Dear Chris

**ICSA response to the FRC’s Review of the Effectiveness of the Combined Code (the “Code”)**

The Institute of Chartered Secretaries and Administrators (ICSA) is the professional body that qualifies chartered secretaries. Many of our members are company secretaries in public listed companies and take responsibility for ensuring that the Code is embedded in the governance structure of their company and that appropriate disclosures are made about corporate governance to the company’s shareholders, usually through the annual report. Their presence in the boardroom, and their direct relationship with the chairman, give company secretaries a clear perspective on the effectiveness or otherwise of the Code in encouraging the most suitable governance framework for their particular company.

Our proposals below concentrate on the institutional and organisational aspects of corporate governance. We shall be making separate proposals on the behavioural aspects of corporate governance to Sir David Walker’s enquiry into governance in the banking sector.

This response has been informed by consultation with a specially constituted working group of company secretaries and the ICSA Company Secretaries Forum which has 30 members, with strong representation from the FTSE 100.
EXECUTIVE SUMMARY

- ICSA supports the ‘comply or explain’ model over regulation
- ICSA supports the unitary board model over a two-tier structure
- ICSA recommends changes to the Code:
  a. to ensure that risk is dealt with appropriately at board level (see section 2); and
  b. to ensure that the time commitment of directors is appropriate and that the board is properly supported in its delivery of good decision-making by formalising the role of the secretariat as a board support function (see section 3)
- ICSA makes further suggestions to improve the effectiveness of the Code in areas including director induction and training, performance evaluation, remuneration, and whistle-blowing (see section 4)
- All comments we make have been tested against our overarching objective of suggesting amendments that will help to foster better boardroom behaviours
- References to ‘him’ or ‘he’ should be construed also as references to ‘her’ or ‘she’ when discussing a director or company secretary

1 INTRODUCTION

- In support of ‘comply or explain’ over regulation (1.1)
- Preference for ‘apply or explain’ (1.2)
- Boiler-plate disclosure (1.4)
- In support of the unitary board (1.5)
- Refer to codified directors’ duties in the Code (1.6)
- Declaration of ICSA interests (1.8)

1.1 At the outset, it is important for ICSA to state that we continue to support fully the principles based ‘comply or explain’ model of the Code over rules-based regulation. The more flexible approach created by this system, when properly implemented, allows companies to tailor governance to their specific and changing needs and permits a greater speed of response to developing circumstances. By its very nature ‘comply or explain’ should encourage companies to give governance matters proper consideration (and where properly implemented change behaviours and create a framework for effective external challenge).

A rigid rules-based system would force companies into a ‘one size fits all’ framework of governance, unlikely to achieve appropriate outcomes for all companies, but resulting in increased costs of compliance. It would also result in less informative explanations, driven by a ‘box ticking’ mentality in order to
comply with the letter of the law rather than the spirit of applied principles.\textsuperscript{1} We would challenge any assumption that a rules-based system would operate more effectively to enhance corporate governance than one based on best practice principles. We note, in passing, that the US system enshrined in Sarbanes-Oxley did nothing to prevent the crisis in the banking system, either in the US or, so far as applicable to UK banks with US registered securities, in the UK.

1.2 We would, however, support more emphasis being given to the fact that a cogent explanation of the non-application of specific code provisions is just as acceptable as complying. The wording in the Preamble to the Code which states, "While it is expected that companies \textbf{will comply} wholly or substantially with its provisions, it is recognised that non compliance \textbf{may} be justified in particular circumstances if good governance can be achieved by other means", does not in our view capture the legitimacy of non-compliance. As mentioned in previous consultation responses we prefer the alternative phrase \textit{apply or explain}. Some encouragement to companies to think in terms of ‘apply or explain’ could usefully appear in the Preamble to the Code to address this point.

1.3 The Preamble to the Code should remind boards that if compliance with the Code is not achieving effective governance in the context of the particular company’s business model, objectives and strategy (for example if the board finds itself managing the business when it should be governing), the board must not be complacent, just because it is complying. Rather it should review its governance model and, where it is necessary to depart from specific Code provisions, do so and provide reasoned explanations for those departures. It should be stated in the Code that it is a responsibility of the board to ensure that the company’s governance arrangements are appropriate.

1.4 We have some concerns about the variable quality of disclosures made under the Code; not least the tendency to ‘boilerplate’ reporting and inadequacies in the reporting of deviations from Code provisions. There have been recent signs of improvement, and further improvement is anticipated following the scrutiny that the reports of the FTSE 350 will now receive as a result of the ICSA Hermes Transparency in Governance Awards. That programme was launched in November 2008 and the inaugural awards will be announced in November this year. Improvements in the quality of disclosure should lead to better informed engagement with shareholders.

1.5 Specific reference should be made in the Code to the collective role and responsibility of the unitary board. This is a model we continue to support – we are not convinced by Sir Richard Greenbury’s arguments (reported in \textit{The Times} on 27 March 2009). To separate the non-executive directors further from executive directors reduces their contact with the executive and we fear that the non-executive directors consequently would become remote and therefore less effective in their ability to challenge the executive directors. In order to promote further the unitary board model, and to remind directors not to abdicate responsibility for the work of board committees, there should be a reminder too about the ultimate responsibility of the board itself in all Code sections [namely

\textsuperscript{1} For more on the benefits of comply or explain see "The Importance Of "Comply Or Explain" In The EU Business Environment" - Feedback to the EU Commission from the ICSA Corporate Governance Summit held in Brussels in October 2008
A.4.1, B.2.1 and C.3.1] which refer to the establishment of a committee of the board.

Within the unitary board model, however, board balance has perhaps become slightly skewed towards the non-executive director. Knowledge is a function of board balance. The trend towards a decrease in the numbers of executives attending board meetings may be detrimental since the Code has, unintentionally, led to a situation of information flow through executives unable to master the whole corpus of the company’s objectives and operations. Periodic appearances by operational directors may not be sufficient to address this potential structural weakness.

1.6 To support induction and training programmes all directors should be reminded by the Code of their duty to act in the best interests of shareholders, and of the role of a board director as a steward of the shareholders’ assets - an individual responsibility of each and every director. A reference in the Code to the duties of all directors, now codified in the Companies Act 2006, could help get this message across.

1.7 The collapse or near collapse of several banks is unquestionably attributable, at least in part, to significant failures in governance, the most fitting response to which may be the strengthening of bank regulation. More generally, however, we have identified two areas of the Code, the amendment of which will improve its effectiveness as a tool for best practice in corporate governance; and help to avoid a recurrence of those failures (or failures in other sectors). The first concerns risk and the second board support. These two items are dealt with in sections 2 and 3 below. In section 4 we address other amendments which we believe are worthy of consideration. All comments we make have been tested against our overarching aim which is to suggest amendments which will help to foster better boardroom behaviours.

1.8 Before detailing our recommendations it is appropriate for ICSA to declare three interests: as the professional body which qualifies and represents chartered secretaries, and as a provider of director training and board evaluation.

2 RISK

- The board, collectively, to establish policy confirming the company’s risk profile and risk appetite (2.1)
- Executive to manage the risks within the policy parameters and board/board committees to have oversight role (2.2)
- Governance reporting to require disclosure of the policy and any delegated authorities for the oversight and management of risk within the parameters of that policy (2.4)

2.1 There is anecdotal evidence that in some companies the only attention given by boards to risk is a passing nod when receiving the report from the audit committee on its annual review of the effectiveness of the company’s system of internal control. As recent events have shown, it is now essential that establishing the company’s risk appetite should be considered a primary function of the full board. We therefore believe that the Code should encourage the embedding of the consideration of risk within business objectives and strategy and that the board should, taking account of appropriate advice from the company’s risk manager and (where necessary) external professional assistance,
be responsible for agreeing the risk parameters within which the company should operate. This matter is one for the board acting collectively; it is not one which may properly be delegated to a board committee. (Executive management manage the risks within these boundaries set by the board. It is the oversight of risk management which can then be delegated to a board committee, usually audit or risk.) The board should not only review risk on a regular basis, perhaps at least quarterly, but should set out its policy clearly so that this can be implemented by management on a day-to-day basis.

Accordingly, the board as a whole, mindful of the possibility of the aggregation of risks (cf. the initial problems at Heathrow Terminal 5), including risk to reputation, should categorise the types of risk which are acceptable for the company to bear in pursuit of its business objectives. Those which should not be tolerated, either at all or subject only to certain specified restrictions, having regard to the business objectives of the company, should be identified. Upon becoming aware of any infringements of the policy, executive management or the company’s risk manager should report them to the relevant oversight committee chairman, or company chairman who should arrange for a full report to be made to the board at its next meeting on the infringement and any corrective action taken.

The glass ceiling which often discourages or even stops risk (and other) managers talking directly to the board has to be circumvented. To improve the understanding of the business by directors and therefore the risks faced, (remembering that executive directors may not themselves be appropriately familiar with all operations), directors, but non-executives in particular, should be encouraged to make visits within the business, which are not ‘stage-managed’ by executive directors, to facilitate interaction by the non-executive directors with the business managers below board level and to enable direct relationships to be fostered.

2.2 Management’s implementation of and compliance with the board’s policy on risk (as distinct from internal control) should be subject to a review, at least annually, as part of any review by the audit committee or other appropriate board committee of the effectiveness of the company’s system of internal control, for the purposes of Code provision C.2.1, unless the review is itself conducted by the full board. (It should be noted that it is implicit in paragraph 25 of the Turnbull Guidance for Listed Companies that there are circumstances in which aspects of the internal control review, which we now propose be extended to encompass this review of the implementation of the board’s policy on risk, cannot appropriately be conducted in a board committee.) One way to address our recommendation may be to enshrine in the Code, with appropriate adaptation as suggested below, the language of sections 15 and 16 of the Turnbull Guidance, viz:

"In addition to the establishment of an appropriate policy on internal control, the board, acting collectively, should establish and keep under constant review throughout the year, revising as necessary, an appropriate policy on risk for the company.

"In establishing its policy on risk, the board’s deliberations should include consideration of the following factors: the nature and extent of the risks facing the company; the extent and categories of risk which it regards as
acceptable for the company to bear; the likelihood of the risks concerned materialising; the likelihood of an aggregation of risks; the company's ability to reduce the incidence and impact on the business of the risks that do materialise; and the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.

"The board should specify in the policy the extent and categories of risk which it regards as acceptable for the company to bear, as well as any restrictions that it deems necessary in relation to the assumption of certain risks or categories of risk. The policy should be reviewed on a regular basis by the board throughout each year and any necessary changes made.

"Management’s implementation of and compliance with the board’s policy should be subject to a review, conducted at least annually, as part of any review by the audit committee or other appropriate board committee of the effectiveness of the company’s system of internal control, for the purposes of Code provision C.2.1, unless of course the review is itself conducted by the full board. Upon becoming aware of any infringements of the policy, executive management or the company’s risk manager should immediately report them to the chairman (or relevant committee chairman) who should arrange for a full report on the infringement and any corrective action taken to be made to the board at its next meeting."

2.3 To ensure that risk is given a higher profile by boards, we suggest that the sentence in the definition of corporate governance in the Preamble to the Code, which states: “Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term” should be extended to include the phrase “within appropriate risk parameters established by the board”. A key role of the board is after all to provide assurance to shareholders as stewards of their assets.

Further, the supporting principles in section A1 should be reworked to make it clear that determining the appropriate categories of risk to be assumed by the company is a responsibility that must be discharged by the board acting collectively; currently all the references tend to imply an indirect or passive relationship between the board and risk. So, rather than the first mention of risk being that the board’s role is to ‘provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed’", the Code should be saying that the board’s role is to provide entrepreneurial leadership of the company and to agree the risk appetite and risk profile of the company; and to keep this under continual review.

2.4 Governance reporting should be extended to require the disclosure of the risk policy (see 2.2), and any delegated authorities for the oversight and management of risk within the parameters of that policy. It is then of course the responsibility of shareholders to challenge boards on the appropriateness of their policies and their delegated authorities in respect of risk, as well as the quality of their risk factor disclosure.

2.5 This does not mean that the Code should in any way discourage risk taking per se (and the Code should perhaps positively assert that fact), rather that the
extent of the material risks taken should be agreed by the board, as stewards of the owners’ assets. Nor are we saying that it is inappropriate for the company secretary, internal audit, or the audit committee to set the framework for the review of the effectiveness of the internal control system (including the implementation of and compliance with the risk policy as proposed in 2.2) and report on it to the board or a board committee. As noted above, there may however be some circumstances when the review should be conducted by the full board.

3 TIME COMMITMENT OF NEDs AND BOARD SUPPORT

- No ‘notional number of days’ for non-executive directors (3.1)
- No limit on number of directorships, but board evaluation to require directors to comment on time commitment of colleagues (3.2)
- Directors to evaluate the secretariat for effectiveness and adequacy of the resource (3.3 and 3.4.1)
- Company secretary always to have direct reporting line to chairman (in addition to any executive reporting line) (3.4.2)
- Company secretary’s remuneration to be decided by the remuneration committee (3.4.3)
- Company secretary, or nominee, to be secretary to the board and all board committees (3.4.4)

3.1 We believe that it is increasingly the case that board directors, and in particular non-executive directors, are realising that their role cannot be described, as has been the practice in the appointment letters of new non-executive directors, as typically demanding a notional number of days per year, often fewer than 30. While it is clearly necessary for new non-executive directors to be given some indication of the typical number of board and committee meetings in a year, companies should now be discouraged by the Code from inserting notional days’ service in non-executive directors’ engagement letters.

3.2 We believe that some non-executive directors spend inadequate time in their role to enable them to understand the business sufficiently that they may then ask the searching, even challenging, questions necessary if they are to fulfil their duties to the company. We reject the idea that, in an attempt to improve this situation, a limit should be set on the number of directorships an individual may or should hold as this of itself makes no allowance for the presence or indeed lack of individual commitments in addition to any directorships. We prefer that the board evaluation process specifically requires directors to comment on the adequacy of the perceived time commitment of their colleagues. This should not be limited to a review of meeting attendance, as currently emphasised in A6, as this may legitimise the notion that non-executives are only directors of companies on board meeting days.

Where it is felt that a director’s other commitments are having a negative effect on his contribution, the chairman could take steps to resolve the issue. We accept that an increase in non-executive remuneration would be necessary to reflect the reality of the continual nature of the role, and the increased time given by the non-executives. Should this have the desired effect of some non-executives taking on fewer roles, there would be more pressure to widen the pool of non-executives. We would like to see more executive directors and members of senior management encouraged, through positive company
programmes, to take up a non-executive position in other companies, as well as more academics and those with public sector and not for profit or third sector backgrounds being appointed. We do not support the idea promulgated by some commentators in recent months that the boards of companies in particular sectors should comprise solely or even mainly people with backgrounds in the particular sector. We believe that this is likely to foster an unhealthy ‘group think’ approach to matters coming before the board. Boardrooms need sometimes to be “uncomfortable places”; diversity of background in the boardroom is more likely to engender the asking of challenging questions.

3.3 In an increasingly complex environment for many sectors, not just financial services, and because the primary board committees must be comprised of independent non-executives, we believe that the support system for the non-executive directors should be more clearly built into the Code.

All directors, but most particularly the non-executives by virtue of their external position in relation to the company, need to be better briefed on company affairs. Their need for focussed information ought to be addressed in a manner more akin to how a cabinet minister would be briefed by his staff on any key government matter.

This support is already provided by the company secretary. However, we believe that to ensure appropriate resourcing, and the quality of that resource, this and an extension of certain aspects of the role should be dealt with much more prominently by the Code. The Code should encourage the establishment in all listed companies of an adequately resourced company secretariat, headed by a company secretary appropriately experienced in matters of law, regulation, secretaryship, accounting, business finance, strategy, ethics and governance, who reports to the chairman.

The company secretary’s role, in addition to supporting the chairman in the effective management of the board and its business and managing regulatory compliance, should be to procure, and advise on, all the information necessary for the chairman and directors to discharge their obligations; as well as advising the board on its task of governing the company – all this leading to appropriate disclosure to shareholders. Through the chairman, the company secretary should have the power to call for any document or information he requires from executive management. This goes much further than the Combined Code’s existing provisions on the company secretary, which tend to describe his responsibilities in somewhat passive terms. Our approach would emphasise the pro-active role of governance in delivering good decision-making. Indeed, it reflects the pivotal role that the company secretary plays, or should play, in corporate governance.

3.4 The Code could be amended to achieve this in the following ways:

3.4.1 Amend the board evaluation process to require the board to consider whether the company secretary and the secretariat team are effective and adequately resourced to meet the needs and expectations of the board.

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2 See the recent article and letter to the FT from David Wilson on this topic at these links
http://www.ft.com/cms/s/0/6e814dc2-23d4-11de-996a-00144feabdc0.html and
http://www.ft.com/cms/s/0/e5572d5e-317b-11de-8b45-00144feabdc0.html?nclick_check=1
3.4.2 Require the company secretary to report to the chairman. He will often have a second reporting line into the CEO, but his reporting line should not be solely to executive management.

3.4.3 To further protect the company secretary’s independence, require the remuneration of the company secretary to be set by the remuneration committee in consultation with the chairman (as recommended in the summary of the principal duties of the remuneration committee in the FRC document on ’Good Practice Suggestions from the Higgs Report’).

3.4.4 To ensure effective interrelationships between the board and its committees, require the company secretary, or his nominee, to be secretary to the board and the principal board committees (audit, remuneration, nomination). This enables timely and effective briefing of board members and facilitates good decision making.

3.5 To capture these changes we suggest that a distinct section in the Code should describe the relationship between the secretariat and the board and that this section draws on the existing material on the company secretary in A5.

Please find suggested drafting for a revised A.5 in Appendix 1.

4 FURTHER POINTS

- Policy on induction and training (4.1)
- Board and committee evaluation to be every third year on a rolling basis, but external (4.2)
- Remuneration committees to have remit below board level (4.3)
- Protection for whistleblowers (4.4)

We would support the following suggestions to improve the effectiveness of the Code:

4.1 There should be a requirement that all directors attend an induction course to ensure they are properly familiar with the content of the Code and are aware of their duties and obligations under the Companies Acts, related legislation and the common law (there would need to be an exemption available if a director had attended a course already by virtue of a recent appointment at another company). The induction process should ensure that new directors are fully apprised, on joining the board, of the company’s risk profile and risk appetite. Further, it may be worth considering bringing some of the elements of the induction checklist from the FRC document on ‘Good Practice Suggestions from the Higgs Report’ into the Combined Code. The checklist recommends that the induction process builds:

- an understanding of the company, its business and the markets in which it operates;
- a link with the company’s people; and
- an understanding of the company’s main relationships.

The board should have a policy on the nature and extent of director induction and training. Subject to the content of this policy, directors could be required to attend update courses, with both business-focussed and legal content, on an
annual basis. NED letters of appointment, and executive service contracts could oblige directors to undertake appropriate continuing personal and professional development each year.

The policy on director induction and training, and the details of the programmes undertaken in any given year should be required to be disclosed in the report and accounts.

Please find suggested drafting for a new A.6 on induction and professional development in Appendix 2.

4.2 Board evaluation is considered by our members to have proven itself to be a key tool in improving boardroom behaviours. However, we consider the requirement in A6 for the evaluation of the board, its committees and individual directors to be both annual and rigorous to be too onerous, and therefore too often satisfying the former requirement but not the latter. We would suggest that while individual director performance should be evaluated annually (externally facilitated every third year), the board and committees should each only be required to be evaluated every third year, but that to ensure rigour and objectivity, the evaluations should be external. This will be better facilitated if, say, some board committees are evaluated in one year, to be followed in the next year by evaluation of the board as a whole, with the remaining board committees evaluated in the next succeeding year. A6 should require the board to state in the annual report whether the evaluations were managed internally or externally.

4.3 To ensure that the balance between reward and risk is properly managed, there should be an extension of the remit of the remuneration committee to senior executives whose expected remuneration (that is, with reference to the expected value of their total remuneration packages, including all benefits) is above a threshold agreed by the board, but which is set no higher than the lowest paid director’s total expected remuneration, and publication of the remuneration policy for these senior executives. There should be a requirement too that the remuneration committee reviews all remuneration policies (ie including those at lower levels) where they could influence the group’s risk profile. Models of performance related pay that facilitate a culture of pursuing sales growth or business expansion contrary to the board’s policy on risk should be prohibited.

There should be a requirement for the board to state, with reasons, the effectiveness of the remuneration policy in achieving the appropriate balance for its particular company between reward and risk and that the meeting of any targets therein would not in fact lead to a position where the risk appetite of the company has been exceeded.

In summary there needs to be a greater link between reward policies and risk policies.

4.4 The Code should deal with whistle-blowing to the extent of stating that a company should not seek to enter into compromise agreements with whistle-blowers if this would inhibit a proper investigation of the allegations made. Further the dismissal of the person in charge of risk management on a day-to-
day basis, and the head of internal audit, should be a matter for the whole board.

We would be glad to expand on any of these points should you like to discuss any of them further.

Yours sincerely

David Wilson
Director of Policy and Strategy
APPENDIX 1

A.5 Company secretary and information

Main Principle

The board should be supported by an adequately resourced company secretariat, headed by a company secretary appropriately experienced in matters of law, regulation, secretariats, accounting, business finance, strategy, ethics and governance.

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

Supporting Principles

The board and its committees should be provided with sufficient resources to undertake their duties.

The chairman is responsible for ensuring that the board and its committees are supplied in a timely manner with information in a form and of a quality appropriate to enable them to discharge their duties and the company secretary should facilitate this. Management has an obligation to provide such information but directors should seek clarification or amplification where necessary.

The company secretary should be responsible for advising the board through the chairman on all governance matters.

The company secretary should ensure the directors, especially non-executive directors, have access to independent professional advice at the company’s expense where they judge it necessary to discharge their responsibilities as directors.

The independence of the company secretary should be protected to ensure that objective and impartial advice can be provided to the board.

Under the direction of the chairman, the company secretary’s responsibilities include ensuring good information flows within the board and its committees and between senior management and nonexecutive directors, as well as facilitating induction and assisting with professional development as required (see A6).
Code Provisions

A.5.1 The company secretary should report directly to the chairman. The company secretary may often have a second reporting line into the CEO, but his reporting line should not be solely to executive management.

A.5.2 The company secretary, or his nominee, should be secretary to the board and the principal board committees (audit, remuneration, nomination).

A.5.3 All directors should have access to the advice and services of the company secretary, who is responsible to the board and its principal committees for ensuring that board and committee procedures are complied with.

A.5.4 The board evaluation process should require the board to consider whether the company secretary and the secretariat team are effective and adequately resourced to meet the needs and expectations of the board and its principal committees.

A.5.5 The remuneration of the company secretary should be set by the remuneration committee in consultation with the chairman.

A.5.6 Both the appointment and removal of the company secretary should be a matter for the board as a whole.
APPENDIX 2

Sections of the current A.5: Information and professional development become A.6: **Induction** and professional development, amended in line with the suggestions made in the ICSA submission.

**A.6 Induction and professional development**

**Main Principle**

*The board should have a policy on the nature and extent of director induction and professional development. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.*

**Supporting principles**

The induction process should ensure that new directors are fully apprised of the company’s business, people and main relationships.

The chairman should ensure the directors continually update their skills and knowledge and familiarity with the company in order to fulfil their role both on the board and board committees. The company should provide the necessary resources for developing and updating its directors’ knowledge and capabilities.

Under the direction of the chairman, the company secretary should facilitate the induction and professional development programmes.

**Code provisions**

A.6.1 The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board.

The induction process should:

- ensure directors are properly familiar with the content of the Code and are aware of their duties and obligations under the Companies Acts, related legislation and the common law
- build an understanding of the nature of the company, its business (including risk profile and risk appetite) and the markets in which it operates
- build a link with the company’s people (including senior management)
• build an understanding of the company’s main relationships including meeting with the auditors and developing knowledge of, in particular, the major customers, suppliers and shareholders

As part of the induction process, the company should offer to major shareholders the opportunity to meet a new non-executive director.

A.6.2 The chairman should ensure that the professional development training programme then keeps the directors’ knowledge up to date.

A.6.3 The policy on induction and professional development, and the details of the programmes undertaken in any given year should be disclosed in the report and accounts.