

Mr C Hodge
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Dear Mr Hodge,

Combined Code Review

We welcome the opportunity to respond to the Review of the Effectiveness of the Combined Code.

It is our belief that good governance practices underpin the operation of companies in a responsible and sustainable way for the benefit of shareholders and other stakeholders. The Combined Code has provided a flexible and meaningful framework of good governance for listed companies, for Boards to consider, together with investor guidelines, and be judged upon under the 'comply or explain' principle. We do not believe that the 'comply or explain' model is fundamentally flawed and this forms the basis of our observations on and suggestions for aspects of the Code that could be updated and, where necessary, strengthened.

We do not believe that the governance issues that have arisen in relation to certain banks and other financial institutions should lead to either a radically different approach to the application of the Combined Code or the same solutions being applied to all companies that are now being discussed in the context of the financial services sector, as many of those issues are purely banking industry related. It is our belief that, whilst the Walker Review may make recommendations that some will argue should be applied to all listed companies, its focus is and should be seen in the context of the review of the banks.

Furthermore neither do we believe that a 'knee jerk reaction' to current issues or strict statutory regulation will improve corporate governance. It is our belief that such regulation is inflexible and is less likely to develop with best practice over time. In addition, it should be noted that regulation of this type rarely allows for non-compliance by a company even where there may be sound reasons for this.

Issues for comment

We note the questions raised in the Review and respond as follows:

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

It is our belief that most parts of the Code have worked well where the culture of the company is one of considering the Code as part of its wider governance considerations. For example, at National Grid, governance is not just a matter for the Board of Directors but is seen as part of a wider framework, for example, through various company wide policies and procedures covering, standards of behaviour, ethics, safety and environmental issues.

Areas where perhaps the Code has worked particularly well are in the increased use and development of director induction programmes and annual performance evaluations; both of which have arguably improved Director and Board performance.

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

Whilst we do not believe the Code either in whole or in part has reduced the effectiveness of the Board, it is conceivable that Directors have become somewhat accustomed to the Code and consequently may not review it regularly; potentially reducing awareness of its contents over time. An additional disclosure could therefore be included requiring the Board to confirm that it has formally reviewed the contents of the Code during the year. This would be in addition to the confirmation of compliance with the Code and reasons given for non-compliance.

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

The following are areas that we would consider to be good practice that could be included or clarified in a revised Code:

- The need for Boards to have a sufficient level of skills and experience has never been more apparent. Each year either the Nominations Committee or the Board as whole should review these for each Non-executive Director to confirm that they remain appropriate in order to effectively discharge their role. We would also refer you to the separate letter on the Review submitted to you by Sir John Parker, Chairman of National Grid;
- Non-executive Directors should ensure that they have sufficient time to undertake their role and their remuneration should be a reasonable reflection of the requirements of that role;

- Each company should not only disclose in the Annual Report the number of Board meetings held during the year it should also provide a clear explanation why that number of meetings is appropriate. Supporting this, a summary of the matters considered by Board during the year should also be disclosed so that shareholders can receive assurance the Board is sufficiently focused on the material issues facing the company;
- The understanding of and response by Boards to changes in the risks faced by companies has become an area of significant focus. Companies should ensure that there is oversight of all their key risks either by the Board directly or through appropriate Board Committees reporting regularly to the Board. This should be disclosed in the Annual Report along with significant changes in the company's risk profile during the period;
- The Chief Executive should not become Chairman. In the event of a Chairman standing down or being removed the successor should be chosen from a Committee led by the Senior Independent Director or other independent Non-Executive Director; and
- A separate Assurance Statement should be provided by the Chairman of the Board or the Chairman of the Nominations Committee. This statement should confirm the effectiveness and fitness of the Board to fulfil its role. Such statement should aim to ensure that the right blend of skills and experience are present on the Board. A separate letter from the Chairman explains this further.

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.

We believe that the comply or explain mechanism is an effective system to allow companies to have a degree of flexibility over their own arrangements which, whilst not being deemed as 'best practice' are regarded by the company as being appropriate for them in their circumstances. Investors have the opportunity to review disclosures in the Annual Report (or earlier through engagement with the Company) and, if they do not agree, can express their concerns accordingly on the AGM subject matter.

We note that the FRC would particularly welcome views on:

The composition and effectiveness of the board as a whole;

Within the unitary Board, the oversight and challenge role of the Non-executive Directors should be clear. The proper forum for detailed oversight

on a range of topics should be the Board Committees, made up of non-executive Directors, such as the Remuneration, Audit and, where appropriate other committees. The Board meeting is the forum for the consideration and approval of strategy. This is where non-executive Directors can bring to bear their considerable knowledge and where management are held accountable for executing strategy and delivering on financial performance.

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

The roles of the Chairman to lead the Board and the Chief Executive along with Executive Directors to lead the Company are clear but we query whether the role of the Non-executive Director is as clear as it could be encompassing both an oversight role and strategy debating and approval role. Please see our earlier comments regarding the appropriate forums for these two roles. We do not advocate a two tier Board system with a separate supervisory Board as found in some countries.

The board's role in relation to risk management;

The Board has overall responsibility for risk management. As mentioned earlier, all significant risks should be subject to effective oversight by the Board or its Committees and the important changes in the company's risk profile over the year should be disclosed.

The role of the remuneration committee;

The Remuneration Committee's principal role is to determine remuneration policy and the remuneration packages for the Chairman, Chief Executive, other Executive Directors and direct reports to the Chief Executive. It should seek to balance the need for remuneration to be motivating for senior executives but not excessive while being closely aligned with company performance. Remuneration Committees should ensure that director's contracts and, in particular, severance arrangements do not reward failure. In addition, Remuneration Committees should ensure that the balance of salary, short term bonus and longer term remuneration does not over emphasise short term performance to the detriment of the long term success of the company.

There should also be transparency around the employees who are material to the company below Board level with the Remuneration Committee having appropriate oversight of their remuneration.

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

The roles and quality of the Chairman and Company Secretary are of vital importance to these issues with the Company Secretary providing additional advice and support to the Non-executive Directors on governance matters. In addition, the Company Secretary can provide support for the Chairman in his role in ensuring that leading governance and compliance is embedded in the Boardroom of the Company. More prominence could be given to this role and we would suggest that the annual Board Performance Evaluation includes the Company Secretary and these issues.

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 a mutual understanding of objectives and make considered use of their votes.

It is sometimes surprising that voting is not significantly higher or that investors do not enter into a dialogue with companies sooner on issues of concern. We would query whether investors should, as best practice, inform companies where they intend to vote against proposals in order that discussions may take place. In addition, although part of the Code, we have seen little indication that major shareholders attend AGMs. They thereby miss the opportunity to discuss issues with the whole Board of Directors and to increase the value to both the company and to smaller shareholders of holding the AGM.

Thank you again for the opportunity to respond to the Review.

Yours sincerely

Helen Mahy
Company Secretary & General Counsel