. Indeed, going back to the Code's beginnings in 1992, it was seen as codifying existing good practice and thus making those, lying outwith those boundaries of good practice, re-evaluate their operating methods.

13. We have recently been studying the impact of the EU's Transparency Obligations Directive in the UK. In particular, where the Directive has offered a completely new practice of ditching preliminary announcements, companies have not unsettled established market practices, with 98% of companies continuing to choose to issue a preliminary announcement. Given this evidence, other experience and the history of the Code, we recommend that if changes are made to it, they are those which codify existing best practice which is clearly valued by market participants. If new provisions are not part of existing best practice, then there would need to be extremely strong evidence that such changes are essential to sound corporate governance in the UK.

"Comply or explain"

14. UK listed companies span many industries, different sizes and varying stages in their development from corporations which have been in existence for over 100 years to those which are relatively newly formed. Consistent with our comments earlier in this letter on the current issues being more with the application of the Code than the Code itself and on the need of many corporations not to comply with the Code provisions but to explain where they have chosen a different route, we strongly believe that the "comply or explain" approach must be retained in the UK.

15. In reviewing the detailed Code provisions we have noted a number of minor areas where amendments may be considered. These include:

- the need for the number of meetings of Board committees and individual attendance records to be included in the annual report. In the interests of shortening that report, it may be that this information can now be given simply on websites;
- Code provision A.1.5 on arranging insurance cover does not seem to be a matter that must be enshrined in the Code;
- the independence criteria set out in A.3.1 applying to non-executive directors and to the chairman on appointment should be reconsidered to see if more flexibility may be introduced and whether some of the "bright line" three or five years rules may be eased. In particular, independence should be considered alongside requisite skills and knowledge of the business to make an effective contribution;
- the provisions underlining principle A.4 on appointments to the Board should explicitly consider the need for diversity and a range of skills, knowledge and experience;
- whether Code provision A.6.1 is necessary as it tends to generate relatively boilerplate disclosures in annual reports;
- whether Code provision C.1.2 on directors reporting on going concern should be expanded to refer to the FRC's guidance on going concern for company directors; and

- Code provision D.1.2 should be deleted as again it results in relatively boilerplate disclosure in annual reports. This topic should be taken up in the discussion with shareholders referred to earlier in this letter.

More thinking time, less box-ticking and no "hobby horses"

16. In our experience, Boards and Board committees are meeting more often and for longer. Time is a precious commodity in business and it is important that the focus is on running businesses better and not on unnecessary box-ticking.

17. Monitoring the debate on corporate governance over the last six months or so has prompted us to make the following observations to the FRC.

    - We continue to support the concept of the Unitary Board. Regarding the quality of support and information available to the Board and its committees, we do not believe that there should be a requirement for a separate secretariat for the non-executive directors. This could increase Board divisiveness and undermine the concept of the Unitary Board. We believe how companies make arrangements to support their non-executive directors is best handled on an individual company basis.

    - Changes should not be made to encourage the reduction of the number of executive directors who serve on Boards.

    - We do not see a need to change significantly the respective roles of the chairman, the executive leadership of the company or non-executive directors. We have heard of calls for making one director responsible for risk management. We do not agree with these calls. To be effective all directors should have roles to play in risk management. These roles differ depending on whether a director is an executive or non-executive and on the duties assigned to individual executive directors.

We set out in an appendix to this letter the FRC's questions and note the paragraphs of this letter which relate to each of these.

Martyn Jones and Isobel Sharp would be pleased to discuss with the FRC our comments and other matters relating to the Combined Code.

Yours faithfully

Deloitte LLP

Appendix 1

FRC's issues for comment

i) *Which parts of the Code have worked well? Do any of them need further enforcement?*

See our comments in paragraphs 1 to 3 of the letter.

ii) *Have any parts of the Code inadvertently reduced the effectiveness of the Board?*

See our comments in paragraph 15.

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

See the second bullet point on page 1 of the letter and paragraphs 7 to 11.

iv) *Views are invited on the usefulness of company disclosures and the quantity and quality of engagement by investors.*

See our comments in paragraph 7 on the role of investors and in paragraph 15 on the usefulness or otherwise of particular company disclosures required by provisions of the Combined Code.