GKN PLC

GKN plc
PO Box 55, Ipsley House
Ipsley Church Lane, Redditch
Worcestershire B98 0TL
England
T +44 (0)1527 517715
F +44 (0)1527 517700

9 October 2009

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

By email: codereview@frc.org.uk

Dear Mr. Hodge

Review of the Effectiveness of the Combined Code: Progress Report & Second Consultation

We welcome the opportunity to comment on the Financial Reporting Council's second consultation on the effectiveness of the Combined Code (the Code). Our views are set out below.

Principles

We are fully supportive of the principles-based approach of the Code and the flexibility afforded by 'comply or explain' rather than the alternative of prescription through regulation. Therefore we welcome the adoption of the three guiding principles. We believe however that any clarification or strengthening of best practice should, where necessary and appropriate, be undertaken through amendments to the Code rather than additional, non-binding guidance in order to avoid a proliferation of supporting material. That having been said, with the exception of a small number of high profile governance failings within a specific sector of the market in recent times, the Code as currently drafted is working well and achieves its objectives.

Responsibilities of the Chairman and Non-Executive Directors (NEDs)

The incorporation into the Code of further clarification of the roles, key responsibilities, experience and expected behaviours of chairmen, NEDs and senior independent directors (SIDs) is unnecessary in relation to listed companies generally. The Code has been in operation for over 10 years and its application, together with relevant legislation/regulation, has ensured a sound level of understanding of the requirements of each role. It is for each chairman, supported by the secretary, to address any shortcomings in behaviour demonstrated by a director.

Furthermore, prescription as to the time commitment expected of chairmen, NEDs and SIDs is likely to result in a further, unsustainable reduction in the number of individuals available for appointment to such positions. The pool of such people has already been adversely impacted by the effects of ever increasing responsibility and risk which attaches to board level appointments and any further “guidance” on time commitment is likely to compound this issue. In addition the time commitment will vary from company to company and throughout the term of office of an individual dependent upon the circumstances prevailing in a company from time to time.

Board Balance and Composition

Section A.3 of the Code works well in practice except to the extent that some institutional shareholders and shareholder bodies apply the independence criteria set out in that section too rigidly or, in some cases, more expansively. This mitigates against the board’s own determination of a NED’s independence which should be considered by shareholders on its merits and not against strictly applied, solely fact-based criteria. The nine year rule generally works well in practice and is a good yardstick against which to judge independence. However, where there are valid reasons to retain a director beyond this period, the rigid application by shareholders of this measure can make an extension of term of office beyond nine years almost impossible.

A chairman fulfilling his role adequately will (with input from other members of the nominations committee) be able to assess the qualities and experience required when recruiting NEDs to ensure that the composition of the board is well balanced. Any further degree of prescription in the Code will inevitably result in this being assessed rigidly from an external perspective thereby either making the recruitment process more difficult or resulting in the need for a much larger NED constituency on a Board. Equally, a chairman should be in a position to determine whether the board comprises an appropriate number of executive directors. Succession planning should be left to the chairman, supported by other members of the nominations committee. No further prescription is necessary.

Frequency of Director Re-election

In the main, if there is an adequate and sufficiently qualitative dialogue between companies and shareholders, any concerns will surface and, in a well-governed company, these will be addressed appropriately. Increasing the frequency of re-election of board members will not of itself increase their accountability to shareholders. It is for each company to decide whether to adopt any form of annual re-election policy in light of developments in best practice and in response to any aspect of its own policy or performance.

We do not support an advisory vote on specific issues or on the corporate governance statement as a whole. Adequate and more appropriate mechanisms already exist whereby shareholders are able to raise any concerns they may have.

Board Information, Development and Support

Further guidance in this area is unnecessary. The responsibility to ensure that directors have the relevant knowledge to fulfil their roles, both on appointment through a sound induction process and through ongoing training, must remain with directors (both executive and non-executive) and the company (supported by the secretary). The chairman should review training needs with the directors on a regular basis and particularly through the annual performance evaluation process. It is worthy of note however that there appears to be a lack of appropriate and high quality external courses for directors; if possible encouragement should be given to relevant representative bodies to address this. The existing Code principle which sets out the chairman’s responsibility for ensuring that the directors receive accurate, timely and clear information remains appropriate.

We do not support the proposition that the secretariat should be divorced from the executive as this is likely to reduce its effectiveness and undermine the unitary board.

Board Evaluation

A company should be free to determine the most appropriate method of evaluation for its board. Many companies are employing external facilitation every second or third year and best practice in this area should be left to develop. The inclusion of such a provision in the Code would mean that it will rapidly become the minimum standard expected of all companies subject to the Code, regardless of how appropriate it may be, and should therefore be resisted.

There is also no benefit to be gained from amending the Code to relax the evaluation cycle relating to committees. Provided companies are afforded sufficient flexibility, they can determine whether to undertake abridged evaluations of committees with a full review, say, every other or third year.

Further prescription in the Code on disclosures relating to board evaluation is likely to result in more boilerplate statements. Similarly, the concept of an ‘assurance statement’ is unlikely to generate more meaningful disclosure beyond that which is already required by the Code.

Risk Management and Internal Control

The Code should not prescribe the need for a risk committee or a chief risk officer for listed companies generally. A company that has sufficient clarity as to the roles of the various individuals and bodies involved in risk management and is content that it has the appropriate structure in place (appropriate disclosure will enable investors to determine this), should be free to decide the manner in which it oversees the management of risk. It may, however, be appropriate to make such prescription specifically in respect of financial institutions given the nature of their business.

We do not believe there is any need to make more explicit in the Code the board’s responsibility for strategic risks and setting risk appetite as currently set out in the Turnbull Guidance.

We are supportive of the suggested rationalisation of disclosure requirements such that all relevant matters are brought together and reported upon in a holistic manner (i.e. risk management and internal controls; risks and uncertainties generally and financial risk). To this end a review of the Turnbull Guidance may prove timely.

Remuneration

We do not support the application to listed companies generally of either the recommendations of the Walker Review or other recommendations concerning remuneration practice for financial institutions. It is wholly inappropriate to introduce such prescription on remuneration matters into the Code when, other than in relation to certain financial institutions, the current system is regarded as working well. Institutional shareholders take the opportunity, through dialogue with the company and/or their vote on the remuneration report, to influence the remuneration policies and practices of listed companies. The inappropriate behaviour of a relatively small number should not drive a wedge through a process which generally works well and thrives on mutual understanding by companies and their shareholders. Shareholders should not be given a more direct role in setting remuneration but should continue to ensure, through effective dialogue, that remuneration committees set appropriate remuneration policies and apply them wisely.

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Quality of Disclosure

We agree that it is desirable to rationalise the disclosure requirements of the Code, taking account also of other related disclosure requirements in legislation and accounting standards, with a view to creating a more meaningful corporate governance statement. However, the need for shareholders and shareholder bodies to evaluate such statements from a qualitative rather than quantitative ('box ticking') perspective would continue to be extremely important. The current cost of governance reporting is not in itself a concern for us.

We do not believe that the FSA or the FRC should take on a greater role in monitoring or enforcement of the Code. Such an approach would move the governance regime inexorably towards one akin to regulation and impose by default prescription in place of the 'comply (or apply) or explain' approach that overall has worked so well. The key to ensuring that it continues to do so is to reinforce the relationship and dialogue between shareholders and boards of companies, not to create a barrier between them by turning the Code into a list of requirements that have to be complied with.

Shareholder engagement

Shareholder engagement should not be forced but rather encouraged such that if a shareholder has concerns he feels able to contact the company on an informal basis for discussion of the issue. This voluntary approach to engagement, which in the main works well, should be allowed to continue. Indeed, in most well-governed companies there is little need for direct engagement with shareholders on governance matters and it would be a waste of time to force dialogue in these circumstances. Provided shareholders are willing to engage when they have concerns there is no need for further prescription in this area.

The disclosure by fund managers and other institutional investors of their voting record is to be encouraged, in much the same way that companies are encouraged by institutional bodies to publish their voting results.

Conclusion

The balance between appropriate guidance and over regulation in corporate governance is difficult to achieve but the Code has proved instrumental in providing a world-renowned governance framework for UK listed companies. It is imperative that this framework is not unintentionally realigned from guidance to regulation as a result of reaction to a handful of governance failures in one specific sector of the market.

Yours sincerely

Judith Fell

Judith Felton
<u>Company Secretary</u>