

Response October 2009

## CBI response to Combined Code review “A review of the effectiveness of the Combined Code”

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Broad brush changes to corporate governance for all companies are not the right response to the financial crisis. The CBI believes that the Combined Code remains “fit for purpose”.

### INTRODUCTION AND EXECUTIVE SUMMARY

The Confederation of British Industry (CBI) is pleased to respond to the **Financial Reporting Council’s (FRC’s)** second consultation. We endorse the broad conclusion reached by the FRC that the Combined Code and its principle-based, ‘comply or explain’ approach remains “fit for purpose”.

There are two broad reasons for reaching this conclusion.

First, there is no evidence to date of significant or widespread failures of corporate governance beyond some specific instances in the financial services sector, so the FRC is right to guard against regulatory mission creep. The Walker Review is part of a specific set of responses designed to address problems in the financial sector. The review of the Combined Code should not be seen as an opportunity to add in greater prescription, which would do nothing to achieve better outcomes in the broader corporate sector.

Second, the Walker Review rightly acknowledges the unique role of banks in the economy, and the specific systemic risks that relate to them. It would be a mistake to assume that recommendations made in the Walker Review for banks and other financial institutions would be good or necessary for all listed companies.

There are a number of other fundamental points in the UK governance model that CBI members strongly support.

CBI members, including investor members, strongly uphold **the UK’s unitary board system**, and would be opposed to measures which tend towards a two tier board structure. UK Boards are and should remain collectively responsible for their actions and decisions.

We believe that the key to good corporate governance is to have balanced boards, made up of people equipped with the right skills, who operate within a culture of challenge. We also believe that a principles-based code remains the best way of achieving this.

As a general point, we commend the existing Guidance of Good Practice Suggestions from the Higgs Report, re-issued by the FRC in 2006, which addresses a number of the topics and issues on the content of the Combined Code raised by the FRC in this second consultation.

We do not suggest, however, that there are any grounds for complacency, particularly in the light of the severity of the financial crisis, and it is right that the Combined Code and the UK governance regime is kept under regular review.

If the FRC is persuaded of the need for changes to the Combined Code, then better regulation principles should apply. These include maintaining a sense of proportionality, the need for any proposals to be targeted to address a specific problem, and for any proposals to be accompanied by an appropriate cost/benefit analysis and impact assessment.

## The Walker review recommendations and implementation

The Walker Review is designed to address corporate governance issues specifically in relation to banks and other financial institutions. It recommends that:

**“Except in a few cases where responsibility for proposed initiative is for the FSA, it is envisaged that most of these recommendations will be incorporated as guidance and provisions in the Combined Code. Precisely how this should be done alongside Combined Code provisions in relation to non-financial listed entities will be for review and determination by the FRC.”**

To put the Walker Review in context, it is widely recognised that the financial crisis was caused by many factors. It is also widely accepted that whilst corporate governance failures in some financial institutions may have played a part in the crisis, they were not the cause of it. Where those failings existed, we believe this was due to the behaviours and failures of those particular boards rather than a generic problem relating to corporate governance codes and guidelines.

Whilst we support the notion that those recommendations in the Walker Review primarily concerned with governance **might be taken forward on a “comply or explain” basis** through the Combined Code, we strongly believe that it would be a mistake to assume that recommendations made in the Walker Review for banks and other financial institutions would be good or necessary for all listed companies. The Walker recommendations reflect the unique role of banks and financial institutions in the economy and the specific systemic risks that relate to them.

The Walker **Review’s** recommendations need to be distinguished broadly between governance recommendations, such as on board structures and the role and responsibilities of the board, chairman and NEDs, and recommendations primarily seeking to reduce and mitigate the systemic risks BOFIs might pose through excessive risk taking encouraged by inappropriate remuneration practices.

On this analysis, the Walker recommendations on governance are already substantially reflected in the Combined Code, and could be augmented by updating the existing FRC good practice suggestions from the Higgs Report as appropriate. The Walker recommendations concerned with mitigating systemic risk and inappropriate remuneration practices should be for the regulator.

There is also nervousness on behalf of investors if they were to end up as a sole policeman on issues that more directly relate to the management of risk in systemically important firms.

We do not believe the Walker recommendations on risk committees and remuneration practices are appropriate for application to all listed companies. Specifically, they are too prescriptive to be compatible with a principles-based approach to corporate governance.

The notion of taking forward a number of the Walker **proposals on a “comply or explain” basis poses questions** for those BOFIs that are not listed and do not have a typical **shareholder base to “explain” to.**

We do not support any wider application of the Walker recommendations on remuneration beyond BOFIs. The existing statutory Remuneration regulations are already heavily prescriptive in terms of what companies must disclose shareholder support. We also believe that some of the stipulations around deferred pay and clawback are less applicable outside of financial services, where performance in largely cash-based businesses can be assessed in a more immediate time horizon.

More generally, we believe that pay and bonuses should be driven by company-wide performance.

A copy of the separate CBI response to the Walker Review recommendations is sent to the FRC, alongside this response.

The rest of this response deals with the other issues raised by the FRC in its second consultation.

## FRC PROPOSED GUIDING PRINCIPLES

The FRC says that it intends to adopt three guiding principles when assessing the lessons to be learnt from the financial crisis and the case for changes to the Code and its accompanying guidance during the next phase of the review. These are:

- Where there is a demonstrable need for best practice to be clarified or strengthened, this will be addressed either through amendments to the Code or additional, non-binding guidance
- Where not constrained by regulatory requirements, we will seek to rationalise disclosure requirements in the Code to encourage more informative disclosure on the issues of most importance to investors and to discourage boiler-plate and box-ticking
- We will seek to avoid an increase in the overall level of prescription in the Code and to preserve its principles-based style

In addition, the FRC states that if there is evidence that the Code may inadvertently have made it more difficult for boards and committees to operate effectively, changes to the relevant sections of the Code will be considered.

The CBI supports this approach and guiding principles.

In particular, we echo the desire to avoid an increase in the overall level of prescription in the Code. We believe that many of the Walker proposals are typically more prescriptive than principles-based in nature and are therefore at odds with this objective.

We wish to emphasise that there must be a sense of proportionality on any proposals for change which may be made, accompanied by appropriate cost/benefit analysis and impact assessment. There must not be significant additional layers of cost placed on business.

There must be a strong awareness of the need to avoid over-reactions and unintended consequences, and we are mindful of the difficulties that arose in the US as a result of Sarbanes-Oxley.

There is also a need to avoid proposals that tend towards two tier boards. CBI members, including investor members, strongly uphold the unitary board concept, which has served the UK and UK businesses well.

## SECTION 1: CONTENT OF THE COMBINED CODE

### The responsibilities of the Chairman and NEDs

The FRC sets out specific issues for further consideration including:

- Whether it would be helpful to give further clarification of the role, key responsibilities and expected behaviours of the chairman, the senior independent director and/ or the non-executive directors, either in the Code or in non-binding guidance
- Whether it would be helpful to provide further guidance on the time commitment expected of the chairman, senior independent director and / or non-executive directors

The CBI strongly supports diverse boards, drawn from a broad talent pool that strikes the right balance between experience and independence.

Promoting a culture of respect, trust and challenge is the most important issue, and ultimately the job of the chairman. The CBI believes that there is only so far you can codify all of this.

We believe that whilst the Walker Review has put together a reasonable package of recommendations around board size, composition and qualification for a chairman and NEDs of banks and financial institutions, these proposals are already largely reflected in sections A.1 and A.2 of the Combined Code.

We believe that the Walker recommendations for a minimum time period of two-thirds of a chairman's working time, and of 30-36 days for service as a NED on a BOFI board, is not appropriate for listed companies generally, and may not even be appropriate for all banks and financial institutions.

Indeed there are times when a period of 30-36 days of service by a NED may be an under-estimate for many NEDs, both of a BOFI and in respect of many listed companies. At other, more 'normal' periods, it could be an over-statement of time.

Ultimately, board success is driven by the quality and timeliness of decisions taken in order to promote and achieve the success of the company. We believe the focus should be on outputs, not inputs and time spent by individual directors. Therefore any specified time period should be avoided.

Prescriptive time commitments could also make it difficult for any current serving executive director to take up a NED position, which would stifle best practice transfer of experience between industries and the development of **tomorrow's leaders**. We believe this is an important mechanism for refreshing the board and promoting boardroom diversity and should not be stifled.

As these issues are already substantially and adequately addressed in the Combined Code, we do not consider major change to the Code itself is necessary.

If further clarification is deemed necessary, then this could be achieved through a review and appropriate updating of the Good Practice Suggestions from the Higgs Report reissued by the FRC in June 2006, which includes guidance on the role of the chairman and on the role of a NED of a listed company.

#### Board balance and composition

The FRC sets out specific issues for further consideration including:

- Whether the Combined Code gives sufficient emphasis to the need for relevant experience among NEDs collectively
- Whether the independence criteria and the way they have been applied by boards of companies and investors have unnecessarily restricted the pool of potential NEDs, and in **particular whether the so called "nine year rule" has resulted in a loss of continuity and valuable experience**
- Whether the recommendation that the boards of FTSE 350 companies should comprise at least 50% independent NEDs has resulted in fewer executive directors sitting on boards and/or boards becoming larger
- Whether more guidance is needed, in the Code or elsewhere, on succession planning and the need to ensure that board composition is aligned with the present and future needs of the business

The CBI believes that the most important issue here is to focus on the overall board balance, as well as the qualifications and experience of specific individuals. This should include achieving an appropriate range of skills across board members and striking the right balance between experience and independence.

If the FRC feels the need to set out further detail on appropriate experience for a NED, we believe that this would be better suited to supplementary guidance rather than any changes to the Combined Code itself.

On NED independence, we said in our response to the initial FRC consultation that the NED independence criteria should be balanced against the need for experience and expertise. This criteria, and putting an emphasis on achieving the right blend of experience and fresh thinking on the board, is **more important than the "nine year" rule** for individuals.

We also support flexibility over the number and proportion of independent NEDs on the board to ensure a properly balanced and flexible board with appropriate balance of skills and experience, including an appropriate number of executive directors. This is particularly true for smaller listed companies. We would therefore suggest that the reference to 50% independent NEDs in Code A.3.2 is reviewed and that this is an area where supplemental Guidance might be appropriate.

Refreshment of the board at regular intervals from the broadest possible talent pool is also an important objective and mechanism for achieving board balance, assisted by **the board's evaluation processes of its existing board**.

On succession planning, the second Supporting Principle to Code A.4 sets down the need for this and it is not clear what more might be said either in the Code or separate guidance.

#### Frequency of director re-election

The FRC asks for views from companies and investors on whether changes to voting would increase accountability to shareholders and which, if any, of the following options they would support as recommendations for possible inclusion in the Code:

- Annual re-election of the company chairman
- Annual re-election of the chairs of the main board committees
- Annual re-election of all directors
- Binding or advisory votes on specific issues, or on the corporate governance statement as a whole

CBI members consider that the current Code provisions in Section A.7 remain appropriate, providing for the rolling re-election of all directors over a period of not more than three years for each director, commencing with the AGM occurring after first appointment, and there is not a consensus view supporting any change.

For example, we do not support the Walker or ISC suggestion that if the remuneration report attracts less than 75% support at the AGM, then the remuneration committee chair, over even the company chair, should stand for re-election at the next AGM. If there is a problem with remuneration or the remuneration report, deferral of the issue for a year to the next AGM, and putting them up for re-election, is not the right approach. The issue needs to be addressed at the time in a dialogue between the chairman and the board with the major investors.

The proposal could also deter NEDs from being willing to chair board committees.

The singling out of specific individuals for annual re-election is also not supported. This runs contrary to the principles of a unitary board and the legal concept that all directors are jointly liable for the management and stewardship of the company.

Setting different rules for different directors could also open up liability issues if a company failed or suffered significant losses, and generally encourage disputes and possible litigation against individual directors.

As a final point, we note that shareholders already have the power to remove directors if they so wish. We do not see any case or argument for any additional binding or advisory votes, or on the corporate governance statement.

#### Board information, development and support

The FRC says that many commentators have highlighted the need for NEDs individually and collectively to have sufficient knowledge of, and information about, the business to be able effectively and constructively to challenge the executive. The FRC suggests this could be obtained in a number of ways:

- Through prior relevant experience, which the sections of the Code dealing with board balance and composition should facilitate
- Through the information they received, whether from the executive or from independent sources

- Through greater contact with the operational activities of the company
- Through induction and ongoing professional development

The CBI believes that appropriate induction and on-going training and development is important for all board directors, not just NEDs.

In response to the FRC's first consultation, the CBI urged the FRC to preserve a framework which encourages:

- An emphasis on ensuring that the Board and particularly **NEDs have sufficient "thinking time" to understand any proposals surrounding the organisation's business strategy**, and that there is not a **shift towards "box ticking"**
- A manageable volume, and timely flow, of information to the board and particularly NEDs, so that they can properly understand proposals and seek further clarification and advice on them if required.

We also stressed the importance of ensuring that boards get the right information about key risks and have the skills to interpret and challenge them. Boards and investors need to be able to assess that all appropriate risks affecting the business have been adequately and sufficiently taken into **account in the company's business strategy**.

**The effective application of the Code's principles is largely** reliant on the behaviour of individuals and their interactions. This is not something that can sensibly be legislated for or regulated.

The CBI supports the emphasis placed by Walker on training and awareness sessions, particularly if the content is left to individual companies to determine what is most appropriate for the company and the individual directors, but it is not clear that anything more needs to be said in the Combined Code.

We also support executive directors gaining experience by acting as a NED in other companies or sectors.

We agree that NEDs should have access to appropriate support, both internal and external, as necessary. But this should not result in a requirement for the creation of independent secretariats to serve NEDs. This should be a matter for individual boards. Many would regard any formal

recommendation for separate support to the NEDs as being contrary to the unitary board concept.

We support timely issue of agenda and papers for board meetings. Whilst this might be the overall responsibility of the Chairman, they are heavily reliant on the Executive and the Company Secretary to achieve this. NEDs should take the matter up if they consider that they do not get their papers soon enough for proper and effective consideration in preparation for the Board, or Board Committee, meeting.

Overall, the existing Code provisions seem to make adequate provision for this, and we do not see a need for any major new provisions in the Code.

If there are particular areas where further clarification would be helpful, this could be addressed in supplemental guidance. There is already some guidance in the Good Practice Suggestions from the Higgs Report referred to earlier in this submission.

#### Board evaluation

The FRC sets out specific issues for further consideration including:

- Whether the Code should be amended to recommend that board evaluations should be externally facilitated at least every two or three years for some or all companies
- Whether the recommendation that the effectiveness of all the main board committees should be evaluated every year should be relaxed in some way, for example to recommend a rolling cycle of committee reviews
- Some commentators considered that after the initial evaluation there was limited value in subsequent annual reviews
- How disclosures in the annual report might be made more informative, either in relation to the process that was followed and/ or the outcomes of the effectiveness review

On the last issue, the FRC states that it believes the **proposal for an “assurance statement” merits further consideration** as it may provide a means of enabling investors to obtain more relevant information while allowing some other disclosure requirements in the Code to be rationalised, and would welcome views on what might be covered by such a statement.

The CBI agrees that the performance of the board and that of individual directors should be regularly evaluated in accordance with arrangements agreed by the chairman and the board.

External evaluation also has a role to play in improving boardroom performance, but the requirements for this should not be prescriptive. Some companies have noted that the presence of external evaluators could hamper or distort normal and full boardroom discussion, and cause confidentiality problems.

The key aspect of board performance is behavioural, and **therefore much less amenable to formal “testing”**. External evaluation should not be a substitute for open debate and robust challenge between the Executive and the NEDs, nor effective communication and engagement with shareholders.

We agree there may be scope for supplemental guidance, but we do not see as necessary any major changes to the current Code provisions.

The CBI strongly believes that the suggestion for an assurance statement **would be “boiler-plating” and would provide low added-value**.

#### Risk management and internal control

The FRC sets out specific issues for further consideration including:

- **Whether the board’s responsibility for strategic risks and setting risk appetite**, as set out in the Turnbull Guidance, should be made more explicit in the Code, and whether the current balance between the Code and the Guidance is the right one
- Whether there is a need for all or parts of the Turnbull Guidance to be reviewed

- To what extent the particular mechanisms recommended for banks and financial institutions would also be appropriate for other listed companies. For example, there were mixed views among commentators about whether separate risk committees were necessary for companies with less complex business models
- How reporting on risk might be improved, for example by rationalising existing disclosure requirements or providing guidance on good communications tools

The CBI response to the initial FRC consultation said that a major lesson from the financial crisis is the need to identify, understand and manage risk better. In particular, the financial crisis revealed that an insufficient emphasis had been placed on “low probability, high impact” risks.

We also said that this demonstrated the importance of ensuring that boards get the right information about key risks and have the skills to interpret and challenge them. Boards and investors need to be able to assess that all appropriate risks affecting the business have been adequately and sufficiently taken into account in the company’s business strategy.

Risk is a matter and responsibility for the board as a whole. Whilst large and complex businesses might benefit from a separate risk committee, for listed companies generally this should be a matter for individual companies and boards. CBI members do not support any extension of this requirement in the Combined Code that all listed companies should be required to have a risk committee.

For most companies, the board as a whole, supported by the audit committee as appropriate, is considered the best means to address risk and assess and manage the business’ risk exposures. This is also an area for boards to keep regularly under review and update their risk management skills, and undergo further training and seek additional external advice as appropriate.

Risk management and reporting is also not just about disclosure. It is also about ensuring that the board is alive to, and responds as appropriate to, new risks affecting the business as they arise.

It may well be appropriate to review the Turnbull guidance in due course, but CBI members do not see this as an urgent or priority issue. In our view, Turnbull remains largely fit for purpose. CBI members consider it would be better to defer any review until it is clear that the financial crisis has been overcome, and when regulators and stakeholders have

more time to undertake a full and proper assessment and lessons learnt. A premature review of Turnbull could lead to inappropriate recommendations and unintended consequences.

## Remuneration

The FRC sets out specific issues for further consideration including:

- Whether to revise the Code to ensure consistency with the **European Commission’s Recommendations and, where appropriate, the FSA’s proposed code of remuneration** practice for financial institutions and the recommendations of the Walker Review
- Whether any other changes to the Code or additional guidance are required to reflect developments in best practice
- Whether shareholders should be given a more direct role in setting remuneration and, if so, how this might be achieved

In response to the initial FRC consultation the CBI noted that the financial crisis had reiterated the need for remuneration strategies to:

- Create a strong alignment between the interests of directors, management and staff and the long- term health of the organisation and its shareholders
- Increase the emphasis of management decisions towards long-term performance
- Unequivocally reject rewards for failure

Equally we said that it was important to ensure that:

- In considering any changes to regulation around remuneration policy there must not be any damage to the **UK’s ability to attract and retain global talent**
- And levels and forms of remuneration ultimately remain a matter for companies and their investors, not regulators

We believe that pay and bonuses should be driven by company-wide performance.

The CBI believes that the existing Combined Code already makes adequate provision on remuneration issues, supported as it is by extensive existing legal requirements for disclosure and accountability.

The EU recommendation only goes further than the Combined Code in a limited number of areas.

We are not convinced that the differences are of such a magnitude or importance to require incorporation in the Combined Code.

The Walker recommendations and the FSA Code are mainly specific to banks and financial institutions, and we do not support a read-across to listed companies generally. Many of the recommendations are not capable of simple transition, since they specifically relate to remuneration practices, and the business model, in the financial services sector.

We do not support any wider application of the Walker recommendations beyond BOFIs. The existing statutory remuneration regulations are already very prescriptive in terms of what companies must disclose and obtain shareholder support.

We do not see a need for a greater role for the Code or other regulatory intervention on remuneration issues in listed companies generally, provided shareholders have all relevant information, which existing statutory regulation is designed to achieve. Shareholders must already approve all share option and share based remuneration schemes, and they have a non-binding vote on the remuneration report. Remuneration policy is for ongoing dialogue between the company and their shareholders, and we would expect the board to consult its major shareholders on key proposals on remuneration.

We have discussed above, and do not support, the ISC proposal in connection with the re-election of the chair of the Remuneration Committee.

## SECTION 2: IMPLEMENTATION OF THE COMBINED CODE

### Quality of disclosure by companies

The FRC sets out specific issues for further consideration including:

- The extent to which it would be possible and desirable to rationalise the disclosure requirements set out in the Code. The FRC would particularly welcome the views of investors on what information is of most value to them, and the views of companies on what information is most costly to produce
- Whether it would be appropriate for the FRC or the FSA to undertake greater monitoring and **enforcement of “comply or explain” statements**, and if so what form this might take

FRC invites views on these issues and on whether there are any other actions that the FRC might take to encourage more informative disclosure.

The CBI strongly supports the “comply or explain” regime under the Combined Code.

If there is scope to rationalise the disclosure requirements we would support that but perhaps rationalisation is as much an issue for statutory regulation and the FSA Listing and Disclosure and Transparency Rules and accounting standards. The FRC has a project on this and we await its conclusions and recommendations in due course.

We see discussion and effectiveness of companies’ corporate governance statements as a matter essentially for discussion and resolution of any issues as part of the regular and on-going dialogue between a company and its major investors, in conjunction with statutory or regulatory disclosure requirements also involved.

It is also the case that information and assistance from boards which investors find most useful varies from company to company.

We therefore do not see a greater role for the FRC or the FSA in monitoring and enforcing comply or explain statements. After all, where not prescribed by law or regulation, the Code is meant to be comply or explain, not comply or else.

The CBI is aware that a number of representations have made that the phrase “**apply or explain**” more accurately reflects the spirit of the Combined Code and we would support that view.

### Engagement between boards and shareholders

The FRC sets out specific issues for further consideration including:

- The framework proposed by Sir David Walker, and the appropriate role for the FRC
- What role, if any, it would be appropriate for the FRC to play in encouraging collective engagement
- Whether further guidance on best practice for companies, investors or proxy voting services would be helpful, either in the Combined Code or elsewhere, and whether the practices currently recommended in Sections D and E of the Code continue to represent best practice
- What other steps might be taken, by the FRC or others, to encourage both companies and investors to be more proactive about regular engagement and with a longer term focus than the annual results presentations

Sir David Walker's proposal that the FRC implement his recommendations via the Combined Code is discussed earlier in this submission. In particular, we reiterate our view that it would be inappropriate to extend many of his recommendations beyond BOFIs to listed companies generally, except where they are already broadly reflected in the Combined Code.

As indicated, the Walker recommendations need to be distinguished broadly between governance recommendations, such as on board structures and the role and responsibilities of the board, chairman and NEDs, and recommendations primarily seeking to reduce and mitigate the systemic risks BOFIs can pose through excessive risk taking encouraged by inappropriate remuneration practices or poor risk management control. **On this analysis, Walker's governance recommendations are already substantially reflected in the Combined Code, which can be augmented by updating the existing FRC Higgs Good Practice suggestions if necessary. Walker's recommendations concerned with mitigating systemic risk and inappropriate remuneration practices should be for the regulator.**

We support the existing provisions in Sections D and E of the Combined Code.

As we have said, it is essentially for companies and their major investors to engage in dialogue, and we do not envisage many new steps or initiatives by the FRC or others, if we are to continue to have a code-based good practice corporate governance regime, outside the mandatory areas prescribed by law.

We can broadly support in principle the FRC taking responsibility for the sponsorship of the proposed Principles of Stewardship, but investors seek to retain ownership through the ISC. There needs to be more discussion and understanding as to what might be proposed. This should be the subject of a further public consultation on the proposed terms of reference of the Principles of Stewardship and the respective roles of FRC and the ISC and other related issues in this area.

We encourage further consultation as to how this might be taken forward into a separate code for long term institutional investors, and / or be incorporated into a re-modelled Combined Code.



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