Financial Reporting Council

Review of the effectiveness of The Combined Code

Summary of the main points raised at meetings with the Chairmen of FTSE companies

July 2009

Introduction

1. The FRC held a series of meetings with the chairmen of companies listed on the Main Market of the London Stock Exchange between April and June 2009 to hear their views on the impact of the Combined Code in particular and developments in corporate governance generally. Invitations were sent to the chairmen of all FTSE 100 companies and to 100 chairmen of FTSE 250 and Small Cap companies.

2. Seven meetings were held with chairmen of FTSE 100 companies. In total 54 chairmen participated, representing 57 FTSE 100 companies. Six meetings were held with chairmen of FTSE 250 and Small Cap companies. In total 35 chairmen participated, representing 41 companies. The meetings were held under Chatham House rules, but the main points from the discussions are summarised in this note.

The overall impact of the Combined Code

3. All FTSE 100 participants and the majority of those from FTSE 250 and Small Cap companies considered that the Combined Code had had a broadly beneficial effect and remained fit for purpose, and its relative lack of prescription was seen as a strength. A number of participants who had chaired newly listed companies, or companies in a turn-around situation, said that they had found it helpful as a benchmark. Where there had been problems they had generally arisen from the way that the Code or the "comply or explain" had been implemented by boards or investors. Adherence to the spirit rather than the letter of the Code was seen as the key to good governance.

4. However a significant minority of FTSE 250 and Small Cap participants considered that the Code was too prescriptive and that this, combined with the perceived box-ticking approach taken by some investors and proxy voting services, put pressure on companies to take steps to comply whether or not it was appropriate for them to do so.

5. There was no support for making the Code significantly more prescriptive although some participants argued that there may be a case for updating or strengthening specific sections of the Code. Some participants were also concerned by what they saw as the potential for "change for change's sake" as a result of the problems in the banking sector.

The role of the chairman and other board members

The Chairman

6. Among the roles identified for the chairman were: getting the right people on the board and creating an environment which brought out in the best in both the executive and non-executive directors; creating the right culture in the organisation; ensuring proper consideration of major risks; avoiding "group think"; and ensuring that there was sufficient opportunity for non-executive directors to challenge and raise concerns while at the same time ensuring that the board remained united. A number of participants described methods that they used to ensure that the non-executive directors had the opportunity to raise issues outside the board meetings if necessary.

7. The relationship between the chairman and the CEO was considered key since challenge from the non-executive directors alone, while necessary, would not be sufficient to constrain a dominant CEO.

8. There was discussion at some meetings of whether there was a need, in the Combined Code or elsewhere, for a clearer description of the chairman's role and/or qualifications for the job. The majority of those who commented would resist further prescription in case this reduced the ability of the chairman to exercise their own judgement or reduced the pool of individuals able to serve as chairman.

9. There was no agreement on whether, at least in non-financial companies, it was desirable for the chairman to have direct experience of the sector in which the company operated, although some participants felt that it was desirable for the chairman to have had experience of working in a company with broadly similar characteristics.

Senior Independent Director

10. Among FTSE 100 participants there was a lot of support for the senior independent director (SID) role as currently practiced, but little enthusiasm for the SID taking a more active role in engagement with shareholders as a matter of course; that was considered to be the role of the chairman. Rather the role should consist of: acting as a sounding board for the chairman; carrying out the evaluation of the chairman; and providing a rallying point for the non-executive directors where needed. The SID was described on several occasions as a "safety valve".

11. There was little discussion of the role of the SID at the meetings with chairmen of FTSE 250 and Small Cap companies.

<u>Non-executive directors</u>

12. The role of the non-executive directors was to provide some form of check and balance to the executive and to offer ideas on strategy. It continued to be an important role, particularly where companies had a dispersed ownership; for example, a chairman of a relatively newly listed company said that the input of the non-executives had been invaluable in ensuring the board looked beyond the day-to-day management of the company. But some participants also cautioned against unrealistic public expectations of what non-executives should and could be expected to do, which went beyond their capacity to deliver.

13. There was general agreement that there was now an expectation of greater time commitment from non-executive directors, in particular those with significant roles on the audit and remuneration committees. Some participants from FTSE 100 companies estimated that the time commitment had increased by up to 50%, while those from smaller companies considered that non-executive directors needed to commit at least two days a month in order to carry out their role effectively.

14. A few participants expressed concern that greater involvement should not lead to non-executive directors being drawn into what was effectively an executive role rather than one in which they provided necessary challenge to the executive. Greater time commitment would also require greater remuneration; both factors might raise questions about independence.

15. Most participants reported that as yet they had experienced no major difficulties in recruiting good quality non-executive directors, although some felt it would become more difficult. This was particularly the case among participants from FTSE 100 companies, who anticipated that the increased time commitment and greater awareness of reputational risk would make it somewhat more difficult to recruit high quality non-executive directors. Particular difficulties were anticipated in recruiting individuals to chair the audit and remuneration committees.

Board balance and composition

Board size

16. Most participants from FTSE 250 and Small Cap companies had a strong preference for small boards, by which they meant boards of ten or fewer members. A number of advantages of smaller boards were identified: there was a better quality discussion; individual directors were clearer about what was required of them and felt more personally accountable for board decisions; and it was more difficult for the CEO or chairman to divide and rule if they were minded to do so.

17. Board size was discussed less frequently at the meetings with chairmen of FTSE 100 companies.

Executive directors

18. There were differing views on the optimum number of executives on the board. Some chairmen preferred only to have two executives on the board (the CEO and CFO), but rather more preferred to have more of the senior team as board members in order for there to be proper discussion of strategy and so that the chairman and non-executive directors could observe the dynamics within the executive team and observe the performance of individual directors for the purpose of succession planning. The balance of opinion was the same across companies of all sizes.

19. A few participants considered that the Combined Code's recommendation that 50% of the board of FTSE 350 companies be comprised of non-executive directors had contributed to a reduction in the number of executives on boards.

Non-executive directors

20. The majority of participants, particularly those from FTSE 100 companies, considered that - at least in some sectors - there might be a need for more non-executive directors with previous experience of working in the same or a comparable sector in order properly to assess the information being provided by the executive. However in addressing this shortfall boards needed to be careful not to over-specialise as it remained important for them to have a broad range of skills and experiences.

21. There was considerable discussion of the so-called "nine year rule". While some participants considered that it was useful as a prompt to consider the balance of the board and said that they had received no objections from shareholders when choosing to retain a long-serving independent director, more took the view that there was no correlation between length of tenure and independence and reported cases where long-serving directors had been lost to the board. This could be particularly damaging to companies with a long business cycle. This view was more widely held among participants from FTSE 250 and Small Cap companies than among those from the FTSE 100.

Frequency of re-election of directors

22. There was no consensus on whether annual re-election of all directors would be desirable. While some participants from FTSE 100 companies indicated they had no objections to the proposal, and one advised that his company was considering introducing the practice, others were concerned that the practice might create greater uncertainty. The majority of participants from FTSE 250 and Small Cap companies also took this view.

23. In addition some participants were opposed to individual directors, for example the chairman of the remuneration committee, being singled out for annual re-election as this would potentially mean they were being made scapegoats for decisions endorsed by the board as a whole. Singling out the chairman of the remuneration committee might exacerbate the difficulty of finding people willing to carry out the role. There was marginally more support, at least among participants from FTSE 100 companies, for the suggestion that the company chairman be put up for re-election every year.

Board information, development and support

24. Many participants stated that they placed particular importance on the non-executive directors having contact with management outside board meetings and getting first hand experience of the company's operations in order to develop the knowledge of the business that was necessary for them to provide effective challenge to the executive.

25. There was no support from participants at the meetings at which it was discussed for the proposal that the non-executive directors should have a separate secretariat, with those who commented considering that it was precisely because the secretariat function was embedded in the company that it was able to serve the non-executive directors effectively. If there was an issue it was to do with the status and level of resource given to the company secretary. Ultimately it was the responsibility of the company chairman to ensure that the board received the information and support it required.

Board evaluation

26. Despite initial scepticism in some cases, almost all participants had found board effectiveness reviews to be beneficial.

27. The process followed for reviews varied, with FTSE 100 companies more likely than smaller companies to have involved an external facilitator. The majority of those participants whose boards had been subject to external evaluation felt that they had benefited from the process, while noting that a lot of the value depended on the quality of the reviewer.

28. Views differed on whether the Combined Code should be amended to require companies to use external facilitators either annually or less frequently. Some felt this would be appropriate, but the majority felt that the Code should not be changed. This was particularly the case among participants from FTSE 250 and Small Cap companies, some of whom felt that for smaller companies with small boards a relatively informal process led by the chairman was most appropriate. Some of these participants also felt that a full annual evaluation was unnecessary for such boards.

29. Some participants suggested that the Code might recommend greater disclosure on the process that had been followed and/or actions arising. One participant recommended a broader statement from either the company chairman or chairman of the nomination committee on whether the board was "fit for purpose"; this might replace some of the existing disclosure requirements in the Code. Others argued against any additional requirements, while not disputing that at present disclosures were largely uninformative. They felt that it was unrealistic to expect boards to say too much in public about any shortcomings, and that more prescription would simply lead to more box-ticking.

30. Asked what criteria they would use to judge the effectiveness of other boards, participants identified a number of considerations including openness and transparency, a willingness of board members to question and be questioned, and the quality of the agenda and the board papers.

Risk management

31. The majority of participants, from all sectors and of all sizes, said that their boards were paying greater attention to the main risks facing their company as a result of the problems in the banking sector. In some cases this reflected a change in the balance of risk - in particular financing risk - rather than any change in risk management practices. However some participants considered that risk assessment and management might have been delegated too much to the executive - or, in regulated sectors, that too much reliance might have been placed on the risk assessments made by the regulators - and board oversight and discussion of risk appetite might have been insufficient. In some other cases it was felt that boards might have spent too much time considering detailed operational issues and not enough on identifying and assessing strategic risks that might not have been picked up through "bottom up" risk management systems.

32. There were differing views on whether, the level of board discussion apart, any changes were needed to their company's risk management systems. In particular there were differing views about the merit of having a separate risk committee. Some FTSE 100 participants had already established such a committee or were considering doing so, noting that the audit committee was not necessarily the best forum for assessing non-financial risks. Others were concerned that setting up such a committee would create confusion about responsibilities or encourage boards to continue to delegate discussion of strategic risk more than was appropriate. There was little support from FTSE 250 and Small Cap participants for separate risk committees.

Remuneration

33. A number of participants were concerned by the extent to which remuneration of executives had increased in recent years, and had become divorced from that of other employees. Some considered that the disclosure requirements had contributed to the problem by encouraging the upward trend. Suggestions were made for aligning remuneration more closely to long-term performance, for example by vesting the performance-related elements of the remuneration package over longer periods.

34. While public anger at overall levels of remuneration was acknowledged, and there was a concern to avoid rewards for failure and perverse incentives, some participants made the point that it remained the case that companies needed to offer competitive packages to attract and retain key staff, especially for those companies operating in global markets. Getting the balance right would be particularly challenging in the current

economic circumstances.

35. There was a general view among participants from FTSE 100 companies that the company chairman needed to sit on the remuneration committee, and a few participants considered the Code should be amended to allow them to chair the committee. Others said they would not choose to take on that role as there was inevitably friction between the remuneration committee chairman and the executive, and it was useful for the company chairman to be able to act as umpire when necessary.

Engagement

36. Most participants were persuaded of the potential benefits of engagement, which included developing trust which might encourage investors to take a more long term view, getting an undiluted investor view of the quality of the management team or the board, and getting a strategic view from fund managers who had analysed the company; but many expressed frustration with the engagement process, leading some to question its effectiveness or usefulness.

37. Views about the effectiveness of engagement with investors varied according to company size, with participants from FTSE 100 companies more likely to have had positive experiences.

38. Many participants from FTSE 100 companies had succeeded in developing constructive relationships with their major shareholders, and a number of techniques were identified for doing so, but others had been less successful. However a number of participants reported a greater interest in engagement on the part of their major shareholders this year, presumably as a result of the economic circumstances.

39. Among participants from FTSE 250 and Small Cap companies, those who chaired companies which had shareholders with significant holdings tended to have had more positive experiences of engagement than those companies which had a widely dispersed shareholder base, since a smaller company was unlikely to represent a significant part of those shareholders' portfolio. There was a view that, except in those circumstances, the quality of engagement tended to decline with the size of the company.

40. However, even those participants that had succeeded in developing constructive relationships with their major shareholders shared some of the frustrations that were raised with the engagement process. These included:

- A perceived lack of interest in governance by fund managers, allied to a box-ticking approach by the corporate governance function in the same institution;
- A perceived lack of 'weight' in most corporate governance departments, with a few exceptions;
- The over-reliance of smaller investors with limited resources on voting services agencies who were also guilty of box-ticking;
- An unwillingness on the part of institutions to respond to invitations to meet the company chairman; and
- An unwillingness to engage on anything other than remuneration.

41. Except in times of crisis most participants from smaller companies had found shareholders uninterested in meeting anyone other than the CEO and CFO, including the chairman. There was little if any interest among their shareholders for meetings with the senior independent director and other non-executive directors, and some argued that Section 4.1.1 of the Combined Code - which encourages such meetings - should accordingly be amended.

42. Despite these frustrations there was some scepticism among participants from FTSE 100 companies of the merits of any proposal to place an obligation on investors to engage with their investee companies, for example by requiring them to meet annually with the chairman. Those participants who commented on the subject felt that this would be likely to lead to a "quota-filling" exercise rather than substantial discussions. This issue was not discussed to any great extent at meetings with the chairmen of FTSE 250 and Small Cap companies.

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