



London
Stock Exchange

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Dear Chris,

REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE: CALL FOR EVIDENCE

We welcome the opportunity to comment as part of the evidence-gathering phase of the FRC's review of the effectiveness of the Combined Code (the 'Code'). The Code has a direct bearing on our markets as all UK-domiciled, Primary Listed Main Market companies are required to report on their application of the Code.

The current economic conditions have tested the effectiveness of the Code and we welcome the FRC's review. However, we encourage the FRC to consider this review within the broader market context, particularly in relation to:

- the international response to the financial crisis, which is based not on an assumption that corporate governance has failed across all sectors, but instead focuses on classifying and reviewing systemic risk in certain areas of the financial sector only;
- the wide variety of companies that employ the Code, nearly half of which are smaller companies where the effect of unnecessary additional regulatory burden will have a disproportionate impact;
- the important role the Code has played in contributing to the competitive position of London as a leading financial centre and will continue to play when recession turns to recovery

Corporate governance standards within certain parts of the financial sector are currently the subject of increased scrutiny and debate. In that respect, the House of Commons Treasury Committee report, 'Banking Crisis: reforming corporate governance and pay in the City' will have an influence. However, we note that the

FRC is working closely with Sir David Walker whose review is primarily concerned with bank corporate governance and urge the FRC to remain mindful of the wide variety of companies, including smaller companies, employing the Code.

By way of context, there are 689 Primary Listed Main Market companies to which the Code directly applies. Of these, it is worth noting that the majority belong to non-bank sectors (684 companies with a total market capitalisation of £1,130 billion) and that nearly half of these companies are FTSE Small Cap and FTSE Fledgling Index constituents with an average market capitalisation of £100m. In contrast, there are only 5 Primary Listed, Main Market banks with a total market capitalisation of £168 billion.

In drafting our response we have taken into account the feedback we have received from a sample of Main Market companies outside the banking sector applying the Code. Overall, this feedback suggests that the principles-based, 'comply or explain' model works and there is no substantive evidence for wholesale changes to the Code. However, we believe there are some areas which may warrant further examination, including:

Shareholder engagement

Measures to encourage increased and direct engagement by major shareholders beyond the annual general meeting period would be welcomed. Engagement of such investors with the non-executive directors in particular should be encouraged.

Risk management

In light of challenging economic conditions, boards seem to be adapting their approach to risk management. Operational risks are extensively reviewed, but the financial crisis has highlighted the need to consider contingency planning for 'high impact/very low probability' macro risks, which may warrant further guidance.

Non-executive directors

Given the additional focus on the non-executive director role, the FRC might consider reviewing the determination of independence within the Code as a way to help expand the associated non-executive director recruitment pool and to allow more flexibility for companies with widely differing business models to balance the need for independence with the need for sector expertise. An example raised included potentially reviewing the nine-year threshold when determining whether or not a non-executive was 'independent'.

Additionally, there would seem to be merit in creating guidance as to the qualities needed for an effective non-executive chairman capable of challenging the executive directors.

Lastly, given the strategic role played by non-executive directors, the need for companies to ensure that they are properly informed in a timely fashion was

reinforced, although mandating a separate company secretariat was not supported, which would be expensive and unwieldy for smaller companies particularly.

Positioning of the Code

There is a need to reassert the Code's authority in light of certain third party interpretations, publications and commentary which have introduced confusion to the corporate governance debate.

We hope our comments are helpful. Please do not hesitate to contact me if you would like to discuss any aspect of this letter.

Yours sincerely

A handwritten signature in black ink that reads "Andrew Wallace". The signature is written in a cursive style with a horizontal line underneath the name.

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Appendix

Comments on the wider context around the review process

The wider response to the financial crisis

The G20 communiqué issued in April states that ‘major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis’. The G20 commentary is framed within the need to examine ‘systemically important financial institutions, markets and instruments’ and the Financial Stability Board has been tasked with defining those ‘systemically important’ criteria. Any review of the Code should sit within the context of an international as well as a UK response to an extraordinary financial crisis concerning organisations that pose a systemic risk, including certain banks.

Corporate governance standards within such banks are currently the subject of increased scrutiny and debate. In that respect, the House of Commons Treasury Committee report, ‘Banking Crisis: reforming corporate governance and pay in the City’ will have an influence. However, we note that the FRC will work closely with Sir David Walker’s independent review of the corporate governance of the UK banking industry, which we hope will help the FRC separate the specific remit of that review, from the day-to-day application of the principles enshrined within the Code by companies operating outside the ‘systemically important’ arena.

The wide variety of companies employing the Code and the impact of change on smaller listed companies

The distinction above is important in ensuring that any recommendations arising from the Walker review, which is primarily concerned with the banking sector, do not automatically translate into blanket proposals to alter the Code for all companies subject to it. This is especially important for smaller listed companies for whom major changes to the Code may have a disproportionate impact.

By way of context, there are 689 Primary Listed Main Market companies to which the Code directly applies. Of these, it is worth noting that the majority belong to non-bank sectors (684 companies with a total market capitalisation of £1,130 billion) and that nearly half of these companies are FTSE Small Cap and FTSE Fledgling Index constituents with an average market capitalisation of £100m. In contrast, there are only 5 Primary Listed, Main Market banks with a total market capitalisation of £168 billion.

We are therefore pleased to note the FRC’s commitment to conducting a regulatory impact assessment as part of any future consultation on proposed Code alterations, especially as the universal feedback from our small- and mid-cap issuer community (including that at the roundtable on the 20th May at which the FRC was represented) is that the Combined Code continues to work well.

The importance of the Code in contributing to the competitive position of London as a leading financial centre

While we support the need to review the efficacy of the Code in the context of the financial crisis, there remains a need to look to the future and to ensure that we protect the international competitiveness of London's capital markets.

The Combined Code has had an important role in building London's competitive position. The UK's approach to principles-based, comply or explain corporate governance is internationally recognised as a successful one. The risk from increasing prescription within the Code is to create unforeseen consequences, as occurred with Sarbanes Oxley in the US. This would be detrimental to London's competitive position and in any case, such a rigid regime has not been immune to the current financial crisis.

It will be important to reinforce the UK's approach to corporate governance when recession turns to recovery. We therefore encourage the FRC to consider the longer term impact when assessing the need to make wholesale changes to the Code now.

Comments regarding the questions raised within the call for evidence

Which parts of the Code have worked well? Do any of them need further reinforcement?

In terms of improving the operation of the Code, a common concern companies have raised is that there are too many third party interpretations of the Code, which attempt either to apply their own specific version or even 'gold plate' the Code with additional requirements covering areas such as corporate and social responsibility, ethical or environmental considerations. We believe the operation of the Code would be improved by the FRC reasserting the authority of the Code in light of certain third party interpretations, publications and commentary which have introduced confusion to the corporate governance debate without necessarily suggesting any improvements.

Have any parts of the Code inadvertently reduced the effectiveness of the board?

We have no feedback that suggests this.

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

We have no feedback that suggests that there are any aspects of good governance practice not currently addressed by the Code or its related guidance that should be.

Is the ‘comply or explain’ mechanism operating effectively and, if not, how might its operation be improved? Views are invited on the usefulness of company disclosures and the quantity and quality of engagement by investors

Feedback from Main Market companies suggests that the principles-based, ‘comply or explain’ approach of the Code continues to work well and should be preserved. The Code appears to maintain the right balance between shareholders’ need to illuminate the operation of the board, with the board’s need to focus on creating value for shareholders within a flexible corporate governance framework. Overall, it is the flexibility of the Code in its current form that is allowing companies to adapt its application according to economic and market conditions.

Companies are keen to ensure that the debate around the Code is contained within the context of the international response to the financial crisis which focuses on systemic risk within the financial sector. They are also keen to guard against an unrealistic expectation that the Code can prevent failure, entirely remove risk or guarantee success.

Companies have cited the need to guard against creating excessive prescription within the Code, which may encourage a ‘box-ticking’ approach by users when assessing levels of compliance. Additionally, the Code must preserve its flexibility as a corporate governance framework that can be applied by a smaller company operating in the UK market and a large company operating a global business model from the UK. Excessive prescription within the Code may reduce its flexibility in this respect.

Whilst feedback suggests that the ‘comply or explain’ mechanism operates effectively, companies would welcome any efforts to ensure more appropriate interpretation of explanations where non-compliance is concerned.

Non-compliance with Code provisions should not mean a failure in corporate governance standards within a company. There may be sound business reasons for being unable to comply, and companies must provide a suitable explanation. However, some third parties appear not to examine the mitigating circumstances for non-compliance. This approach leaves the market with the wrong impression of the company’s corporate governance standards, and suggests that the explanation provided is invalid. Companies would like to see voting agencies in particular take a more proactive role in interpreting explanations for non-compliance.

Comments concerning the content of the Code

The composition and effectiveness of the board as a whole

Companies are aware of the need to ensure the maintenance of a balanced and effective board, recognising that board evaluation (including peer evaluation)

offers the opportunity to improve board effectiveness at the margins and so should be encouraged.

However, whilst the importance of board evaluation is understood, companies are not in favour of obligatory, independent reviews, which they consider to be counter-productive and could have the unintended consequence of driving decision-making away from the board.

Companies do not consider that charging different factions of the board with separate tasks concerning elements of Code compliance would be appropriate. This was rejected as potentially divisive and undermines the notion of the unitary board structure.

The respective roles of the chairman, the executive leadership of the company and the non-executive directors

Companies are aware that the role of the non-executive director is subject to increased scrutiny and have raised two areas worthy of further examination where the Code and surrounding guidance is concerned.

Given the additional focus on the non-executive director role, the FRC might consider reviewing the determination of independence within the Code as a way to help expand the associated non-executive director recruitment pool and to allow more flexibility for companies with widely differing business models to balance the need for independence with the need for sector expertise. The determination of 'independence' within the Code provisions, which includes a suggestion that a non-executive director with more than nine years' service should not be deemed independent, is one aspect cited as having potential for review.

Additionally, there may be merit in creating guidance as to the qualities needed for an effective non-executive chairman capable of challenging the executive directors. However, feedback from companies suggests that the qualitative assessment of a non-executive director for a role at a particular company should be the preserve of the company concerned and there was no appetite for creating specific non-executive director qualifications.

The board's role in relation to risk management

In light of challenging economic conditions, boards seem to be adapting their approach to risk management, focusing more closely on their risk assessment process and associated internal controls. Feedback suggests that separate work on integrating the remuneration considerations with the risk management process within FSA regulated organisations is naturally being applied by non-financial institutions as a matter of course.

However, whilst operational risks are extensively reviewed and appropriate systems and controls put in place, the financial crisis has highlighted the need to consider contingency planning for 'high impact/very low probability' macro risks and this area may warrant further guidance.

Once again, companies are keen to avoid creating unrealistic expectations for the risk management process and raise a concern that imposing excessive prescription within the Code on this area would inhibit what should be an iterative process.

The role of the remuneration committee

Feedback suggests that there is no particular need to re-examine the remuneration committee's role or its effectiveness. Companies recognise that the subject of remuneration is under increasing scrutiny and note the interventions of shareholders in the debate around remuneration policy when deploying their vote on the subject in the annual general meeting. There was no support for introducing additional prescription in the Code on this area.

The quality of support and information available to the board and its committees

Given the strategic role played by non-executive directors, the need for companies to ensure that they are properly informed in a timely fashion was reinforced, although mandating the need for a separate company secretariat was not supported, which would be expensive and unwieldy for smaller companies in particular.

The content and effectiveness of Section 2 of the Code, which is addressed to institutional shareholders and encourages them to enter into a dialogue with companies based on mutual understanding of objectives and make considered use of their votes.

Feedback we have received suggests that measures to encourage increased and direct engagement by a wider shareholder constituency beyond the annual general meeting period would be welcomed by companies.

Companies note that engagement with the larger shareholders tends to be regular and productive. However, companies appear to have difficulty in encouraging those bodies representing minority investor interests, such as voting agencies, to engage with them regarding application of the Code. Equally, interaction with a wider class of investors may not extend beyond the annual general meeting or 'crisis periods'.

There is support for encouraging investors to increase their engagement with non-executive directors and a suggestion that investors could play a more proactive approach here.

Companies require flexibility regarding investor liaison, noting that there is a distinction in approach between short-term and long-term investors, which have different aims and levels of engagement. Equally, companies have expressed difficulty in reconciling the needs of fund managers and those of the corporate governance manager within the institution concerned and would welcome more meaningful integration of the two roles so that they can better satisfy the requirements of each.