THE COMBINED CODE - RESPONSE TO INTERIM REPORT PUBLISHED BY FINANCIAL REPORTING COUNCIL ON 28 JULY 2009

1) The responsibility of the chairman and the non-executive directors

Can I make two points:

1.1) It is important that the main focus be on the chairman, rather than on the NEDs. The latter of course must play their part – but their effectiveness will to a very large extent depend on the role set for them by the chairman. It is the chairman who leads on the non-executive component of the board, on setting its culture, and in overseeing that they receive adequate information in a user-friendly way. They will certainly find the task of assessing the strength of key management harder unless this is facilitated by the chairman. A concern that I have is whether the FRC has a tendency to view matters through the eyes of the chairman – whereas any analysis of the adequacy of board conduct has to start with the impact on the board of chosen or de facto positions taken by the chairman.

1.2) Would it be helpful to flesh out (a bit) the concept of the unitary board. On the one hand there is the executive, keen to push forward its considered direction. On the other are the NEDs, inevitably far less informed, having great difficulty in pro-acting – and also in having a full grasp of the external factors potentially relevant on major corporate moves. It is unclear to me that bank boards really functioned as unitary boards through recent times. I do not know whether the FRC has commissioned research to see what the unitary board concept is seen to mean in complex companies in other industries – especially in companies that have experienced major misfortunes.

Clarification of the concept could briefly address the importance of the NEDs feeling themselves to be personally involved in major decisions (as opposed to taking a passive role in allowing decisions really taken by the executive to proceed); to be close enough to the business for them to have a chance of being able to pro-act effectively should that become necessary; and to be sufficiently aware of external conditions for them to be able to add effectively to the debate on major proposals (e.g. acquisitions) brought forward by the executive. If the unitary board concept was clarified, then it should be clarified to be part of the chairman's job to oversee the position – and maybe to articulate the adoption of a different means of going about the business of the board.

If these points were addressed, the gap in potential effectiveness between the chairman and the NEDs would be lessened – something which perhaps recent major misfortunes shows would be desirable, at least in the banking sector.

2) Board balance and composition

It would be good indeed if the hard line rules concerning board balance, and director independence, could be softened. They currently provide too much opportunity for box-ticking by corporate governance specialists – maybe not serious, but an irritant that can give corporate governance a bad name.

Would it not be right to place the responsibility to assemble a good board firmly on the chairman, working through the nomination committee? This result is largely, but not entirely, achieved under the Combined Code by the provisions (A.4.1) that the chairman should chair the nomination committee, and (A.6) that the chairman should act on the results of the performance evaluation. A clear statement to this effect would be better.

3) Frequency of director re-election

I do have major reservations about the idea of the whole board being put up for re-election each year. This could (actually on occasion would) facilitate a predator being able to mount an ambush on a company by torpedoing the board at the AGM without much warning, and with much less than an outright majority of the share capital. At the least, the Takeover Panel should be brought into the process of considering this before the idea is adopted.

Annual re-election of the chairman to some extent raises the same issue – less than a majority could at short notice inflict a major blow to the company. I am not convinced that annual re-election of the chairman, or the chairs of the main board committees, would increase accountability to shareholders. The Companies Acts already enable the prescribed proportion of shareholders to force a vote on a director – a power rarely used.

The idea of a specific vote on the corporate governance statement seems likely to me to give rise to a further piece of AGM boilerplate – not harmful, but to a large extent just another resolution, and only likely to have any real use if those institutions with reservations actually turn up and speak to justify their point of view.

4) Board information, development and support

Apart from points already made, it will at most be rare for the NEDs to want to take separate advice. At that point board collegiality must presumably have broken down. If it is still there, concerned NEDs will be given direct access to the company's own advisors – who surely can be presumed to be reputable unless the company concerned is outside of the establishment.

5) Board evaluation

I do hope that external evaluation every second or third year is not going to be made compulsory for all listed companies. It would be better to leave this in the discretion of the board, but if there is to be compulsion, it should only extend to major companies – probably not beyond the FTSE 100.

Annual evaluation of committees is largely a box-ticking exercise, but this would likely be the case whether it is carried out annually or less frequently. Annual evaluation is not harmful, however, and should mean that problems are surfaced reasonably promptly.

The Code (A.6.1) addresses the evaluation of the chairman – without, however, recognising that looking at the chairman's job of necessity involves looking at the operation of the board. The SID's review (with the NEDs) of the chairman should lead to a private session between the SID and the chairman – before the full examination by the board of its performance. If there is to be an "assurance statement", the possibility of this being put out over the name of the SID and other NEDs should be considered. It certainly would be welcome if this addressed the general quality of board involvement specifically, if there is clarification of what constitutes a unitary board, whether the board has functioned as such a board. The banking crisis had examples of clean (or virtually so) "comply or explain" statements in circumstances where it looks as though the real quality of corporate governance may have been questionable.

6) Risk management and internal control

I don't have views on the questions raised – but would raise concerns about the length and complexity of the disclosures seen in the annual reports of banks in the run-up to the banking crisis. Statements of such length and complexity must be difficult not only for external readers but also for the NEDs and maybe even the executive directors. Boilerplating, and expansion by lawyers, seems to have become the order of the day. A better way needs to be found to prioritise and summarise major risks.

7) Remuneration

Exhaustive attention is currently being paid to this topic. The whole subject of director remuneration disclosure by UK companies is already driven by the law, rather than the Code. The result is often to produce agonising detail, but to mask significance.

As a separate point, although there can presumably be no turning back now, we can all see the ratcheting effect that remuneration disclosure can have.

One point perhaps worth making is the link between on the one hand job security and satisfaction, and on the other remuneration. Much of the financial services industry operates on the basis that money is the key element in the employer/employee relationship – whereas, certainly in the past and surely with many non-financial organisations today,

two-way loyalty and collegiality avoided such an aggressive stance on financial reward and many of the problems to which this gives rise. I remember years ago, post big bang, being told by a senior man at a leading investment banks that he expected about 40% of his bankers to move post the bonus round.

8) The implementation of the Combined Code – the quality of disclosure by companies

Two points here:

- If there is to be oversight of governance disclosure, how is this to be done and who should do it?
- How is this to be applied in relation to overseas companies (to which the Code is now to be applied when premium listing is sought)?

8.1) Oversight of corporate governance disclosure

It may be quite a slippery slope for the FRC to undertake the process of identifying where explanations of non-disclosure are omitted. The mere identification of areas where there was non-compliance would be pretty box-ticking and uninteresting. Would this not, sooner or later, lead to the FRC being asked to monitor the adequacy of explanations? To date the FRC has kept out of this – which seems thoroughly wise, unless the FRC is going to develop a unit more along the lines of the Takeover Panel. A further point that occurs to me concerns the possibility that the FRC may be asked to police not only explanations that are absent, but also where a statement as to the way in which a company applies a main principle of the Combined Code is omitted.

The FRC does not currently have its own investigative capability – unlike the FRRP. However, although the FRRP now does have some role in relation to a small number of corporate governance disclosures, a full extension of the FRRP into corporate governance monitoring would not seem to fit with its current approach.

8.2) Overseas listed companies

At present, overseas listed companies (that is those outside the EU) with a primary listing in London do not have either to address their adherence to the main principles of the Combined Code, nor to comply or explain. They merely (which seems much more sensible to me) have to explain the significant ways in which their actual corporate governance practices differ from those in the Combined Code.

The FSA's Handbook Notice 92, published on 25 September 2009, changes this in relation to overseas companies that are to have a premium listing under the new regime coming into operation in April 2010 (to apply in relation to accounting periods starting after 31 December 2009). It is too early for me to be clear on the implications of this, but the fact

that the Combined Code is now to be applied in full both by UK and overseas companies will need to be thought through.

9) Engagement between boards and shareholders

I have little experience of engagement between institutional investors and listed companies on business issues – beyond annual and interim results presentations which have seemed reasonably satisfactory, so far as they have gone.

When it comes to a dialogue on corporate governance issues, as the FRC will be well aware, there is a great deal of difference in the experience of major listed companies and their smaller brethren. Smaller companies (including those in the FTSE 250) are only able in exceptional circumstances to engage on corporate governance issues with decision-makers on the investment side. Their engagement is limited to corporate governance people in the institutions, or in bodies like PIRC – thus "engaging" with people whose horizon is limited to making a judgement on the basis of corporate governance evaluation, with limited appetite for the evaluation of the business issues that is seen by the company to justify the stance taken. This is a deeply frustrating experience for those involved – as, probably for all companies, is the gap between investment/business people and the corporate governance specialists in the institutions.

However, beyond that, all I feel able to contribute to this topic is to comment that the effectiveness of the approach recommended by the Walker Review – and the ISC recommendations – will need to be seen in practice. As the Government will be experiencing, the demands made if a significant shareholder is really to perform his role effectively are very great. The institutions can direct fire-power at individual situations – but whether they are able to do that over the full generality of companies within the FTSE 100, let alone outside of it, must be questioned in the foreseeable future.

CHARLES ALLEN-JONES 9 October 2009