By email: codereview@frc.org.uk

Mr Chris Hodge
Corporate Governance Unit
Financial Reporting Council
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16 June 2009

Dear Mr Hodge

Review of the effectiveness of the 2008 Combined Code - March 2009

GC100 is the association for the general counsel and company secretaries in the FTSE 100. There are currently over 120 members of the group, representing some 90 issuers.

The GC100 welcomes this opportunity to respond to the FRC's review of the effectiveness of the 2008 Combined Code ('Code'). The members of the GC100 have carefully considered the impact and effectiveness of the Code and are pleased to provide their following thoughts and recommendations based on practical experience of dealing with the Code on a daily basis and against the background of the current perceived failures of governance in the financial services sector.

You will be aware that the GC100 fully supported the sensible and modest changes to the Code implemented following the last review. We feel that a period of relative stability without further significant changes would allow companies to fully 'bed-in' the existing provisions. The GC 100 does recognise the clear challenges from the recent crisis. This presents opportunities for the Code to evolve in certain important areas. Boards can evolve their behaviours so that the governance system defined by the Code can work well, have the confidence of shareholders and the public alike and provide for a high performing board. This may be better achieved through additional best practice guidance than through substantial change to the principles in the code.

There is not a case for "bright line" regulation.

Dialogue with Shareholders

This lies at the heart of the system of governance described by the code. This dialogue can only take place effectively if there is a clear understanding by both the owners and the company on the scope of disclosure and reporting.

Companies need to understand and accept the legitimate expectations of the shareholders

as owners. Shareholders must have the resource and time for disclosures and reports to be properly considered and evaluated. It is important that non-compliance statements given by companies should provide investors with the necessary information that they require to evaluate the companies' corporate governance arrangements. Investors and governance bodies alike should take a positive approach when reviewing governance reports and areas of non-compliance with the Code. We firmly believe that the Code's explanation regime will work well as long as the above points are reinforced and followed. This will only work if companies and their investors enter into a dialogue at the appropriate time.

The GC100 believes that a different emphasis in language will assist companies, investors and governance bodies including voting advisory services to maintain a healthy dialogue regarding the explanations given. We therefore recommend that 'comply or explain' be changed to 'apply or explain'.

In this respect, we believe enhanced dialogue between companies and investors would be welcome, not just around reporting times, but more generally in order for companies to explain in more detail areas of possible, or potential, non-compliance and the reasons why. Investors could equally put forward their views regarding possible alternatives/solutions which would avoid concerns around box-ticking and the generally perceived negative reaction to non-compliance whatever the reason. Any lack of understanding can sometimes lead to a stand-off between company and investor which ought to be capable of resolution through better and more informal dialogue.

Conflicts of Interest

In accordance with Section 175 of the Companies Act 2006, directors have a statutory duty to avoid conflicts of interest. This provision, which came into force on 1 October 2008, states that *a director must avoid a situation where he/she has, or can have a direct or indirect interest that conflicts, or may conflict with the company's interests.* The Companies Act 2006 now allows directors of public companies to authorise conflicts and potential conflicts, where appropriate and where the articles of those companies contain the necessary authority. Authorisation safeguards include:

- only independent directors who have no interest in the matter being considered will be able to take the relevant decision;
- in taking the decision the directors must act in a way they consider, in good faith, will be most likely to promote the company's success; and
- directors will be able to impose limits or conditions when giving authorisation if they consider this appropriate.

The GC100 has issued comprehensive guidance in connection with this issue and therefore feel there is no need to consider the inclusion of a further Code provision relating to the board's consideration and disclosure of directors' conflicts of interest in line with the GC100's own guidance**.**

The Board and the Non-Executives

We would reiterate the point that independent non-executive directors have a crucial role to play in ensuring good governance within companies. The GC100 believes that the

board has an important role to play in the consideration and identification of non-executive directors' independence as defined by the Code.

Each Board should be encouraged to determine and clearly communicate the role that it plays in governing the Company and the role of the non-executives

It is important for their to be a clear understanding of what non-executives do not do as opposed to what they do.

This will enhance the understanding of the politicians and the media who frequently expect the non-executives to be involved in the management rather than the governance of the Company.

It is vital that the FRC and other regulators are at one on this topic and that they communicate that fact effectively.

In order to scrutinise the performance of management in meeting agreed goals and objectives, non-executive directors should be properly resourced. The Code already prescribes that all directors and especially non-executive directors should have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities and to enable them to actively challenge executive management. This is an important aspect of maintaining good corporate governance as a weak non-executive would ultimately lead to a one-sided board dominated by executive membership.

Again, the Board should determine how this resource should be provided either externally or internally through say the Company Secretary

It is the responsibility of the company to ensure that all directors, and in particular non-executive directors, have the necessary training (which should be on-going throughout their term of office) such that they are in a position to understand the nature of the business and the risks inherent in that business. With an ever increasing complexity of products and services offered by companies, particularly in certain sectors such as the financial services industry, it is paramount that all directors understand the complexity involved and the risks arising under differing scenarios. We do not believe that the introduction of specialists to perform this role is the right way forward. On the contrary, we believe enhanced training and development for all directors would improve the level of understanding and thereby improve the level and depth of challenge which non-executive directors can bring to the executive management.

We would like to stress that good corporate governance does not necessarily go hand in hand with good management. We feel that full compliance with provision A.6 relating to performance evaluation, should go some way to identifying and tackling issues associated with bad management. The Code provides a framework for good governance but will not be able to tackle issues associated with bad management on its own. A rigorous board/committee evaluation process is an important aspect of the Code and, if followed, should help bring some of these issues to the surface. In view of this, we would recommend that this area of the Code should be emphasised and followed by all companies. Non-compliance in this area may justifiably be questioned by investors

<u>Remuneration</u>

In line with the proposed implementation of the FSA's Remuneration Code of Practice, we feel that the Code should emphasise that any remuneration policies including bonus

payments should be consistent with and promote effective risk management within the company. The role of the remuneration committee should include the approval and periodic review of the adequacy of the company's remuneration policy. The remuneration committee should ensure that remuneration procedures, policies and practices do not have the effect of encouraging an excessive risk-taking approach by directors and senior management. The FRC may want to also consider issues associated with encouraging excessive risk-taking when setting remuneration policy for employees at lower levels in the organisation. Equally, Remuneration Committees should also have regard to the risks associated with the achievement of specific targets, whether financial, economic or otherwise, linked to annual incentive schemes and the potential cumulative effect of such targets over say a three year period. This is an area that is currently outside the remit of the traditional remuneration committee role and may need to be considered going forward.

The GC100 is satisfied with the Code's provisions relating to the overall board balance of executive directors and independent non-executive directors. The Code's provisions relating to the respective roles of the chairman, the executive leadership including the chief executive and the non-executive directors within the Code is adequate in describing the framework. It is up to the Board to put flesh on these bones and to communicate these roles clearly. Investors should be encouraged to discuss any areas of non-compliance with the company based on explanations provided.

Risk

The Board as a whole has an important role to play in relation to Risk Management, including the process through which key risks that will affect a business going forward are identified and overseeing the management of such risks. Risk Management is integral to the successful operation of all companies. Different businesses inevitably face different risks and different risk profiles. These risk and risk profiles will change from time to time depending on circumstances. As stated above it is the Board as a whole which is responsible for determining the risk appetite, articulating the risk profile and ensuring that key risks are identified and managed. We do not believe this should be seen as a separate role or responsibility and should reside with the Board as a whole. It should be up to individual Boards to decide how best to discharge their responsibility and whether to have a separate Risk Committee or to ensure that the terms of reference of the Audit Committee cover the identification and management of key risks but the Audit Committee has a key role to play in making sure that all aspects of the companies business and activities are properly maintained and adequate controls exist to mitigate those risks.

Shareholders

Section 2 of the Code will only be effective if institutional shareholders actually enter into a dialogue with companies based on a mutual understanding of objectives and then make considered use of their votes. At the moment, there is some evidence to show that this does not always happen. If shareholders review their companies' corporate governance arrangements including any departures from the Code in a pragmatic and informed manner, this area of the Code will be effective and useful to both parties. We therefore feel that this important aspect of the Code should be monitored.

We also feel that the findings of the Walker Review on corporate governance standards within the UK banking industry should be monitored to ensure that any areas for improvement within the Code are captured. We are of the opinion that the Code should stay general and not become industry specific. A consistent approach for all listed companies with the opportunity to explain any departures from the Code is, in our opinion, the best way forward.

Our considered responses to your specific individual questions are set out below:

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

   The Code works well as a framework for good corporate governance and the 'comply or explain' regime is adequate as long as it is utilised correctly by companies and investors alike. There are a couple of areas including board evaluation and remuneration committee responsibilities which could be reinforced and these are highlighted in this letter.

   The GC100 does not advocate any wholesale changes to the Code but would urge companies to follow its guidance where appropriate. The Code will only provide a framework for good governance but will not alleviate the issues caused by bad management within a company. These behavioural issues can certainly be influenced through a robust board/committee evaluation process and possibly through guidance on best practice from the FRC.

   The consideration of the independence of a non-executive director should be balanced with the skills and experience each director brings to the Board in addition to the evaluation of each director's performance. Adherence to a rigid 9 year independence rule for non-executive directors may result in valuable members of the board having to step down at the end of this period. We feel that a pragmatic approach to this provision should be taken by companies and investors alike.

   We would like the FRC to provide illustrative guidance of what constitutes 'recent and relevant financial experience' for the purposes of Code provision C.3.1. Clarity on this is lacking in the existing Code.

2. *Have any parts of the Code inadvertently reduced the effectiveness of the board?*

   The Code requires performance-related elements of remuneration to form a significant proportion of the total remuneration package of executive directors. Should we consider the length of time for measuring these performance-elements? The Code refers to long-term incentive schemes and share options but does not require any portion of the annual bonus to be measured over a period of time. Some executives can extract maximum value out of the assets of the company over short-term periods but may ignore the long-term implications of doing so? Consideration that performance conditions should not only be relevant, stretching and designed to enhance shareholder value but should also be apportioned to achieve short as well as long term value for stakeholders.

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

   We feel that the existing provisions relating to board evaluation should be strengthened for the reasons given above. The FRC may also like to consider the inclusion of a provision relating to the content and disclosure of Auditors' Liability Limitation Agreements.

4. *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*.

On the whole, we feel that the 'comply or explain' mechanism is satisfactory although this could be improved upon. The current approach implies that any explanation given by a company will be seen as non-compliance of the Code. This may lead to an incorrect assumption that the governance arrangements within the company are in some way flawed and subsequently increases the risk of a box ticking approach amongst some of the governance bodies and voting advisory services.

As mentioned earlier in this letter, the GC100 believes that a different emphasis in language will assist companies, investors and governance bodies including voting advisory services to maintain a healthy dialogue regarding the explanations given. We therefore recommend that 'comply or explain' be changed to 'apply or explain'.

We trust that the above response on behalf of our members will contribute towards the development of the Code and the overall enhancement of good corporate governance. We do not agree that the Code should be tailored to deal with the corporate governance issues associated with particular industries e.g. the banking sector. The Code should provide a consistent framework that is fit for purpose for quoted companies regardless of their industry. Finally, we would urge the FRC to cooperate with the other reviews which are ongoing in order to ensure a coordinated approach to any changes in corporate governance.

As a matter of formality, please note that the views expressed in this letter do not necessarily reflect the views of all of the individual members or their respective employing companies.

Yours sincerely
For and on behalf of the GC100

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Centrica plc

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