

FINANCIAL REPORTING COUNCIL

CALL FOR EVIDENCE

FOR THE REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE

1. The comments below are from Pinsent Masons LLP, a top 15 UK full service commercial law firm, acting for private and public sector clients worldwide. They have been drafted by Martin Webster, the head of our corporate governance unit within our Corporate group which comprises 43 partners and more than 100 other lawyers. The latest Hemscoff guides put us fourth among law firms for the number of fully listed clients and second for AIM clients. The firm was voted Legal Firm of the Year at the Real Business/CBI FDs' Excellence awards in May 2009.
2. We are not responding to all of the issues you have noted in your March 2009 Call for Evidence and will instead confine our comments to specific points we have noted in the period since your last review of the Code.
3. As a general point, we do not believe that there is anything fundamentally wrong with the provisions of the Combined Code or the way it has operated. We are not of the view that problems in the financial sector in the last year have been caused by shortcomings in the Code, or that they could have been prevented by changes to the Code. To suggest otherwise would be to offer a rather simplistic solution to a very complex series of problems. We do not, therefore, believe that a review of the Code should start from the assumption that it is necessary in order to fix perceived problems in the financial or corporate sector.

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

4. An over-emphasis on risk can reduce the effectiveness of a board. The board of directors of a company are there to oversee the management of the business. That is not solely a matter of identifying and assessing risk and seeking to mitigate its effects, however important that one role may be. Rather, their responsibilities encompass strategic direction and supervision of management. If they spend too much time on risk, they can spend too little on these other areas. A workable balance is required.

The composition and effectiveness of the board as a whole

5. There is a tendency (perhaps following the US example) for boards of directors largely to comprise non-executives, with only the chief executive and finance director as executive members. This seems to risk divorcing the board from the day to day management and operation of the company and perhaps encourages directors to concentrate too much on theoretical issues as opposed to how the business makes its money. A board is more likely to understand the business of the company if it has managers among its members who are present at regular board meetings to be challenged on what the company is doing and to provide explanations in response to questions put to them. Not having that executive presence on the board risks isolating the directors from the every day business of the Company. It can also isolate the few executives who are on the board, so that there is less of "team atmosphere".
6. We would therefore advocate some guidance in the Code on the balance to be achieved on a board between executive and non-executive directors. We do not favour prescriptive rules, but would welcome some reinforcement of the concept of a unitary board made up of a balance of executive and non-executive directors, as opposed to a large number of non-executives to whom a few executives are held answerable at infrequent board meetings.

Is the "comply or explain" mechanism operating effectively?

7. We believe strongly that the comply or explain regime is the correct mechanism by which the Code should operate. Compliance with the Code should remain, essentially, voluntary, with strict disclosure and transparency requirements so that shareholders can easily judge the position and make their views known if they need to.
8. But there are two areas where further guidance in the Code may help. First, it should be emphasised that the Company's obligation is to make its position on compliance with the terms of the Code transparent. If a Company does not comply, it should have the courage of its convictions to explain why and to face any opposition from shareholders. Having done that, the Company should not be criticised for any supposed breach of the Code. If it explains its non-compliance in sufficient detail, the Company has indeed kept to the terms of the Code and it is wrong for shareholders (or those who advise them on voting) to suggest that they are in breach.
9. The second point is that, having made full disclosure of a Company's non-compliance, it is for the shareholders to take action if they do not like what is happening. Too often in the past it has seemed that shareholders have voiced unhappiness with board decisions but failed to put sufficient pressure on the Company or to vote against proposals when they have the opportunity. If there have been failures in corporate governance in the last few years, it has often seemed to be failures on the part of shareholders rather than Companies or their boards.

The role of non-executive directors

10. We would make a brief point under this heading which is that the role and duties expected of non-executive directors cannot be satisfied by an individual who has heavy and demanding responsibilities in another full-time job. It seems to us unrealistic that, for example, a finance director or chief executive of a large company can at all times guarantee to devote sufficient time and scrutiny to the affairs of another company on whose board he serves as a non-executive director. He may bring many valuable qualities and much experience to the role, but at times of crisis he will not be able to devote sufficient time to both roles and one (if not both) will inevitably suffer.
11. The same point would apply to a non-executive director who has many other non-executive posts.
12. We also think it inevitable that non-executive directors, if they are to be asked to devote more time to the board on which they sit, will need to be paid more than has been usual with most companies to date. Current fee levels do not seem to us to be realistic given the level of responsibility and the commitment which is expected of these directors.

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

13. We believe that the support given to directors in holding management to account is key. Consideration should be given in the largest companies to enhancing the company secretariat so that it can serve as a real resource for non-executives to probe and to challenge information given to them by the executives. It may be that a few companies are doing this already, or that the internal audit function can be expanded to provide this service. Although one does not want to create an alternative powerbase within a company, we see real value in giving non-executives the ability to test information and investigate questions independently of the company's management.
14. The position of the company secretary is also of crucial importance. That role needs to be strengthened and its key status must be emphasised. Except perhaps in the

case of the smallest companies, best practice should not be to combine the job with that of finance director or another senior executive position. The company secretary needs to have a degree of independence in the role, especially when advising the non-executive directors, and that is difficult to achieve when the occupant of the office is also an executive director.

If you have any queries on the points made above, or require any further comment, please do not hesitate to contact Martin Webster on 020 7418 9598 or martin.webster@pinsentmasons.com or at Pinsent Masons LLP, CityPoint, 1 Ropemaker Street, London EC2Y 9AH.

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May 2009