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PRISM
COSEC

18 Hanover Square
London W1S 1HX

Tel: 020-3008 6446
chris@prismcosec.com

Submitted by email to
codereview@frc.org.uk

Dear Mr Hodge,

Prism Cosec response to the Financial Reporting Council (FRC) Review of the Effectiveness of the Combined Code

Prism Cosec is a company secretarial practice and corporate governance consultancy that seeks to promote integrity and effectiveness within the boardroom. Our principle activity is in assisting companies with quoted securities on the Main Market of the London Stock Exchange and the Alternative Investment Market on company secretarial and governance matters. A number of our clients are listed in the FTSE100 Index and we are the Company Secretary for one FTSE100 quoted company. Our team consists of five Chartered Secretaries all of whom have extensive experience working for quoted companies and all of whom are working with quoted clients currently. We are therefore well placed to comment on the Combined Code, particularly its application by quoted companies, and our comments below draw on recent and current experience across a range of such companies.

Our responses to the ***Review of the Effectiveness of the Combined Code: Call for Evidence*** paper published by the FRC in March (Call for Evidence) are split into three sections:

- General Questions on the Combined Code
- Questions on the Content of the Combined Code
- Questions on the Application of the Combined Code

As far as possible we have followed the structure of the Call for Evidence paper to assist the evaluation of our response. However we believe that there are broader issues that the FRC should consider within this review and we hope that these comments will be given serious consideration by the FRC. In particular we note that changes to the Combined Code have always been made in *response* to particular circumstances or issues. This reactive and piecemeal approach means that the Code has not necessarily been reviewed holistically or proactively. Consequently it is silent on significant governance matters, such as corporate social responsibility, because it has not needed to address such issues. Such governance issues are important to investors and in regard to corporate social responsibility the Combined Code has been overtaken by the Companies Act as the driver of good governance.

As a company secretarial practice, we believe that the Combined Code and the "comply or explain" disclosure regime which it espouses is a valuable one for issuers, investors and the London market itself. We note that the current exercise is the third review of the Combined Code since the last major revisions in 2003 albeit, unlike the previous two, this review is taking place against a backdrop of considerably less favourable economic conditions. There is a risk that the regulatory response to these conditions will be to take a more prescriptive approach to the corporate governance in listed companies. We believe that such an approach would be wrong adding cost but not effectiveness to the process.

We note that some commentators are viewing failings in the banking sector as being indicative of failings in the prevailing corporate governance norms in the UK. We would argue that the banking sector is not indicative of corporate governance across the market as a whole. The ability and willingness of boards to comply with the Combined Code is influenced by a wide range of factors such as financial size, organisational and geographical spread, operational and product complexity, culture to mention some of the key variables. Companies in the banking sector are, in terms of size, product complexity and organisational spread, at the most sophisticated end of the spectrum on these variables. All issuers are expected to adhere to the same Principles and Provisions of the Combined Code irrespective of size and complexity with the only exception being certain provisions relating to board and committee membership where some relaxation is allowed for companies outside the FTSE250. We therefore question whether the Code needs to recognise these variables more in the standards that it sets. Like the Listing Rules it may be appropriate to consider chapters of the Combined Code application only to certain sectors or certain sizes of company.

We suggest therefore that the need is for smarter regulation to help address some of the root causes of recent economic excesses. If the current review of the Combined Code can contribute to this it would be a good outcome.

1. General Questions on the Combined Code

The responses in this section are based on the questions set out in section 11 of the Call for Evidence.

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

We believe that the sections on audit and remuneration have worked well partly because they are the areas that are, in practice, where the governance processes are well adapted to corporate circumstance in the companies that we have worked with. Interestingly, having worked with a number of IPO's over recent years, we believe that the comprehensive approach to risk identification and mitigation now required for prospectus purposes during an IPO means that newly listed companies have a broad focus on risk. Consequently their audit committees generally have a good grasp of risk from the start and develop a healthy ongoing dialogue with management about the evolution of the risk profile over time. As indicated in section 2.3 below, we do not necessarily see that executives and audit committees work in a totally symbiotic way when it comes to management of risk but we regard the issue as behavioural rather than structural.

In the area of remuneration committee work we have seen good compliance with the requirements of the Code. The need for a coherent policy and structure in the determination of executive remuneration is understood and respected. The level of debate between companies and investors on remuneration issues is indicative, in our view, of good disclosure. We do however also note a need for further alignment in section 2.4 below.

The areas which we believe are less effective are those on board structure (both in relation to board appointments and board development) and investor relations. The reporting of these aspects of the Code tends toward a formulaic approach.

Nominations: Section A.4 of the Code deals with appointments to the board with the nominations committee seen as a key element of that process. In our experience the nominations committee is used to rubber stamp board appointments rather than drive the process of appointing new directors. Disclosures tend as a result to be lacking in substance.

Board development: Sections A.5 (information and professional development) and A6 (performance evaluation) are interpreted in a rather woolly and loose way and reporting on compliance with them is often equally loose. There seems to be no major incentive or great enthusiasm to develop practice and reporting on these aspects of the Code.

Investor relations: We suggest that Section D on the use of annual general meetings should be updated to reflect (a) the increasing trend towards the use of poll voting rather than voting on a show of hands which makes Code Provisions D.2.1 and D.2.2 look increasingly out of date. As a general point the increasing use of electronic communications may promote better flows of information but do not necessarily improve the level of engagement with issuers.

1.2 *Have any parts of the Code inadvertently reduced the effectiveness of the Board?*

The Combined Code places a lot of emphasis on the balance of the board and particularly the importance of independent non-executive directors to the board process. We agree with the need for independent supervisory directors. However, we do not believe that sufficient focus has been placed on the role of the executive management and, especially, the Chief Executive Officer. Thus, the Combined Code is clear in giving guidance on the responsibilities of the Chairman and the non-executive directors but does little to guide on the responsibilities of the Chief Executive Officer (see 2.2 below). There has been press comment about the ineffectiveness of the accountability of the chief executives of major banks to their boards and it may be that there should be disclosure by chief executives as to how they have discharged their duties within the framework of good governance (perhaps using the Supporting Principles in Section A.1 of the Code as a point of reference).

The emphasis of the Combined Code on the role of non-executives and executives seems to have had two unintended consequences:

(a) It has resulted in relatively few executive directors being appointed to the board and has contributed to the chief executive officer primarily (but also sometimes chief finance officers) becoming the sole conduit(s) of communication from the board to the executive teams and vice versa. A less than even-handed approach to communication by a chief executive officer thus becomes difficult to discern and may result in non-executive directors being kept in ignorance of prevailing cultural attitudes within the company that are contrary to the wider interests of shareholders.

(b) It has sometimes polarised boards on certain issues where a collegiate approach is essential. The new emphasis on directors duties contained within the Companies Act 2006 may begin to address this. The Combined Code does not seek to encourage it.

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

The Combined Code is silent on matters of ethics and corporate social responsibility generally. It makes no attempt to put a governance structure in place for this and the reporting on this important area of governance has been left to the Companies Act to prescribe. We believe that the Combined Code should formalise the governance of this area through a board corporate social responsibility committee (which is already in place in many companies). Significantly the Association of British Insurers (ABI) and National Association of Pension Funds (NAPF) are taking more of a lead in setting the standards in this area.

Similarly the recent legislation on directors duties particularly in relation to conflicts of interest highlight the lack of emphasis on this important area of governance in the Combined Code.

1.4 *Is the "comply or explain" mechanism well understood and, if not, how might its operation be improved?*

The "comply or explain" mechanism is well understood but does not necessarily operate effectively or meaningfully. In the first instance compliance reporting by quoted companies is policed by the auditors who are often prescriptive in the advice that they give to companies about their Directors, Corporate Governance and Remuneration Reports. Consequently we believe that there is an inherent disincentive to companies to "tell their story" when it comes to "comply or explain" because auditors are encouraging standardised formats for disclosure and issuers tend to prefer safer boilerplate text rather than more expansive explanations.

The audit profession also seem generally more interested in areas of the Combined Code which have direct links to financial reporting. Their focus tends towards those aspects. Neither the audit profession nor the legal profession encourage idiosyncratic reporting. Such adviser attitudes tend to push issuers toward standardised wording in their corporate governance reporting.

Shareholder, institutional representative and press comment on corporate governance seems to focus more on certain matters than others – board structure and remuneration being among the key areas of focus. Other lower profile areas e.g. board evaluation or induction do not come in for much scrutiny and often compliance becomes a matter of ticking the box rather than necessarily being perceived to be value-adding.

A review of who actually should be holding companies to account for all aspects of their Combined Code compliance could be a useful exercise. We do not believe that a Sarbannes-Oxley tick-box review is the solution but a mandatory qualitative review of the board process could assist boards in improving their attitudes and therefore reporting against the "comply or explain" criteria. We expand on this point further in section 2.5 below.

2. Comments on the Content of the Combined Code

2.1 *The composition and effectiveness of the board as a whole.*

The advent of board evaluation and routine assessment by committees has promoted greater focus on the composition and effectiveness of the board. Whilst some boards have embraced these requirements enthusiastically, many seem to approach them more reluctantly particularly those outside the FTSE 250.

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

As indicated above, the role of the Chairman and non-executive directors has, in recent years, been defined clearly by the Combined Code. The role of executive management has not. The Combined Code defines the role of the Chief Executive as being "the running of the business" (Supporting Principles A2). There has been little focus on how the Chief Executive should be held to account for the stewardship of this role, particularly by reference to the criteria for board effectiveness defined in Supporting Principle A.1 (i.e. entrepreneurial leadership, prudent and effective controls, provision of financial and human resources and setting of values and standards).

2.3 *The board's role in relation to risk management?*

In our experience the framework set up by the Smith Guidance and Turnbull Guidance means that audit committees, on behalf of their boards, have processes in place for identifying risk and evaluating how risks are mitigated, managed or reduced. We question how effectively this process is linked to the executive management process of companies. At times it seems that risk management is an isolated workstream which is undertaken because of the need to report something to the audit committee rather than being an integral aspect of the decision-making process.

Reporting on risks and uncertainties as expected within the Business Review and the Reporting Statement on the Operating & Financial Review is undoubtedly focussing minds on the need for better reviews of risk identification and management. Reporting on risk has, in our view, been better in respect of financial risk because that lies within the comfort zone of audit committees and audit firms. Operational risk has we believe been less well considered and should be treated more centrally within the audit process.

2.4 *The role of the remuneration committee?*

The role of the remuneration committee is now well-established within most companies. Remuneration appears to be the area of greatest dialogue between boards and shareholders, particularly so at the moment. Discussion about performance-based incentives is extensive, sometimes perhaps disproportionately so. The level of discussion is facilitated by the reporting of remuneration policy and practice that has been put in place within the governance processes established by the Code. Thus the focus on reporting should not be taken as weakness in the governance process itself. Nevertheless, the alignment of remuneration incentives to strategy and delivery is still some way off. KPI's used to benchmark incentives do not necessarily agree with the KPI's listed elsewhere in an annual report thus indicating that the Code needs to encourage a more holistic approach to governance rather than compartmentalising it into the discreet categories of strategy, remuneration, audit etc..

Our other observation on the role of the remuneration is that there are occasions where the chief executive officer can exercise too much influence in the deliberations of the remuneration committee. On the one hand the committee depends on the chief executive officer for guidance on the performance and expectations of the senior executive team and therefore cannot exclude the CEO from its deliberations. However, we have noted occasions where a persuasive and vociferous CEO has pressurised committee members on the remuneration of the senior executive team as a whole, including his own. In such circumstances it is possible to see why remuneration committees may find it hard to be totally objective in setting executive remuneration.

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

The provision of support to the board and its committees is primarily the role of the Company Secretary who works with Chairman, executive directors and management. Usually the Company Secretary is dependent on the Chief Executive Officer and the Chief Finance Officer (among others) for papers and information supplied to the Board. The Chairman supported by the Company Secretary is expected to ensure that directors receive "accurate, timely and clear" information". If a CEO and/or CFO do not arrange for information to be made available or make information available which is lacking in objectivity because of a particular hidden agenda, it is very difficult for this responsibility to be fulfilled. In our experience most boards work hard to establish board processes that fulfil both the spirit and the letter of the Combined Code, however, there is scope for abuse.

One weakness in the current version of the Combined Code is the lack of robustness in the framework of decision-making to boards. The current requirement for a schedule of matters reserved to the board goes no further than requiring that such a schedule exists. There is no way of ensuring that all decisions that should be made by the board are in fact actually referred to the board. Neither is there any guidance on the level of support that the board should expect to receive prior to making board decisions. Section 172 of the Companies Act and the GC100 Guidance on this matter seems to have been far more effective in highlighting the quality of information behind board decision-making processes than anything in the Combined Code.

Similarly we question whether there should be more auditing of the provision of information to boards. In particular the process for preparing and approving papers at executive level and the provision of information and recommendations for approval under the schedule of matters reserved to the board is an area we believe should be subject to audit or third party review.

2.6 *The content and effectiveness of Section 2 of the Code encouraging them to enter into dialogue with the company?*

We have little to comment on Section 2 of the Code other than to note that the level of dialogue between investors and companies on governance matters is still very patchy. We are not aware of significant interaction between major investors and directors except when performance has not been very strong.

3. Comments on the Application of the Combined Code

We believe that the "comply or explain" approach does offer boards flexibility in designing their governance arrangements and should promote good dialogue over the adequacy or otherwise of those arrangements. However, the level of engagement with investors themselves is still relatively small, particularly for companies outside the FTSE100. Some investors such as Hermes and Standard Life have developed commendable approaches to dialogue with issuers. Representatives of the institutional shareholders, particularly the ABI and NAPF have also developed some good approaches to dialogue with companies about governance matters. However they are not particularly open to discussion about areas of explanation of non-compliance where companies have provided it.

As an example of this, some of the companies we work with have a major shareholder as Chairman of the Board. In each case there is no doubt that the experience and knowledge that the Chairman brings to the role as well as a commitment to the long-term interests of shareholders is beneficial yet such explanation is often overlooked by such bodies because of a strict adherence to Code Provision A.3.1 on independence.

We believe that there are still sections of the Combined Code e.g. board nominations and evaluation, where application is formulaic rather than interpretive. In these areas, further engagement with companies and those who advise them, particularly the auditors, may be needed to see how such processes could be made more value-adding for companies.

Conversely, there are areas where processes are in place e.g. board and committee meetings which are critical to the internal control of the company but there is no accountability for the application or effectiveness of those processes either through auditor review and/or disclosure to shareholders. We suspect that more audit review of corporate governance reporting should be encouraged in these areas. We also believe that auditors and regulators could do more to encourage companies to show why they choose to apply the Combined Code differently to other companies so that the link between the interpretation of principles and the value to shareholders of that interpretation can be made more explicit.

Please contact us if you would like to discuss any of the points made in this submission in more detail.

Yours sincerely

Chris Stamp
Director
Prism Cosec