INTEGRITY SOLUTIONS (UK) LIMITED

COMMENTS AND INPUT INTO PROPOSED CHANGES TO THE COMBINED CODE
MAY 2009

PREAMBLE

The contents of the herein proposed amendments to the Combined Code as a primary source of governance in the United Kingdom are based upon a number of observations, namely:

Our own years of global experience after many years in the governance advisory and services industry;

The opinions and experiences of other global bodies such as the ICGN and the UNPRI;

The review, reports and opinions of other leading experts and commentators in the field of governance, and finally

The media and the views and opinions expressed by commentators and reporters specializing in the field of governance.

In summary our analysis of the above has brought us to some main conclusions, namely:

1. The collapse of the financial sectors and its concomitant effect on global economies has shattered the public's confidence in capital markets, companies and management. To have some chance of rectifying this situation, and the alternative to self-regulation - namely over-regulation – it's imperative for corporates not only to re-affirm their commitment to sustainability issues such as values, ethics, community and the economy, but to provide concrete evidence of the same. This is an imperative, not only to restore trust, but as a sine qua non for the sustainability of organisation in a globalised economy;

2. Other than the above, with the rare exception, we do not think that the reasons for governance failures lie so much with the Principles of the Combined Code itself, but rather with the implementation of the same. In this regard, of concern is the complete lack of access by Boards to tools that facilitate and enhance their ability to measure and monitor governance and management as well as to benchmark and

report on the same. Shareholders are similarly handicapped through a lack of effective means to gauge the levels and effectiveness of governance in companies;

3. Suggested enhancements to the Principles are in the areas of Board composition, risk management, remuneration

We have intentionally tried to keep our comments and suggestions as brief and concise as possible. We have not submitted comments on possible changes to the accounting standards as we did not consider the same to form part of the submission requirement.

Whilst we do not presume to have all the answers or solutions to the current crisis facing world economies or than of the United Kingdom specifically, we trust that our suggestions may be of some assistance to the Financial Reporting Council as it seeks to review the Combined Code and the Principles enshrined therein.

A. NEW PRINCIPLE A7:

The Board is responsible for identifying and integrating sustainability issues into corporate strategy and management systems.

Sub Principles:

- Approve and review annually a Code of Conduct for the Board
- Approve and review annually a Code of Ethics for group
- Monitor the enterprise-wide implementation of corporate values by management
- Include report by a Director in the annual report on the group's progress with regard to the enterprise-wide implementation of values
- Consider forming a Committee to formulate, develop and recommend policies for the following areas:
  - ✓ Corporate social responsibility programs
  - ✓ Environmental policy
  - ✓ Ways to report effectively with regard to both issues

MOTIVATION:

The global financial crisis has resulted in another crisis of confidence in the capital markets, management's integrity and the effectiveness of self-regulation. The collapse of once sound financial institutions has struck at the very heart of the public's confidence in markets and management. As an alternative to over-regulation, companies need now, more than ever, to send a strong signal that they have learnt from their mistakes, are fully reformed and are committed to taking the community's interests to heart in all future management decision making. This is not only a necessity to restore confidence, but is an internationally recognised requirement in the continuity, longevity and sustainability of any corporation in the global economy.

B NEW SUPPORTING PRINCIPLES:

1. *Supporting Principles to Main Principle A1:*

The Board is responsible for proper oversight of risk management systems, controls and processes throughout the organisation. In this regard it should;

- Ensure regular and reliable Information flow to Board
- Establish Risk Committee (recommended for financial institutions)
- Set and monitor the group's Risk Appetite
- Prepare a meaningful Statement on risk management systems and monitoring in AR

MOTIVATION:
A recent OECD Report[1] (the 'Report') concluded that 'risk management systems have failed in many cases due to corporate governance procedures...'; 'information about (risk) exposures in a number of cases did not reach the Board and even senior managers, while risk management was often activity rather than enterprise-based; and finally, ' … systems in place for monitoring and managing risk left a lot to be desired.' While the principle of the Board being responsible to risk oversight and monitoring does appear in the Combined Code, under the circumstances, it would appear prudent to elaborate and highlight this principle.

[1] ('The Corporate Governance Lessons from the Financial crisis' by Grant Kirkpatrick, OECD 11 February 2009)

2. ***Supporting Principle to Main Principle A3:***

With regard to companies trading in the financial sector, the classification of Independent Financial Expert should also be included for Director classifications accompanied by a brief explanation of the criteria applied for the classification.

MOTIVATION:
The Report[2] highlighted, as another reason for governance failure, the 'potential weakness in board composition.' In a number of local bank failures the lack of banking experience and qualifications was apparent in all the failed institutions. To what extent the lack of such experience or qualifications contributed to each institution's demise may be debatable, but, if nothing else, logic and perception alone would indicate a need to highlight this shortcoming. Some, such as Lord Myners[3] and Nestor Advisors have highlighted that the 'most important problem of boards is the weak capacity of its directors to understand investment banking.'

3. ***Supporting Principles to Main Principle A4:***

The Nomination Committee should ensure that the Board has sufficient members with the requisite technical skills and expertise as appropriate for the company's particular industry sector.

The Nomination Committee should agree and recommend the maximum appointments an NED may hold at the same time. This recommendation, as approved by the Board, should be published in the annual report.

The Nomination Committee should determine and agree the retirement age of Directors and publish the same in the annual report.

MOTIVATION
The need for the requisite skills at Board level has already been mentioned. In the financial sector particularly, there would appear to be a need for those with financial expertise particularly as applied to risk management. This was supported by survey colleagues, Nestor Advisors[4] , highlighted 'inexplicably low levels of expertise in the boards of some of the most complicated businesses in the world.' as one of the reasons for corporate governance failure.

Lord Myners[5] suggested that the heightened level of commitment expected in future from non-executive Directors will require that they devote 'more time to

[2] Footnote 1
[3] Financial Times 15 October 2008
[4] 'Governance in Crisis: A comparative case study of six US investment banks', NeAD Research Note 0109/April 2009-05-26
[5] Financial Times 5 April 2009

the activity than they have in the past.' By definition, this will mean less capacity to sit on too many other boards.

The Nestor Advisors survey found that the age of members of the Boards of Bear Sterns and Lehman Brothers boasted an average age of 67.9 and 69.4 respectively and concluded that 'there seems to be a discernable relationship between age and failure.' There often appears to be a point where an ageing board might present a 'significant risk'. The same clearly applies to the local scene as Lord Myners [6]was quoted as saying ' they typical bank board resembles retirement home for the great and good: they are retired titans of industry, ousted politicians and the occasional member of the voluntary sector. If such [an approach to] selection, more likely to be found in Debrett's Peerage than the City pages, was ever good enough, it is not now.'

4. ***Supporting Principle to Main Principle A5:***

The Chairman should ensure that relevant, reliable and timely information is received by Directors – especially in regard to risk management and oversight issues. For this purpose, the Board and Company Secretary should actively support the use and application of appropriate tools as a means to facilitate the distribution of relevant information timorously and effectively permitting ready access without the necessity of waiting for a Board of Committee meeting to be called.

MOTIVATION:
The Report [7] concluded that 'information about (risk) exposures in a number of cases did not reach the Board and even senior managers' and as a result some Boards were not aware of the looming collapse of the company. Furthermore, informal studies conducted by MIT and Accenture Research in the USA, in collaboration with Prof Stephen Davis of the Millstein Center for Corporate Governance and Performance at the Yale School of Management found that there was a complete dearth of tools available to non-executive Board members by which to monitor management performance and/or gain access to corporate information. It follows that the sooner Boards know about material risk issues, the sooner they can take mitigatory action.

[6] Ibid

[7] Footnote 1 above

5. ***Supporting Principle to Main Principle A6:***

The annual Board and Committee evolutions should include a rigorous evaluation of the Charter / Remit of the Board and of each Committee including the effectiveness of the flow and reporting of information from management to the Committee and from there to the Board.

The Board / Committees should actively seek to support the implementation of tools that facilitate such flow of information to the board and provide ease of access to the same by Directors.

MOTIVATION:
In the light of the governance failures highlighted in the Report – particularly regarding risk management and the Board's inability to pick up on failures in risk management issues and remuneration – the necessity for more rigorous assessments of Board Committees and their effectiveness, not to mention the Board itself, would appear to be timely and appropriate. 'Competence and board dynamics must be tested thought independent evaluation, and the process for this should be evident to the market.'[8]

6. ***Supporting Principles to Main Principle B2:***

B.2.2 The definition of 'senior management' should be extended beyond the current recommended definition – especially in areas where large sums of bonuses are (or are likely to be) paid out.

Shareholders need to approve all bonus schemes as well – especially where the same are likely to result in substantial payments annually.

Bonus and incentive structures should be linked to risk and should not be short-term orientated.

All group remuneration schemes should be considered and monitored annually by the Audit or Risk Committee.

MOTIVATION:
The Report concluded that many of the excessive bonuses paid out were to members of staff below first line executive level. Secondly, in many instances (e.g. UBS bank in Switzerland) bonus structures had no downside and unlimited upside with no consideration to the risks of the underlying transactions or the long term benefits of the same. Whilst it may be difficult to know where to draw the line, it

[8] ICGN Second Statement on the Financial Crisis dd 23 March 2009 para 5.1.2 page 4

should be possible to determine – if only from past records – which structure paid the most and highest bonuses and to use that as a yard-stick.

Finally, due to the complexity of some schemes and as part of the 'stress testing' the Report suggested that Audit/Risk Committees to assess the levels of possible exposure for the company.

7. *Supporting Principles under Accountability and Audit Section C2:*

The Board is responsible for the oversight of risk management systems, controls and processes enterprise-wide.

The Board is responsible for determining the group's risk appetite and for ensuring that management implements the same in all major business trading activities.

The Board must ensure that it identifies the main risk areas and that the same are regularly monitored by management.

Management and the Risk/Audit Committee should submit regular reports on the level of risk exposure on already identified areas of risk as well as any new potential risk areas.

The Board should support the adoption of tools to facilitate the free flow of risk management information to its members.

MOTIVATION:

Although the Combined Code does refer under Principle A1 to Non-executive Directors having to 'satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible,' for reasons set out above, it is submitted that there is a need to highlight and elaborate on the Board's responsibility for risk management oversight and monitoring in particular, due to the failure of Boards to give this area proper attention in the past.

8. *Supporting Principles to Main Principle C.3.2:*

The roles and responsibilities of the Audit Committee to include:

Ensuring the free flow of internal controls and risk management information to the Board;

Monitoring risk aspects of the group's remuneration policies – particularly regarding incentive structures;

Particularly in companies operating in the financial sector, Audit Committees should have at least one member who is classified as an Independent Financial Expert.

Stress testing to the groups' risk management systems, processes and models and reporting the results to the Board.

MOTIVATION
From our own experience in practice, supported by the results of the Report[9] and the results of Nestor Advisors Survey[10] , there is a preference in the financial sector for Boards to have a separate risk Committee. However, where this responsibility is allocated to the Audit Committee, its responsibility to monitor and report on the same should be included in its remit. Secondly, we have mentioned above the recommendation for the Audit/Risk Committee to review the remuneration incentive schemes recommended by the Remuneration Committee and in the light hereof, a reference to this duty should be include in the appropriate Committee's remit as well.

Finally, the issue of stress testing risk management systems through different scenario planning and assumptions was one of the outcomes of the Report. Such tests were recently also applied to all the banks in the USA to test their capital adequacy levels. Regular stress testing of internal risk management models will hopefully help to highlight shortcomings or incorrect assumptions as so assist Boards in identifying problems earlier rather than later.

9. Supporting Principle to Main Principle D:

The Chairman should investigate and encourage the implementation of appropriate tools that facilitate the communications between the company and shareholders, particularly in the areas of governance and strategy. In this regard, the ability to provide benchmarked results is particularly useful.

MOTIVATION
See comments above regarding the access to Non-executive Directors to appropriate tools to facilitate access to information and act as an aid in monitoring.

[9] Footnote 1 above

[10] See reference above

*10. **Supporting Principle to Main Principle D2:***

D.2.3 Include 'Risk Committee' to list of committees whose Chairmen should attend the AGM.

MOTIVATION
Self-explanatory.

11. Additions to the Disclosure requirements:

In the light of the above recommendations the following additions to disclosure requirements in the annual report are recommended:

Which Directors are classified as Independent Financial Experts and the criteria used to determine the same;

A Directors' report on progress with regard to implementation of Code of Ethics enterprise-wide;

A Directors' statement on their responsibility for implementing, monitoring and reviewing risk management systems; steps taken to implement the same enterprise-wide, and to facilitate information flow; any material issues and actions taken to avoid re-occurrence; regularity of review of systems; results of stress testing;

Improved disclosure on the implementation of governance architecture and the implementation of good practice; tools utilised to measure and monitor the same; benchmarked results against industry peers;

Expanded reporting on the results of the Board and Committee Evaluations, what major outcomes arose, changes to Terms of Reference arising out of the evaluations and steps taken to attend to any material issues;

Results of the Risk/Audit Committees review of the group's remuneration schemes.

Tools needed:

- equip boards, management and stakeholders
- i.e. to enhance the implementation of the existing and adapted Principles and good governance - 'It is vital that regulatory reform enhances

> corporate governance solutions and does not aggravate existing weaknesses' (*ICGN Second Statement on the Global Financial Crisis dd 23 March 2009*)

SHAREHOLDERS

Not all shareholders have the capacity or resources for effective oversight of management. They should therefore be encouraged to support the development and implementation of standardised tools capable of measuring and reporting on agreed areas of governance with the ability to benchmark the same against industry and sector standards.

The ICGN stresses 'the importance of institutional investors addressing their conflicts of interest, ensuring balance in their own governance structures, allocating proper resources to governance oversight and recognising their own accountability to their end-beneficiaries who are individual savers and pensioners.' (*ICGN Second Statement on the Global Financial Crisis dd 23 March 2009*). Furthermore, the ICGN in its recent guideline for investors[11] states that 'shareholders should take governance factors into account and consider the riskiness of a company's business model as part of their decision-making. Governance should not be a parallel activity. It needs to be integrated into investment.' How is this to be achieved without the use of appropriate tools and benchmarking?

REGULATORY FAILURE:

Given the failure of the regulatory authorities to properly identify possible risk and/or problem areas and to act on them, there is clearly a need to find a means to measure, monitor and benchmark levels of implementation, particularly in core industry sectors e.g. financial sector. 'Central banks and regulators did not respond decisively when they realized that markets were mispricing risk. They allowed banks to operate with too little capital, with excessive leverage and too little attention to liquidity risk. They failed to pick up on poor risk management by boards and on poor lending practices in the mortgage markets.' (*ICGN Second Statement on the Global Financial Crisis dd 23 March 2009*)

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[11] Second Statement on the Global Financial Crisis dd 23 March 2009