Board Oversight in Difficult Times

Lessons from the FTSE All Share

December 2009

The All Party Parliamentary Corporate Governance Group

‘Influencing the policy agenda for business, economic and social prosperity’

LINTSTOCK

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Foreword by Philip Dunne MP

Since its formation in July 2004, the All Party Parliamentary Corporate Governance Group has played a very active role in the business agenda at Westminster with our focus this year on the financial crisis.

As the United Kingdom navigates its way through unprecedented economic challenges, we have asked what implications this turmoil is likely to have (or, indeed, ought to have) on the governance of listed companies. We also considered whether these findings should be confined to the origin of the crisis, in banking and financial services sectors, or whether there are any lessons for the governance of the wider corporate landscape.

The study was conducted via questionnaires and interviews with over 120 Company Secretaries and 80 Chairmen in the FTSE All Share Index and we are grateful for the high level of response we received. Our primary interest has been on board oversight but the study continues to address the role of shareholders and regulators, and how their relationship with companies is likely to change as a result of the response to this crisis.

We are grateful to Lintstock for the research they have carried out on behalf of our Group. I am delighted to present their findings in this document which we hope will be of value to board members, shareholders, regulators and parliamentarians alike.

Philip Dunne MP
Chairman
APPCGG

Introduction and key findings

This study focuses on the likely changes in Board, Shareholder and Regulatory oversight of FTSE All Share companies as a consequence of the financial crisis. The intention was to find the extent to which each of these groups could learn lessons from the crisis which have broader consequences than the financial sectors alone.

A questionnaire and series of interviews was conducted with Chairmen and Company Secretaries of FTSE All Share companies. In total we received 82 responses from Chairmen and 140 responses from Company Secretaries: 59 in the FTSE100, 98 in the FTSE 250 and 65 in the FTSE Small Cap. A list of study participants is found in the appendix. We would like to thank all participants for their high level of support.

The key findings fall into three categories; the role of the Board, the role of Shareholders and the role of Regulators:

The Role of the Board

- The vast majority of respondents stated that they had already experienced an increase in the workload of non-executives as a direct result of the recent crisis. Almost all respondents agreed that the shift was likely to be permanent in nature.

- A number of respondents felt that there was likely to be greater emphasis on risk management and the adequacy of funding arrangements which the company has in place in future. It was also commonly stated that non-executives generally are being more demanding of management.

- When seeking new recruits for the board the attribute which respondents felt would be sought after in the wake of the financial crisis was financial experience and also, importantly, direct experience in the company sector.

- The majority of respondents who felt that further director 'training' would be beneficial thought that it ought to be conducted in-house with a view to fostering a greater understanding of the company amongst non-executives.

- Almost all respondents felt that enough was being done in the oversight of auditors whereas around half felt that there ought to be greater focus on risk oversight by non-executives.

- There was a general recognition that the importance of certain functions would be elevated as a result of the financial crisis. Whilst the question of which functions would be ascribed greater importance depends on the company, there were two clear winners: Risk and Internal Audit.

- Almost all respondents felt that remuneration structures had contributed at least in 'some part' to the economic crisis. Many respondents expressed their exasperation at how short-term the market has become and pointed out that companies were merely following the demands of the market when setting their remuneration targets.

The Role of Shareholders

- Some felt that greater scrutiny from institutions was likely to be limited to more elaborate 'box ticking' exercises whereas other respondents expected – and in some cases had already experienced – a greater quality of engagement.

- The most common criticism of the role of shareholders related to the part played by the 'governance specialists' in these institutions. Many respondents seemed frustrated at the lack of alignment between the fund management arm of the institutions and the governance function

- The majority of respondents agreed that the move towards more regular corporate reporting has promoted short-termism on the part of shareholders and companies alike. Few respondents welcomed this move and spoke of the fact that these disclosures are often uninformative for investors and burdensome on the company.

- Around a quarter of respondents felt that 'short-selling' ought not to be considered a legitimate investment technique. Of those which did consider it to be 'legitimate', many felt that additional regulation to promote transparency and prevent abuse was required.

The Role of Regulators

- The vast majority of respondents felt that the current regulatory framework was the most effective means of overseeing corporate governance. However, some respondents felt that, whilst the current framework was appropriate for mainstream PLCs, the regulatory framework for the financial sectors ought to be overhauled.

- Despite the fact that the overwhelming majority of respondents supported the current regulatory framework and the continued application of the Combined Code on a 'comply or explain' basis, over a third of respondents conceded that there was a risk that the Code would lose credibility in light of the financial crisis.

- Many respondents criticised the response by proxy advisory firms and institutional investors to 'non-compliance' with the Code. There were further suggestions that the terminology ought to be changed to 'apply or explain' due to the negative connotations of 'non-compliance'.

- Respondents felt that there would be at least 'some more' and in many cases 'much more' regulation and emphasis on enforcement as a result of the financial crisis.

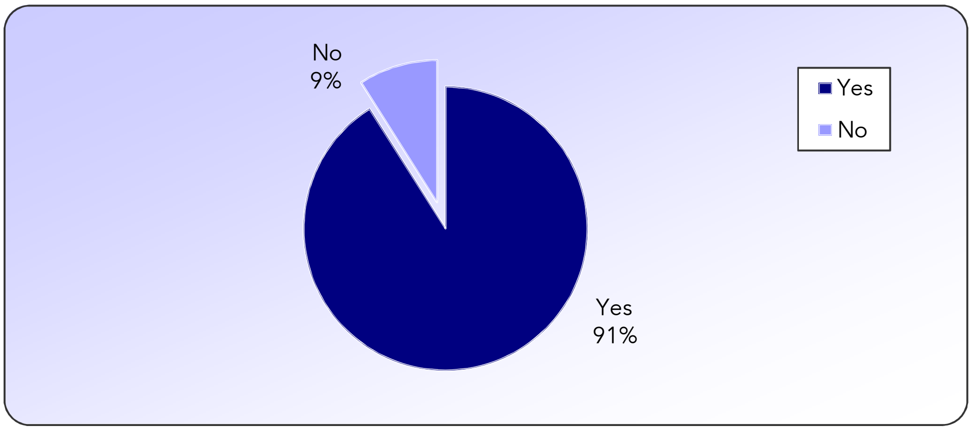
- The vast majority of respondents felt that the governance implications of the recent crisis were confined to the financial services sectors and that it would be wrong to generalize to the wider corporate landscape.

The Role of the Board

The majority of the study focused on the role of the Board of Directors in the recent crisis and in what ways, if any, companies felt that there would be a shift in emphasis at the top.

Board Workload

Do you feel that the workload of non-executive directors is likely to increase as a result of the recent crisis?



The vast majority of respondents stated that they had already experienced an increase in the workload of non-executives as a direct result of the recent crisis. Whilst, in part, this increase has been due to the short-term need to manage the fallout of the crisis on their businesses, almost all respondents agreed that the shift was likely to be permanent in nature.

> *"I think there will be an expectation that NEDs will have a better understanding of the business and will need to spend more time on this. NEDs themselves will want to have a deeper understanding. I suspect this will be a permanent shift. Having said that, care needs to be taken to ensure the pendulum doesn't swing too far and NEDs become "full time". It's NEDs' other interests which can bring fresh perspectives and challenge."*
> **– FTSE 100 Company Secretary**

Many respondents pointed out that the workload has been gradually ramping up over the past ten years and that the responsibilities of today's non-executives greatly exceed those of non-executives in the past.

> *"More and more is being expected of NEDs and I doubt that trend will reverse. There is a danger that the distinction between executive and non-executive directors becomes blurred; further that this will actually lead to a loss of independence and annulment of their original purpose."*
> **– FTSE 250 Company Secretary**

It was also suggested that the increase in workload would result in fewer non-executives being willing to fulfil the role and that the current fee structure ought to be reviewed in order to compensate for the increase in responsibility.

> *"All NEDs will recognise the greater level of scrutiny expected of them and this will inevitably lead to a higher workload. The difficulty will be the willingness of many companies to remunerate accordingly."*
> **- FTSE Small Cap Chairman**

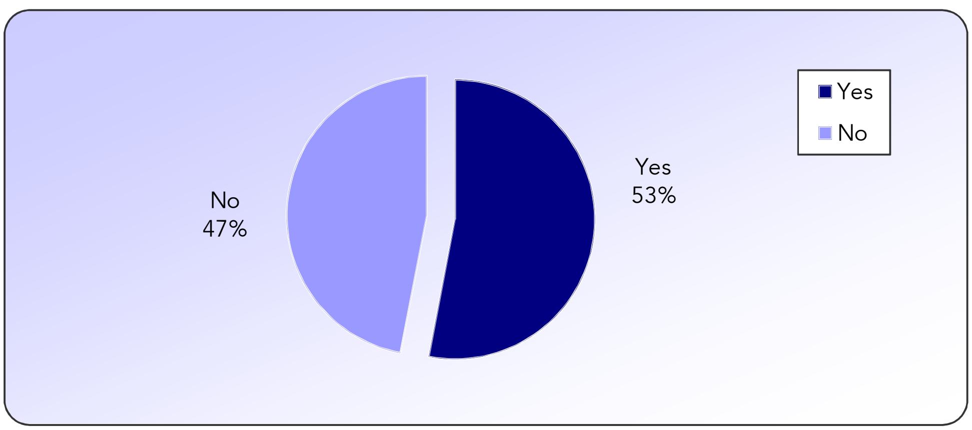
It was also suggested that the increasing emphasis on the workload of non-executives might lead to an inability of full-time executives elsewhere to fulfil the role.

> *"I am concerned that if the demands get too great the ability of people who have existing executive roles to carry out non executive roles will be reduced. I think this would be a retrograde step."*
> **- FTSE 100 Company Secretary**

Overall, respondents felt that the increase in workload could yield benefits for shareholders as long as the board and the board committees focussed on the "right things".

Board Agenda

Has the focus of the agenda of the board or the board committees changed as a result of the recent crisis?



Around half of the respondents noted a shift in agenda as a result of the crisis and, again, many pointed out that this shift in agenda was likely to be permanent in nature. In the short term, respondents stated that the board was dealing with issues such as capital requirements and asset valuations but longer term it was felt that there is likely to be greater emphasis in the agenda on risk identification and management.

"Clearly an increased focus on risk; when looking at risk itself the focus is increasingly on the methodologies utilised in analysing and evaluating risk and the validity of these methodologies."
– FTSE 250 Company Secretary

Respondents repeatedly referred to a number of areas which will require greater scrutiny in the future. These included:

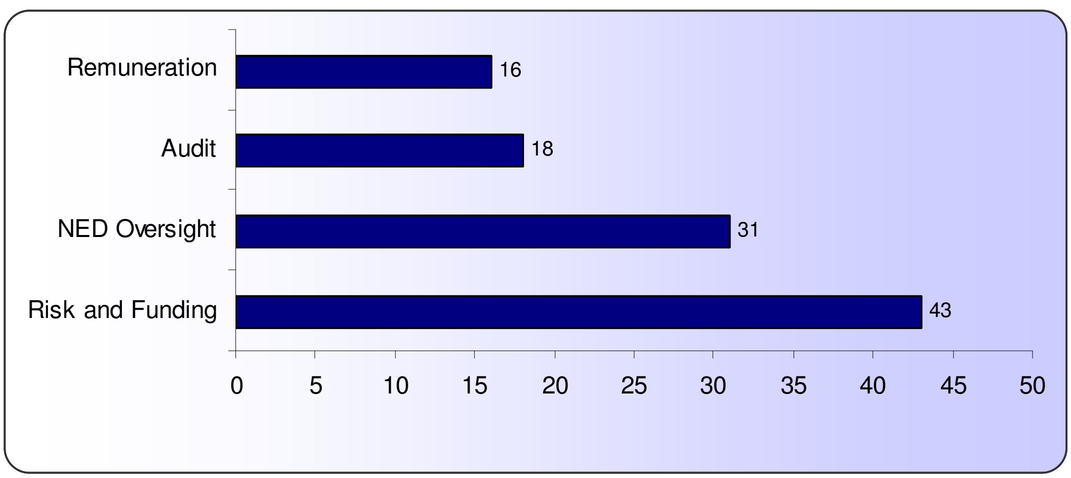
i) funding arrangements
ii) hedging strategies
iii) counterparty exposure
iv) pension deficits

It was frequently pointed out that the level of time spent managing some of these areas was likely to decrease once the markets return to normal and growth resumes. Despite this, the fact that these risks materialised in such a dramatic fashion means that it is only natural that boards should place greater emphasis on their management in future.

"The lessons learnt from the crisis are unlikely to be forgotten."
- FTSE Small Cap Company Secretary

We asked on what areas there was likely to be greater focus in the future in light of lessons learned through the financial crisis.

In what areas is there likely to be greater focus as a result of the financial crisis?



Unsurprisingly, a number of respondents felt that there was likely to be greater emphasis on risk management and the adequacy of funding arrangements which the company has in place. It was also commonly stated that non-executives generally are being more demanding of management.

"The biggest change appears to be greater awareness of the implications of decisions. This is more noticeable from non-executives who may be concerned about how a decision could affect their reputation and therefore their employability."
- FTSE 100 Company Secretary

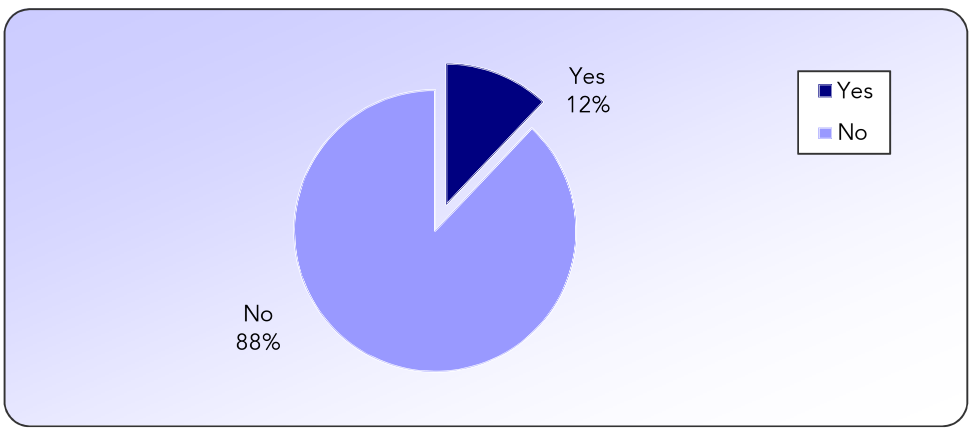
"We have just been more active, with more dialogue between the Board and the management team, and more analysis of 'what if?' scenarios."
- FTSE 250 Chairman

A number of respondents (across all sectors) also stated that their board will be examining the adequacy of remuneration structures in greater detail (see Executive Remuneration).

"Even boards who display good governance and communication will be looking at this to ensure a gold standard of operation. Inevitably remuneration will also be examined in terms of re-alignment of rewards, particularly in the financial sector."
– FTSE 250 Company Secretary

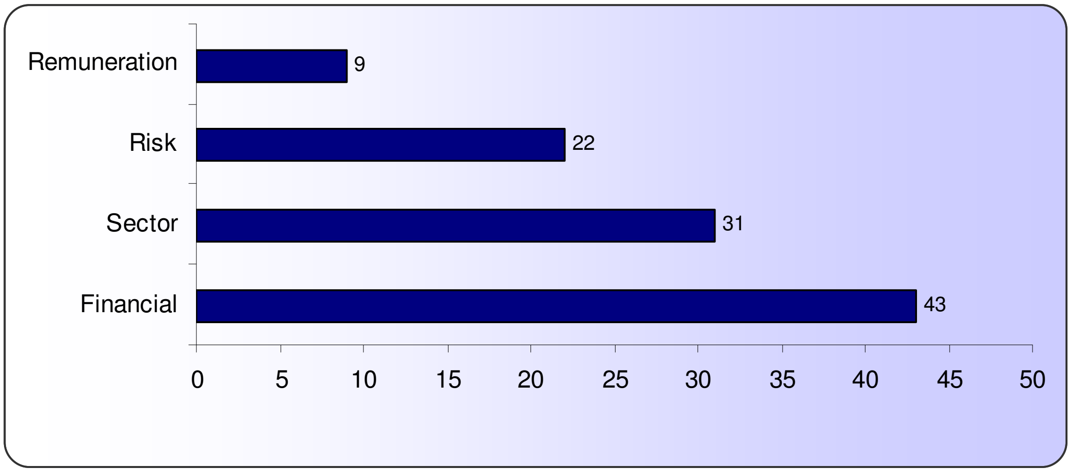
Board Expertise

Are you likely to consider any changes in your current board composition as a result of the recent crisis?



The vast majority of respondents stated that they have not considered any immediate changes in the composition of the board as a result of the financial crisis. However, when considering new appointments through the natural process of board renewal, it is clear that greater weight is likely to be placed on certain key attributes.

What attributes in new non-executive appointments are likely to be the most sought after?



Unsurprisingly, the most common attribute which respondents felt would be sought after in the wake of the financial crisis was financial experience. Perhaps more surprising is the number of respondents who pointed out that the main requirement needed was that of company or sector-specific experience rather than the recruitment of 'generalist' non-executives.

"More emphasis is likely to be placed on candidates having direct experience of the sector, rather than being generalists."
- FTSE 100 Company Secretary

Some felt that the financial crisis might have the welcome consequence that boards focus on what their requirements of non-executive candidates ought to be rather than recruiting based upon external perception. It was suggested that non-executive are far too often chosen with a view to giving institutional investors a "warm feeling" rather than on the basis of the value they provide to the business.

"A re-evaluation of the benefits of significant commercial experience versus 'diversity'"
- FTSE 100 Chairman

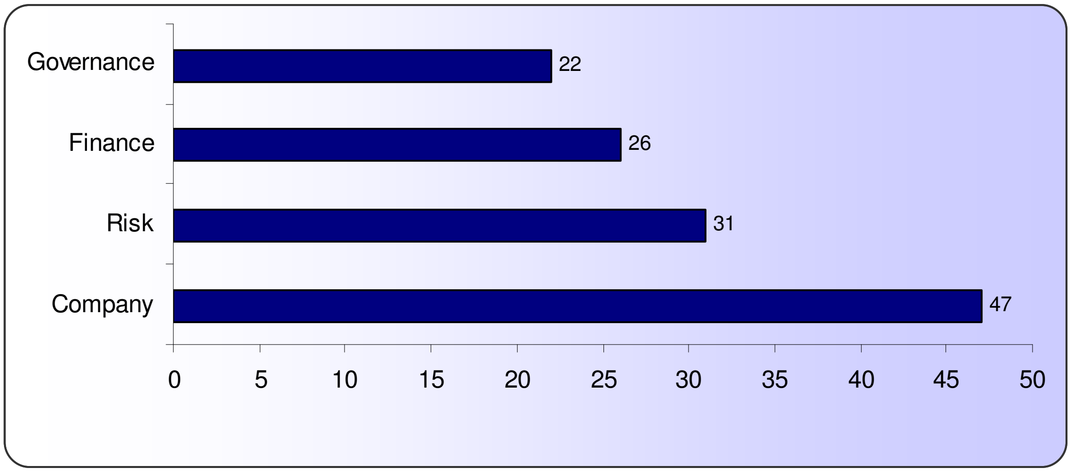
Interestingly, some respondents also felt that that the financial crisis might lead to a greater emphasis being placed on "professional skills" (e.g. accountancy) instead of wider business experience.

"Real risk experience and understanding. Fewer businessmen with general experience and more qualified professionals."
- FTSE 250 Chairman

It was even suggested a few times that the financial crisis might give rise to the need for the creation of a "professional non-executive director".

> *"A more fundamental shift would be to have "full-time" non executives - say no more than 3 appointments - and who have the ability and time to be as attuned as management. However, cost will be on a par with executive management."*
> - FTSE 250 Company Secretary

In what areas, if any, do you feel board members would benefit from further training?

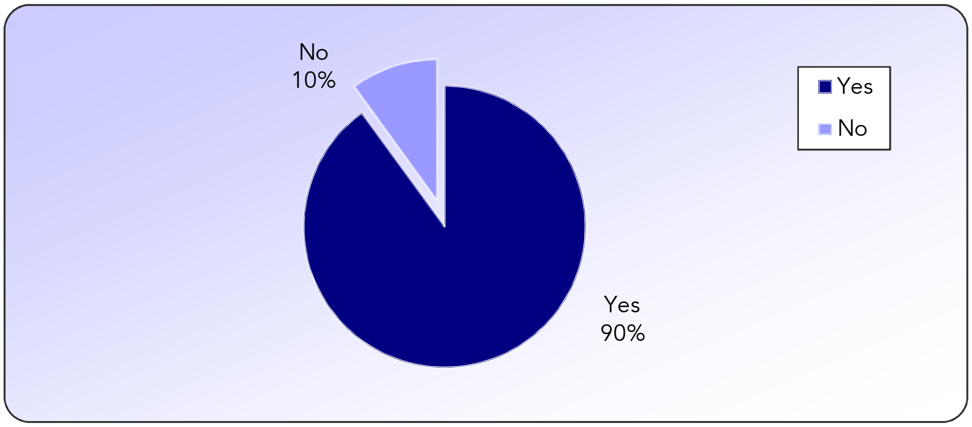


In terms of director training, many respondents felt that further training was not required directly as a result of the financial crisis. Interestingly, the vast majority who did feel that further 'training' would be beneficial thought that it ought to be conducted in-house with a view to fostering a greater understanding of the company amongst non-executives.

> *"Personally I believe training is a waste of time. If anything effort should be made for [....] non executives to be each given a senior manager/executive director to shadow and to change this on a 6 monthly or yearly cycle."*
> - FTSE 250 Company Secretary

Board Oversight of Risk

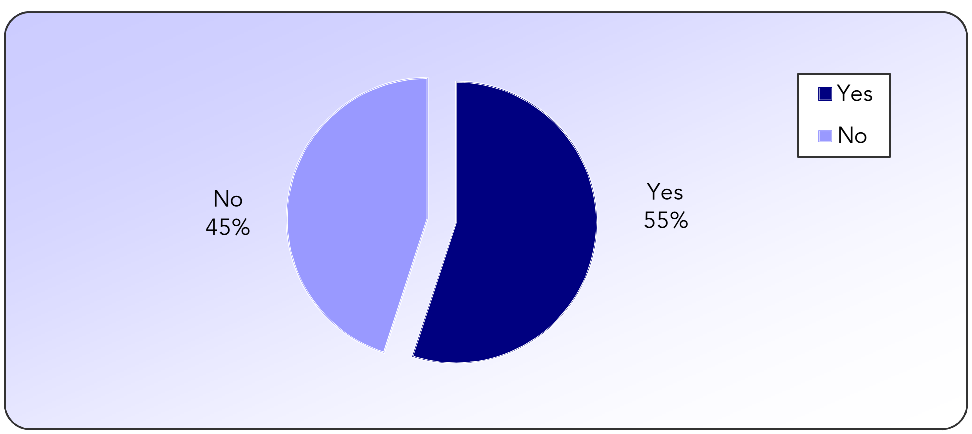
Do you feel that there is enough focus by the non-executives on the oversight of auditors?



Many recent regulatory developments have focussed on the board's role in overseeing auditors. In this regard, it is not surprising that the vast majority of respondents felt that enough was currently being done in this area. Many respondents further stressed that there ought not to be any further regulation in this area and that the current balance was correct. However, it was also pointed out by a number of respondents that there are limits to what can be achieved by the board and the audit committee members insofar as they will always necessarily be reliant on representations made by management and the external and internal audit functions.

> *"The NEDs have to rely enormously on the auditors and the FD for an overview and all the information they receive. It cannot be otherwise."*
> - FTSE 250 Chairman

Do you feel that there is enough focus by the non-executives on the oversight of risk?



Whilst it is clear that most respondents felt that enough was being done in the oversight of auditors, it is striking to compare the balance of opinion with respect to risk oversight – where around half of the respondents felt that there ought to be greater focus on the part of non-executives. It was suggested by some respondents that the board's responsibility in relation to the oversight of risk was often not fully understood and that there was a tendency for boards to rely on work carried out elsewhere.

> *"I think that one of the main reasons for the current economic crisis is due to non-executive directors not probing into risk appetite and management of risk. Non-executive directors should not accept that risk is 'managed by those clever people in derivatives - and in any case is reviewed by the auditors and overseen by the regulators'. Directors should ensure they understand the risks that are being taken, how they are managed and the implications for the company if anything goes wrong."*
> **- FTSE 100 Chairman**

> *"There are two tasks - reviewing the system which identifies, assesses and manages risk, and examining the outputs of that system in terms of key risks. The former is probably an Audit Committee role, the latter must inform the strategy-setting process so is a board responsibility. I think there is a generally inadequate focus on this topic."*
> **- FTSE100 Company Secretary**

It was often suggested that too much of the responsibility for the oversight of risk was delegated to the Audit Committee and that boards should take more of a role.

> *"It is not uncommon for the Boards to delegate the active oversight of risk to the Audit Committee. This is clearly a Board matter."*
> **- FTSE 250 Company Secretary**

Many respondents felt that there was often inadequate understanding of risks amongst non-executive directors. For some respondents the complexity of the risks which companies have to consider made them doubt whether boards could really be expected to consider the appropriateness of specific risks (rather than the adequacy of the risk management framework) whereas other respondents felt that there was a role for the whole board as long as the correct balance was struck.

> *"There is a trend towards to much complexity. The real risks must be kept in view by keeping them few in number and as simply expressed as possible."*
> **- FTSE100 Chairman**

It was often stressed that risk management processes need to be embedded throughout the organisation and, therefore, are truly an executive function. Many felt that the role of the board ought to be limited to ensuring that the right framework, appropriate culture and, crucially, people are in place.

"It needs to be recognised that non-executives must at the end of the day base their judgments on evaluating management rather than on second guessing management decisions."
- FTSE Small Cap Chairman

A few respondents also suggested that the oversight of risk – and understanding of risk amongst the company's shareholders – would be enhanced by greater reporting.

"In light of the recent 'risk issues', maybe there should be more disclosure within the Annual Report & Accounts. CSR now has a bigger focus, sometimes resulting in its own separate report. Maybe now is the time for Risk to be reported on in much more depth."
- FTSE 250 Company Secretary

Board Oversight of Management

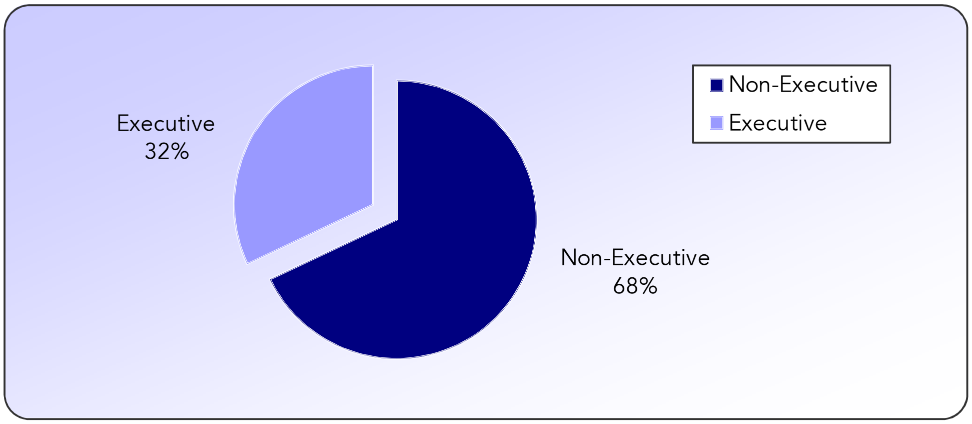
As part of Lintstock's board evaluation practice, we have found that one of the most common complaints made by non-executives is in relation to the oversight of management. It is often suggested that the increasing emphasis on the concept of 'independence' at board level has resulted in a board-to-business disconnect developing[1]. Bridging this divide is important not just for the purposes of human resource management and succession but, crucially, in relation to the formulation of strategy and the oversight of risk.

Clearly, one way to bridge this divide is to have greater executive representation on the board. Our research shows that the proportion of executive to non-executives has reduced over the last 7 years to the extent that now there are on average just 2.8 executive directors per board in the FTSE 350. This is, in part, due to the regulatory drive for independent oversight.

"Higgs requirement for the majority of the board to be independent makes it almost impossible to have more executives without the board becoming too large."
- FTSE 250 Chairman

[1] Lintstock is undertaking a study entitled "*Reconnecting the Board to the Business*" in partnership with the London Stock Exchange. The study will examine strategies for engagement between non-executives and top management. Publication is due in Spring 2010.

Average executive director representation in the FTSE 350



Avg Board Size – 8.7 members

Source: Lintstock Corporate Practice Profiles, November 2009

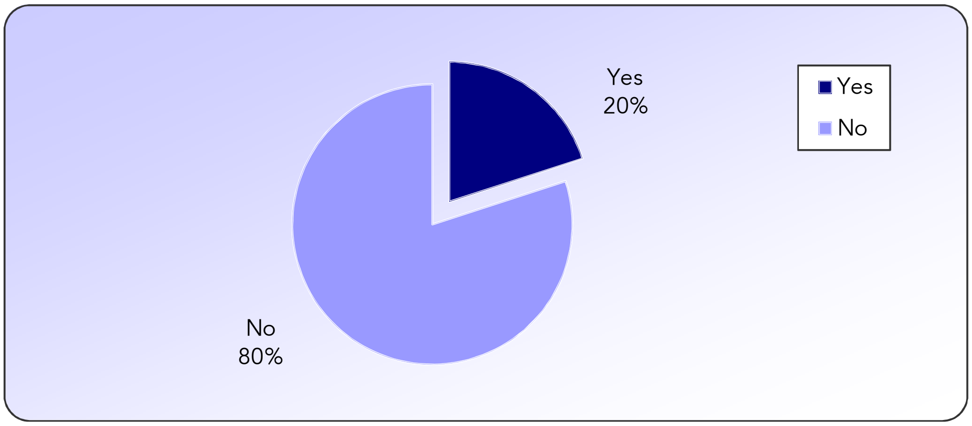
Most respondents felt that the balance of non-executive to executive board membership is about right at the moment. Many respondents suggested that it was not just a question of having more executive director representation but ensuring that the board does not lose its connection with the business more generally.

> *"[Greater executive director representation] should not be needed. However, efforts should be made to ensure that there is an effective mechanism for senior management to communicate directly with NEDs."*
> **- FTSE 250 Company Secretary**

> *"It depends on the way the CEO manages his team and the importance of certain sections of the business. Filtering all the key issues through the CEO might mean the Board does not always receive the full details, but written board reports and a schedule of senior management presentations to the board should address these issues without the need for permanent board appointment."*
> **- FTSE 250 Company Secretary**

> *"For companies which have a disconnect between the non-executives and management frankly the better option is either (i) a revolt from the non-executives and replace management completely; or (ii) resignation of the non-executives and leave it to management solely to work their way through the issues."*
> **- FTSE 250 Chairman**

Do you feel that there ought to be greater executive director representation at board level?



Of those that did feel that there was a tendency towards too little executive director representation, there was a suggestion that the US model whereby the two sole executive directors are the CEO and the CFO was too restrictive for the UK model of governance which is more consensual in nature.

> *"There has been a tendency to restrict executive directors to the CEO and FD. Boards should reflect the complexities within the business and representation on the board should be appropriate."*
> **- FTSE 100 Chairman**

> *"In the US system a lack of executive representation on boards exacerbates the problem of information asymmetry. But in the UK, the balance is better."*
> **- FTSE Small Cap Chairman**

> *"A US style Board where only the CEO and CFO represent management is unhealthy."*
> **- FTSE 100 Company Secretary**

The most common reasons cited for greater executive director representation or, at the very least, greater exposure of non-executives to top management were to give non-executives a greater insight into the business, succession planning and to ensure that power is not concentrated in the hands of too few.

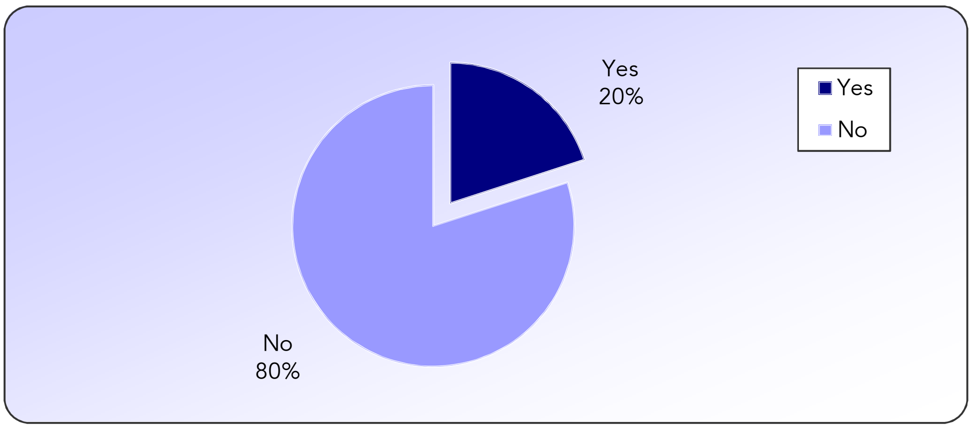
> *"Having wider exec representation on the board helps to 'keep the CEO honest' and provide the NEDs with access to wider insight into operational matters. A wider group of executive directors provides opportunities for possible successors to the CEO to gain boardroom experience and for the board to see them in action."*
> **- FTSE 100 Company Secretary**

> *"I have serious doubts about Companies which have pared down executive representation and thus left too much in the hands of a very few"*
> **- FTSE 250 Chairman**

"It is ridiculous for a board to simply have the CEO and FD represented and the balance NEDs, who definitely will not know the business inside out and backwards. Companies should encourage their key staff to have a long-term involvement and the possibility of a board place in due course. In this way, it will have people on the board who actually know the business and understand its culture."
- FTSE 250 Chairman

"The relationship & trust between the Chairman; CEO/Executive directors & NEDs has been more critical than in the past. Personal/strategic differences have been ruthlessly exposed."
- FTSE 250 Chairman

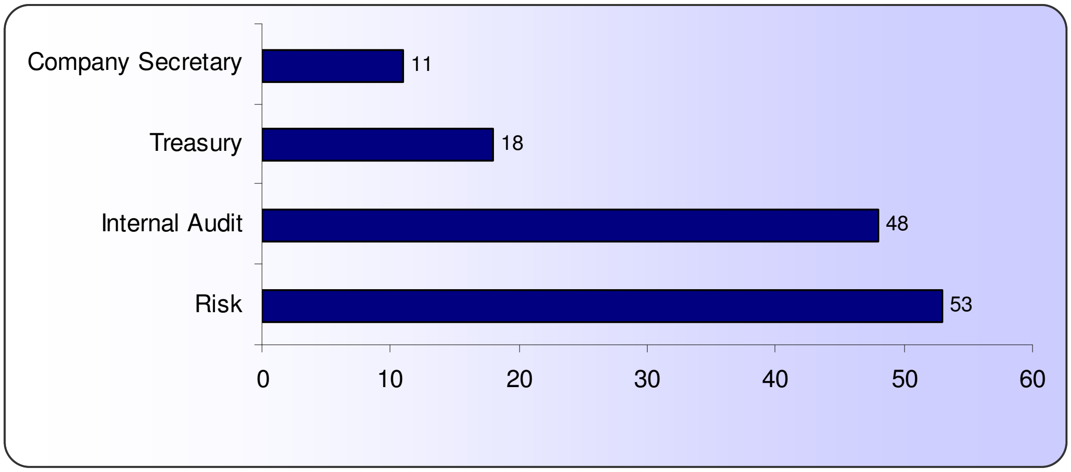
Are there any areas of the business which you feel ought to have more direct accountability to the non-executives on the board?



There was a real split of opinion when it came to questioning whether there ought to be greater direct accountability from business areas to the non-executives on the board. The majority felt that there should not be such further accountability and warned against the risk of making "non-executives accountable for the executive line". Unsurprisingly, those respondents who felt that there ought to be more direct accountability almost universally pointed to risk management as the prime candidate.

"Compliance & risk management could be configured in a way that is more akin to the typical internal audit function, where the head of internal audit often has at least a dotted line reporting relationship to the Chairman of the Audit Committee."
- FTSE 100 Company Secretary

Which internal functions, if any, do you feel ought to be elevated in importance as a result of the recent crisis?



Whilst there was a split on the issue of direct accountability, there was a general recognition that the importance of certain functions would be elevated as a result of lessons learnt through the financial crisis. Whilst clearly the question of which functions would be ascribed greater importance depends on the company in question, there were two clear winners: Risk and Internal Audit.

It was, however, stressed by a number of respondents that the question of functional importance should be left to the companies themselves to decide what is appropriate for their business rather than through outside influences as a spill-over from the financial crisis.

> *"Certain industries have messed up big time (banks etc); I do not want more internal functions in our business just because other people running businesses in the financial sector failed. We already have too many rules which have clearly not been thought through properly [….] why should we suffer more rules telling us how to run a business when clearly the old ABI rules screwed up so badly with the banks?"*
> **- FTSE Small Cap Company Secretary**

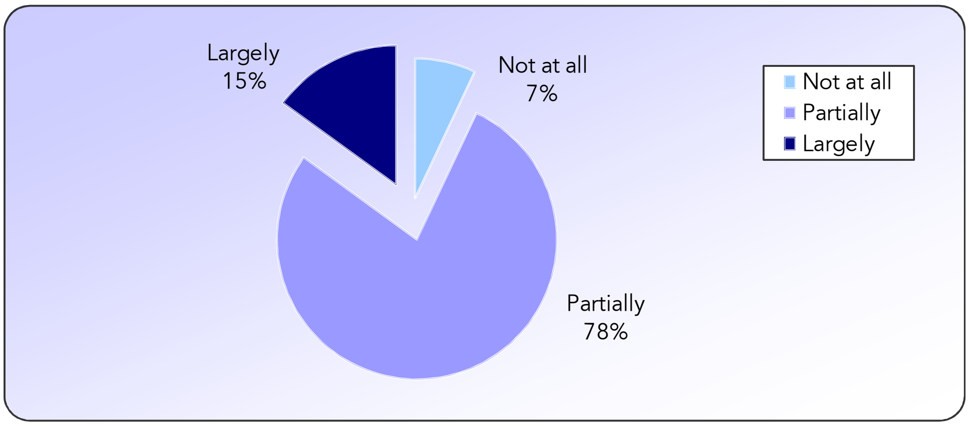
Executive Remuneration

With respect to remuneration, it should be noted that a number of respondents pointed out that their observations were restricted to the financial services industry.

"Clearly this doesn't apply to all companies or sectors, but there is an issue with the short-term nature of incentives in financial institutions which without doubt has contributed to the economic crisis."

- FTSE 100 Company Secretary

Do you feel that the remuneration structures companies operate have contributed to the economic crisis?



However, it is striking to note that almost all respondents felt that remuneration structures had contributed in 'some part' to the economic crisis. Many respondents expressed their exasperation at how short-term the market has become and pointed out that companies were merely following the demands of shareholders when setting their remuneration targets.

"Like it or not the remuneration culture starts with those acting on behalf of the owners of the business - the institutional investors. The drive for bonuses starts with them, encouraging and rewarding short-term performance - thereby raising the share price and finally the stock options and bonuses of those that deliver to the institutional investors. Consultants have added fuel to the fire".

- FTSE 250 Chairman

"We have a culture created by the Stock Market that makes individuals running companies failures if they do not meet targets. Therefore short-termism is the only way forward for listed PLCs."

- FTSE Small Cap Company Secretary

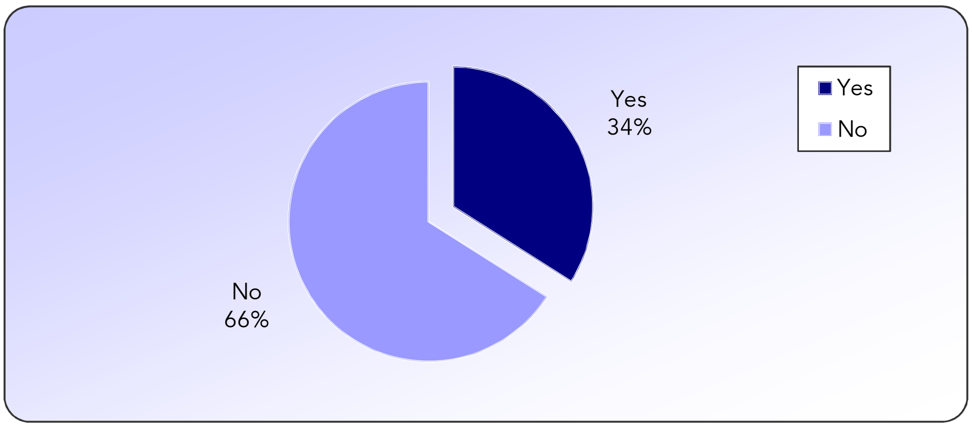
"[It's] crowd psychology too. In the old days, if a banker made a lot of money for his bank, he got the sack - because he must be taking undue risk. That lesson has been forgotten."

- FTSE Small Cap Chairman

Many also lamented the extent to which the remuneration landscape has changed such that all senior employees feel entitled to an 'equity stake' in the business rather than being contented with drawing a salary for performance.

> *"Frankly there is now an assumption that as an executive you have an "equity" stake in the business. This culture is completely wrong. All it is is a job with a salary - if people feel the need for an equity stake then they should buy shares in their company."*
> **- FTSE 250 Company Secretary**

Do you feel the board ought to have wider responsibility for the company's employee remuneration plans?



Many respondents felt that the board already had sufficient responsibility for overseeing the remuneration plans of employees within the organisation. However, a number of respondents stressed that the board ought to limit itself to overseeing the 'framework' by which employees are remunerated and should not be involved in the individual details.

> *"Just because it is not part of the regular boardroom function does not mean it is not responsible. The board should be aware of employee remuneration plans but not involved in drawing them up or operating them."*
> **- FTSE 250 Chairman**

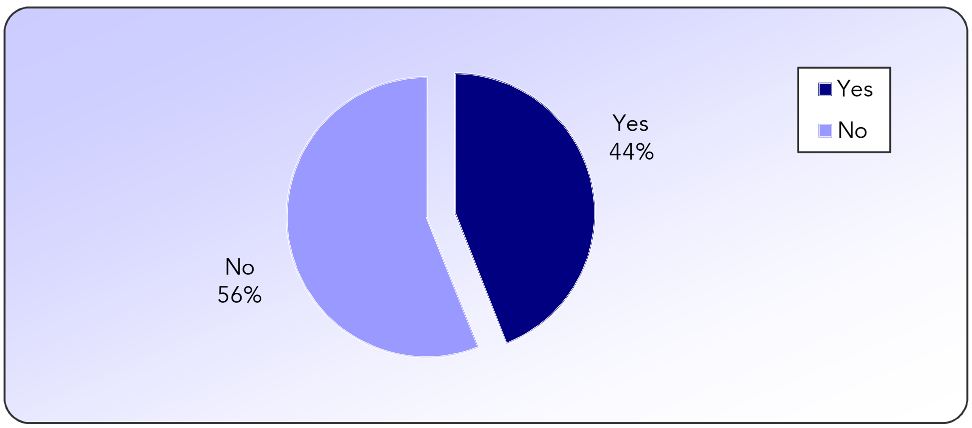
There seemed to be divergent practices in this area as a significant minority of respondents felt that the board ought to have greater responsibilities in this area.

> *"Boards ought to understand the behaviour that will be 'driven' by the business's remuneration approach at every level. Going forward reward policy at every level of the business should be reviewed."*
> **- FTSE 250 Chairman**

Again, some respondents drew a distinction between the practices which ought to be exhibited in 'financial institutions' and those that were appropriate for the wider corporate environment.

> *"In Financial Institutions possibly 'Yes', unless the FSA's approach to bringing in risk-based remuneration is successful. In non-financial companies, the Board should be able to trust the Executive Management team, as the bonus culture is much less of an issue at levels below senior management."*
> **- FTSE Small Cap Chair**

Do you feel that there ought to be greater disclosure regarding the pay structures which are in place for non-board level executive management?



A significant minority of respondents felt that such disclosures would be beneficial whereas the majority felt that the status quo should be maintained. Many respondents questioned how shareholders would benefit from such disclosures and expressed doubts as to whether the current disclosure burden was counterproductive, suggesting that shareholders are already 'buried' in disclosure for dubious benefit.

> *"We have had more disclosure requirements than any time in history and still no-one reads it or takes heed! The problem with greater disclosure is that it is simply NOT read and becomes boilerplate."*
> **- FTSE Small Cap Company Secretary**

A number of respondents again distinguished between the need for individual disclosure of remuneration and more general disclosure of the structure of remuneration. Many felt that whilst the individual disclosure might be of little benefit to shareholders the disclosure of the remuneration philosophy as it applies to the executive management might be of some benefit.

> *"Shareholders would appreciate disclosures regarding the objective of executive reward structures and the safeguards in terms of risk/reward."*
> **- FTSE 100 Chairman**

"Only in relation to the structure of pay and proportion of performance-based - whether it is the same as for the main Board member remuneration structure."
- FTSE 100 Company Secretary

With respect to the disclosure of individual remuneration, a number of respondents warned against such disclosures on the basis that they might result in pay being 'ratcheted up' in a similar way to that of executive directors and that disparities between geographies/departments have the potential to cause discord in the company.

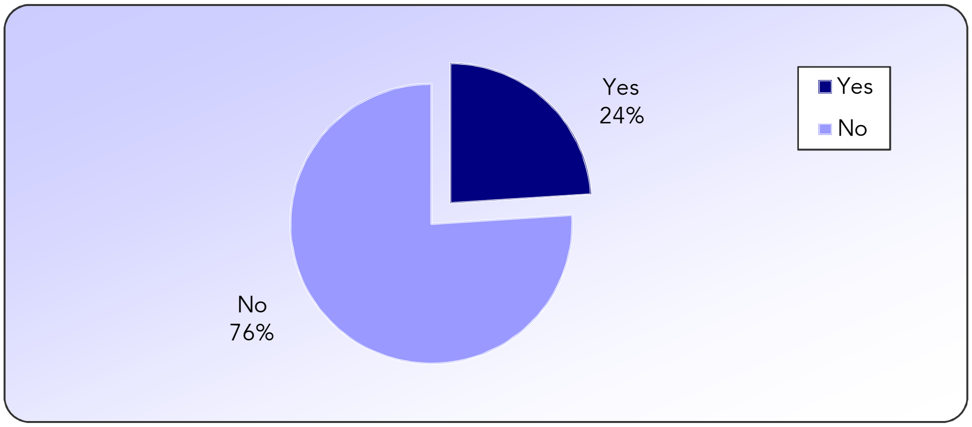
"Greater disclosure would be likely to result in salaries converging towards the highest levels rather than the opposite. There would also be many problems with overseas staff in countries where salary levels are different from those in England."
- FTSE Small Cap Chairman

As regards actual changes to the structure of remuneration plans, there were very few suggestions as to what specific changes are likely. Mindful of work ongoing in this area, some respondents suggested that there was likely to be a greater emphasis on deferral and 'proving' performance over time. Transparency was also highlighted as being key to remuneration plans going-forward, as some respondents criticized the current level of complexity involved. In part, it was suggested that this complexity is driven by the widespread use of remuneration consultants.

"I question the role of remuneration consultants in advising upon remuneration policy and the complexity that this can bring. Moving forward, a structure that is transparent and understood from top-to-bottom is likely to be one most companies will continue to strive for."
- FTSE 100 Chairman

Board Evaluation

Do you feel that the focus of your board evaluation will change in the coming year?



Most respondents did not see the need for the focus of their board evaluation to change over the coming year. It was no surprise that of those that felt the focus might change, the oversight of risk was cited as the most likely candidate for greater scrutiny. It was also suggested by a few respondents that boards might find it easier to be more critical of their own performance than during the 'good time' and that additional rigour may be applied to the process.

> *"Additional, deeper questions around business understanding and risk awareness would be candidates for inclusion next year."*
> **- FTSE 100 Company Secretary**

> *"The Boards I am involved with will spend more time on discussing and agreeing the skill & experience needed round the Board table. Action will follow in retiring those who are no longer capable/appropriate & finding the highest quality replacements possible. I believe in a number of cases Chairmen/Boards have been aware of inadequacies, but in easier times they could be tolerated."*
> **- FTSE 250 Chairman**

The Role of Shareholders

When questioned in what ways the interaction with shareholders was likely to change as a consequence of the economic crisis around half of the respondents did not feel that any changes were likely. A number of respondents also questioned the value of interaction from both sides.

"A probable consequence will be greater conflict between listed companies and some of their institutional shareholders. Probably this will make little difference to how companies are in practice managed but will provide a basis for non-executive directors demanding higher fees for greater exposures."
- FTSE Small Cap Chairman

Regularity of Engagement

There was a broad range of responses in respect of the regularity of engagement with institutional investors as some companies suggested that this was somewhat sporadic and did not note any recent change whereas a few others noticed an increase in the amount of engagement.

"The key to shareholder engagement is time & respect. Is the shareholder really interested in this investment? Unfortunately many funds (for diversification) hold too many shares - for the resources they have able to them – to really understand and monitor the business."
- FTSE 250 Chairman

"Not much - we talk to them (or offer to); they don't have the time to talk to us much."
- FTSE100 Chairman

Whilst most companies suggested that there was a lack of appetite on the part of investors to engage with them, a few others noticed an increase in the amount of engagement requested by their investors in light of the financial crisis.

"As chairman, I have spent more time speaking to shareholders in the last twelve months than in the preceding 12 years."
- FTSE 250 Chairman

Quality of Engagement

There was a similarly broad range of responses when we questioned whether respondents expected the quality of their engagement with institutions to improve. Some felt that greater scrutiny from institutions was likely to be limited to more elaborate 'box ticking' exercises whereas other respondents expected – and in some cases had already experienced – a greater quality of engagement.

> *"More direct discussions with the fund managers rather than the analysts or Corporate Governance people is already happening."*
> - FTSE Small Cap Chair

> *"Companies will expect, and be more willing to engage with institutional shareholders. Companies may also try harder to explain in shareholder communications the character of the company's approach to governance rather than seeking to review compliance against the Combined Code. Given the emphasis being placed on shareholder interaction this can be expected to be a permanent structural change."*
> - FTSE 250 Company Secretary

> *"Probably more box ticking required from the CG police; but as far as we see no one we meet takes any notice of the CG police; they are seen as a bit of a joke"*
> - FTSE Small Cap Company Secretary

> *"Shareholder associations have become even more intrusive and fixated on quantitative measures."*
> - FTSE 250 Chairman

With respect to the areas in which respondents felt that there would be greater scrutiny from shareholders, it was thought that there would be more demand for regular information flows about the business and greater transparency around risk management and remuneration practices.

> *"There will no doubt be more interest paid by shareholders and greater questioning of management on the strength of business, balance sheet, funding, etc. We have already seen shareholders being better prepared when meeting with management and asking more pertinent questions."*
> - FTSE 250 Company Secretary

> *"Possibly more business updates and greater transparency around risk."*
> - FTSE 100 Company Secretary

> *"We expect more scrutiny, communication and challenges from shareholders. Shareholders may also require greater disclosure from the company particularly in relation to remuneration."*
> - FTSE 250 Company Secretary

The Role of Governance Specialists

The most common criticism of the role of shareholders related to the part played by the 'governance specialists' in these institutions. Many respondents seemed frustrated at the lack of alignment between the fund management arm of the institutions and the governance function. Some respondents also complained of lack of seniority within the corporate governance department of the institutions.

> *"The interactions on Governance topics are often of low quality/rather sterile. Investment managers should handle these matters directly and not pass them off to 'specialists'."*
> - FTSE 100 Chairman

> *"The Governance and Investment teams should be merged – they are at opposite ends of spectrum at present."*
> - FTSE 100 Chairman

> *"It would be a real advantage if some institutions better coordinated their governance units with those managing their portfolios."*
> - FTSE 250 Chairman

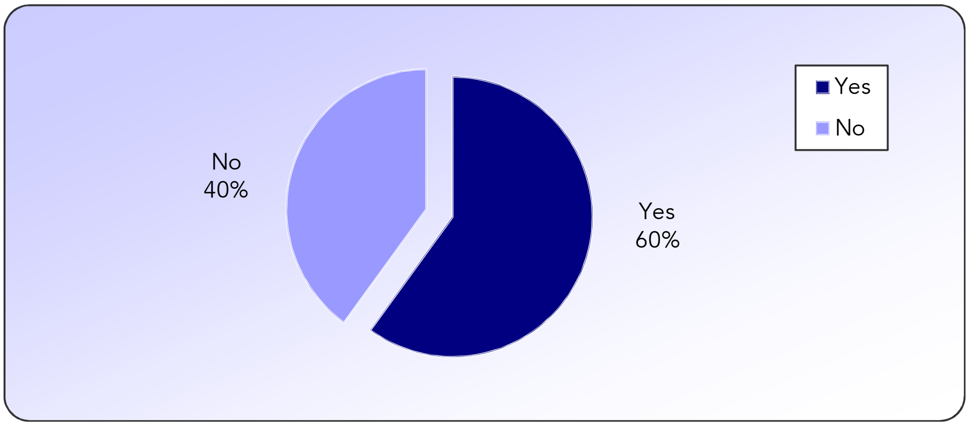
Short-Termism

Dealing with the question of short-termism within the market, many respondents complained about the demands placed on them by investors.

> *"There is far too much focus on 'short-termism'. Until investors take a longer view then we will always face the risk of decisions being taken for short term gain to the detriment of long term value for shareholders."*
> - FTSE 100 Company Secretary

> *"Just look at the turnover of institutional actively managed portfolios; fund managers tend to be rewarded for their short-term relative performance."*
> - FTSE 250 Chairman

Do you feel that the move towards quarterly reporting has promoted short-termism?



The majority of respondents agreed that the move towards more regular corporate reporting has promoted short-termism on the part of shareholders and companies alike. Few respondents welcomed this move and spoke of the fact that these disclosures are often uninformative for shareholders and burdensome on the company.

> *"I think that there is now more reporting than is necessary and that this provides an avoidable overhead."*
> **- FTSE Small Cap Chair**

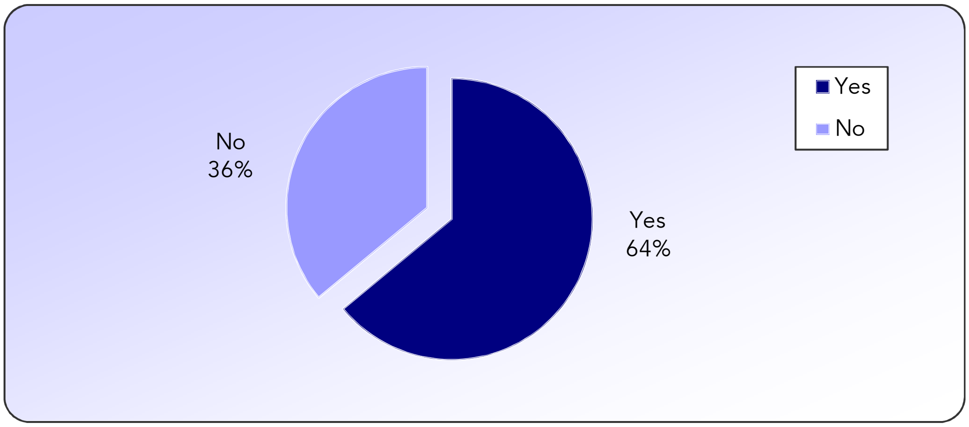
> *"Any 'reporting event' leads to a focus on the likely impact of that announcement. As a result too much effort goes into the immediate 'pay back' rather than the longer-term objectives."*
> **- FTSE 250 Chairman**

However, a few respondents suggested that more regular reporting had contributed to greater market efficiency.

> *"Provides greater transparency for shareholders. In our industry where changes happen quickly and the business needs to respond equally quickly, quarterly reporting enables key messages to be given by management."*
> **- FTSE 250 Company Secretary**

Selling shares "short"

Do you feel that short-selling is a legitimate investment technique?



Whilst the vast majority felt that short-selling should be considered a legitimate investment technique, a number of respondents expressed their misgivings about the practice.

> *"The difficulty is that it creates a class of shareholders who have no interest in governance or contributing to the long term and some may have an interest in spreading rumours in order to drive share price movements."*
> - FTSE 100 Chairman

> *"As far as I am concerned Boards need to plan for the long term and short-selling totally discourages this essential duty of the Board."*
> - FTSE 250 Chairman

> *"It is a parasite that should be made illegal."*
> - FTSE Small Cap Company Secretary

Many respondents felt that a greater degree of transparency was required and control was needed to ensure that the practice is not abused.

> *"Provided that there is sufficient disclosure and that there are mechanisms to suspend short selling on certain stocks to regulate the market in a potential crisis situation."*
> - FTSE 100 Chairman

> *"Short selling can lead to market divergences in a company's share price and should be monitored by the Market Regulator."*
> - FTSE 100 Company Secretary

Some respondents felt that the practice increased efficiency and liquidity in the market but these positive comments were in large part balanced by views to the contrary. In general terms, the majority of respondents were not particularly in favour of the practice itself but felt that it was wrong to interfere in the operating of the market unless absolutely necessary.

> *"Please ignore the spurious arguments about shorting adding to market liquidity. It adds profit-making opportunities to market participants and leaves companies and outside investors with a real problem in pricing and accessing equity. We didn't have liquidity problems before shorting became so significant."*
> **- FTSE 250 Chairman**

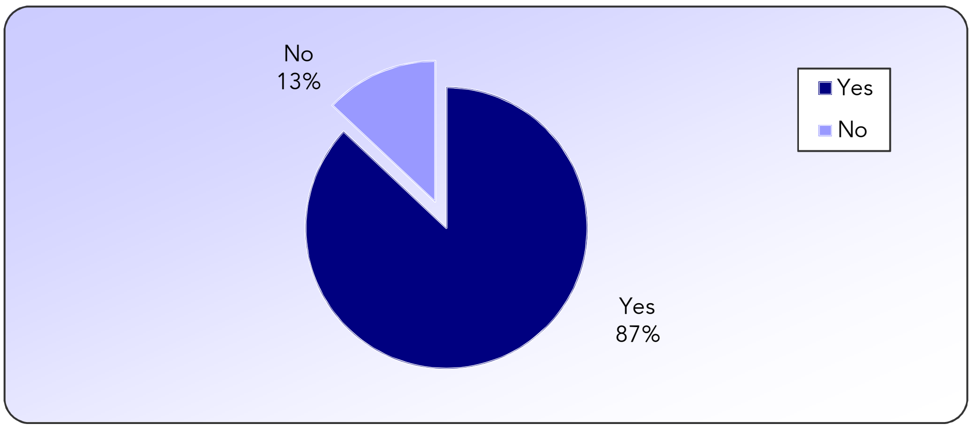
> *"It is a contentious topic, but on balance it is wrong to interfere with markets."*
> **- FTSE 100 Chairman**

The Role of Regulators

Finally, we questioned the role that the Regulators had played in the financial crisis and asked what respondents expected to see as a response to the crisis as well as what they would like to see.

Regulatory Framework

Do you consider that the current regulatory framework remains the most effective means of overseeing corporate governance?



The vast majority of respondents felt that the current regulatory framework was the most effective means of overseeing corporate governance. However, some respondents felt that, whilst the current framework was appropriate for mainstream PLCs, the regulatory framework for the financial sectors ought to be overhauled.

> *"It is inappropriate for financial services companies. This has been recognised by the FSA and I would broadly support the FSA having a more thorough review of business models as well as the previous focus on consumers."*
> **- FTSE 100 Chairman**

> *"For most listed companies the combined code is more than adequate. In the banking and financial services sector, the regulatory oversight has clearly been inadequate and needs reform."*
> **- FTSE 100 Company Secretary**

Whilst there were some pointed criticisms as to how the United Kingdom regulatory framework was 'applied' most respondents favoured the 'principle-based' approach over the more prescriptive model adopted in the United States. A number of respondents pointed out that the United States framework has not been any more effective than that practised in the United Kingdom in preventing the financial crisis.

"Support 'comply or explain' model over prescriptive regulation. Note that Sarbanes Oxley regime did not prevent the crisis in the banking system either in US or in UK."
- FTSE 100 Chairman

"The code appears much more effective and less costly in terms of compliance than a Sarbanes Oxley type approach."
- FTSE 100 Company Secretary

When it came to criticism of the way in which the United Kingdom framework was applied the comments broadly fell into two areas – the relationship between the regulator and listed company boards and the 'tick-box' approach to enforcement.

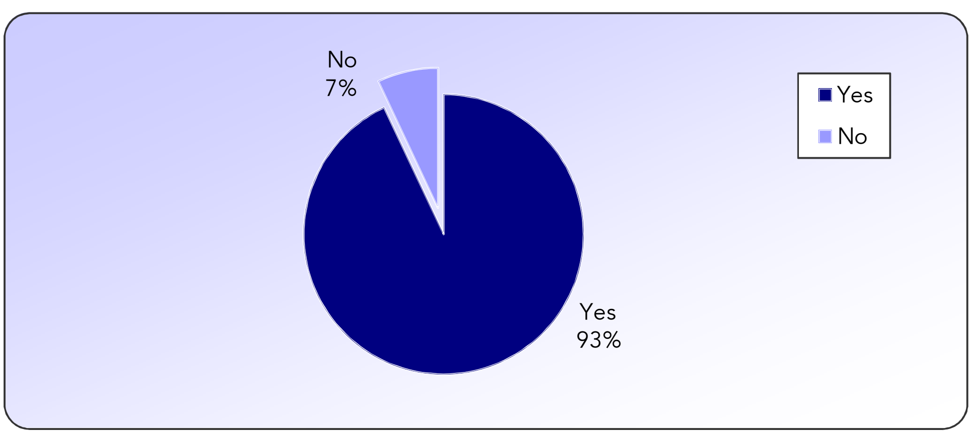
"We need a better understanding (and more skilled interchange) between regulators and Boards."
- FTSE 250 Chairman

"Force regulators to only employ people who have worked in corporates."
- FTSE 250 Chairman

"No senior regulator should be in post who has not had a spell of secondment with a company in the business."
- FTSE 250 Chairman

"Tick box approaches must be avoided and the focus must be to the benefit of all shareholders."
- FTSE 250 Chairman

Do you feel that the 'comply or explain' regime remains the most effective means of enforcing the Combined Code?



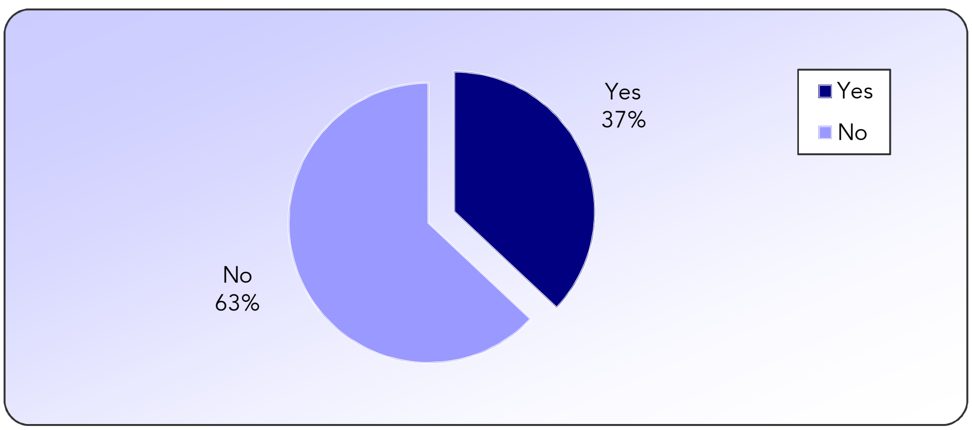
We then asked whether respondents felt that the 'comply or explain' regime was the most effective means of enforcing the Combined Code. Again, the vast majority supported the status quo. Once more, however, there was much criticism of the way in which it was applied by institutional investors and, particularly, proxy advisory firms.

> *"Better to call it 'apply or explain' - otherwise a sensible choice not to apply a provision of the Code can always be badged as 'non-compliance'."*
> **- FTSE 100 Company Secretary**

> *"It is enforced by a completely different set of people to those who make investment decisions. Ultimately it inevitably descends into box ticking, rather than comply or explain as the governance people in institutional investors do not have the resources or seniority to influence actions or understand the explanations."*
> **- FTSE 250 Company Secretary**

Despite the fact that the overwhelming majority of respondents supported the current regulatory framework and the application of the Combined Code on a 'comply or explain' basis, over a third of respondents conceded that there was a risk that the Code would lose credibility in light of the financial crisis.

Do you feel that there is a risk that the Combined Code will lose credibility in light of the recent crisis?



Many respondents felt that if the Code was enforced on an alternative basis (e.g. on a mandatory basis) it would make little difference to the current crisis and that, again, the more prescriptive rules applied in other markets have hardly yielded superior results.

> *"What makes you think it hasn't already lost credibility?"*
> **- FTSE 250 Chairman**

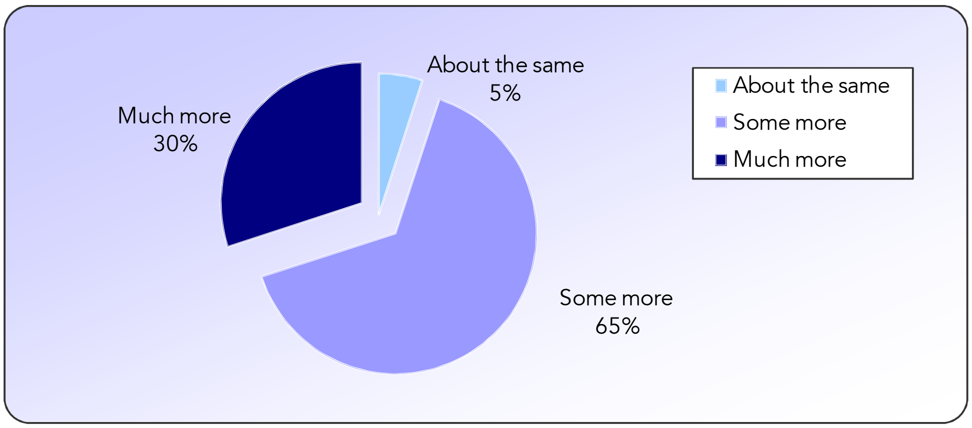
> *"The Combined Code has little to do with the recent crisis. If, owing to short-termism, a whole sector wishes to behave like idiots in terms of their businesses then the Combined Code (or any other code) will not stop them."*
> **- FTSE 100 Company Secretary**

"I don't think the crisis has demonstrated flaws in the Combined Code, but there is nonetheless a risk to its credibility in the climate of blame and recrimination that now holds."
- FTSE Small Cap Chairman

Regulatory Response to the Crisis

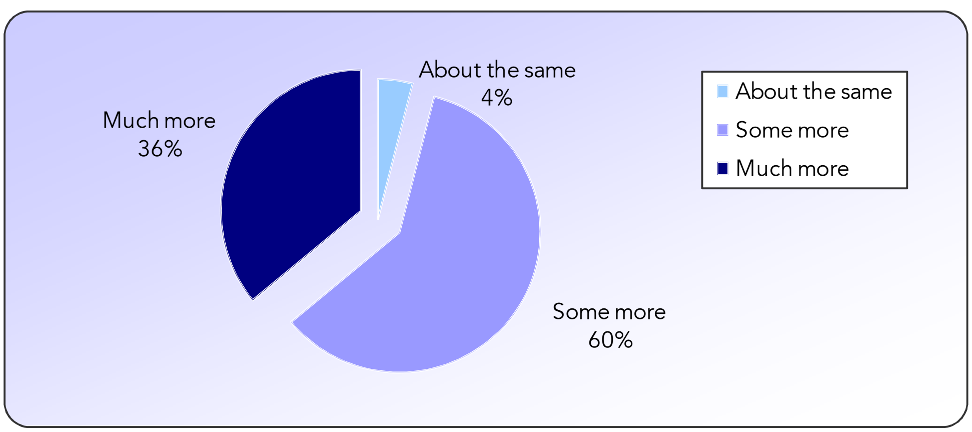
Whilst establishing that most respondents felt that the current regulatory framework is the most appropriate means of overseeing corporate governance in the United Kingdom, we next asked what was likely to be the regulatory response to the crisis. Firstly, we asked whether there was likely to be an increase in regulation.

Do you feel that there will be an increase in the amount of regulation over the next five years?



Secondly, we asked whether there was likely to be greater emphasis on regulatory enforcement post-financial-crisis.

Do you feel that there will be greater emphasis placed on regulatory enforcement over the next five years?



In each case, respondents felt that there would be at least 'some more' and in many cases 'much more' regulation and emphasis on enforcement as a result of the financial crisis. The vast majority felt that greater regulation was unnecessary apart from in the financial services industry. Many, however, expressed a fear of 'regulatory creep' beyond those sectors.

I fear that they [regulators] will focus on risk management and on remuneration in all sectors rather than reflecting deeply on what regulators could have done differently."
- FTSE100 Chairman

"I suspect there will be much more regulation for financial institutions. The danger is that this spills out into other sectors where it is not so needed."
- FTSE 100 Company Secretary

Respondents stressed that greater regulation of PLCs was not needed. Many felt that there was a risk that misguided regulation would make it more likely that a crisis would happen in the future and would stifle companies in the meantime.

"The Government must be vigilant not to fall into the Sarbanes-Oxley trap, which inflicted enduring damage on the US financial services industry. No knee jerk reactions, please."
- FTSE 100 Chairman

"I fear much more - which will be a thoroughly bad thing as it will keep aiming at the problems that have happened and make Boards less able to adapt to the problems looming around the corner."
- FTSE 250 Chairman

"More and more attention will be paid to 'parking offences' because it is easy to do but 'smash and grabs' will be undetectable and therefore unregulated. Our regulators are not experienced in the businesses that they regulate."
- FTSE 250 Chairman

"Sadly what this means is that Boards will spend much more time trying to make sure that they have complied with all the regulations, rather than running a successful business."
- FTSE 250 Chairman

Combined Code Consultation

We also ask respondents to consider what aspects of the Combined Code they would like to change. As noted above concerning the regulatory framework, many respondents criticised the response by proxy firms and institutional investors to 'non-compliance' with the Code. There were further suggestions that the terminology ought to be changed to 'apply or explain' due to the negative connotations of 'non-compliance'.

Beyond those issues, the most common suggestion was that the 9 year service criteria for independence ought to be reviewed. This response ties in with the theme throughout this study that one of the most important skills required of directors is a sufficiently deep understanding of the operations of the company which they serve.

> *"Given that there is a desire for NEDs to have a better understanding of their companies, the 9 year independence rule needs to be reconsidered."*
> **- FTSE 100 Company Secretary**

> *"Recognising that the value of 'knowledge' which a non-executive director gains during his period on the board may outweigh the supposed lack of 'independence' which is currently believed to occur after 10 years on the board. An individual with an independence of mind does not suddenly lose it after 10 years."*
> **- FTSE 250 Chairman**

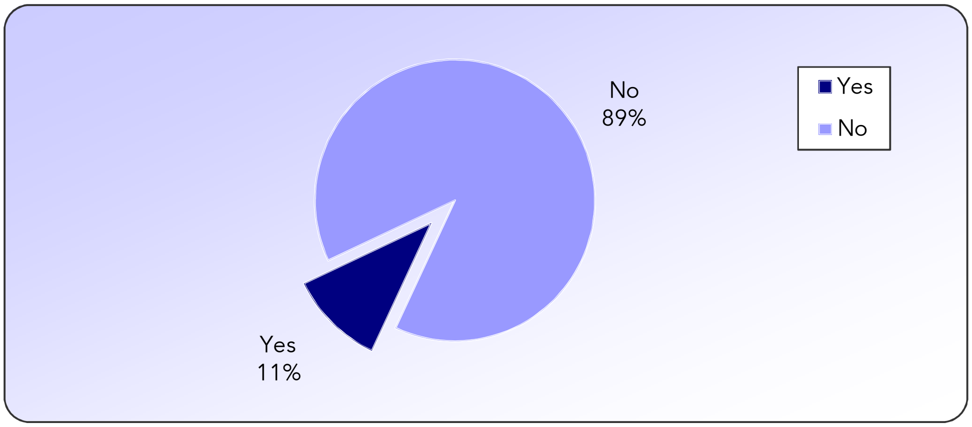
> *"Is it surprising that the NEDs serving on the boards of our banks did not understand what was going on? Not one director of the Royal Bank of Scotland had more than 7 years' experience serving on the board"*
> **- FTSE 250 Chairman**

Similarly, it was pointed out by a few respondents that the banks which fared best during the financial crisis were those where the previous CEO succeeded to the position of Chairman. Again, this would suggest the value of a deep understanding of the operations of the business amongst non-executives.

> *"Would prefer the 'apply or explain' terminology as 'comply' has too many negative connotations. Should be ok to depart from specific provision if well argued explanation is given. Note that the two banks who have fared better than most, both had CEOs who became Chairmen."*
> **- FTSE 100 Company Secretary**

Lessons learned from the Crisis

Do you feel that the corporate governance implications of the recent crisis ought to include the whole corporate sector rather than just the financial service sectors?



The vast majority of respondents felt that the governance implications of the recent crisis were confined to the financial services sectors and that it would be wrong to generalize to the wider corporate landscape. A few respondents were more open-minded, however, suggesting that important lessons could, perhaps, be learned for all sectors.

> *"If there are valuable lessons to be learned (e.g. a more proactive approach to and understanding of risk management), they should be applied equally to all companies."*
> **- FTSE100 Company Secretary**

> *"There is a huge opportunity for all sectors to learn from the plight of the banks. The review of banking should retain a broader context so we can learn the lessons."*
> **- FTSE 100 Company Secretary**

Many respondents added that the greatest risk posed by the financial crisis was that new rules are applied to the non-financial sectors in an ill-considered fashion.

> *"The greatest risk is an over-reaction by regulators and investors which places all businesses in a tight strait-jacket which stifles entrepreneurial activity"*
> **- FTSE 250 Chairman**

It is clear that all respondents felt that their boards were unlikely to forget how the financial crisis has impacted their respective businesses. There was no single suggestion as to what the key learning across all businesses ought to be. In the words of one respondent:

> *"A speedy recovery could lead to short memories and few lessons learnt. The biggest risk is that a great cultural change in attitudes towards governance does not occur."*
> **- FTSE 250 Chairman**

Appendix – List of study participants

We received 222 responses to this study; the names of the companies which participated are listed below. We would like to thank all of them for their generous support.

3i Infrastructure
888 Holdings
Aberdeen New Dawn
Absolute Return Trust
Aegis Group
Aggreko
Alliance Trust
Alternative Investment Strategies
Anglo & Overseas
Anglo American
Anite
Antisoma
Ark Therapeutics Group
ARM Holdings
ARRIVA
AstraZeneca
Atkins (W S)
Avis Europe
Aviva
Axis-Shield
Babcock & Brown Public Partnerships
Babcock International Group
BAE SYSTEMS
Balfour Beatty
Barclays
Barr (A G)
Barratt Developments
Berkeley Group Holdings
BG Group
BlackRock Commodities Inc Inv
Bloomsbury Publishing
BP
easyJet
Edinburgh US Tracker Trust
Elementis
Enterprise Inns
Eurasian Natural Resources
Experian
F&C Capital & Income
F&C Commercial Property Trust
F&C US Smaller Companies
Fidelity Special Values
Filtrona
Foreign & Colonial Investment
French Connection Group
Friends Provident
GlaxoSmithKline
Gleeson (M J) Group
Go-Ahead Group (The)
Greene King
Halfords Group
Hampson Industries
Hansard Global
Hays
Helical Bar
Henderson EuroTrust
Henderson TR Pacific Investment Trust
Hikma Pharmaceuticals
Hilton Food Group
Hiscox
Hogg Robinson Group
Homeserve
ICAP
IG Group Holdings
Old Mutual
Paragon Group of Companies
PartyGaming
Pearson
Petrofac
Premier Farnell
Premier Oil
ProStrakan Group
PV Crystalox Solar
QinetiQ Group
Quintain Estates & Dev
R.E.A. Holdings
Rank Group (The)
Rathbone Brothers
Regus
Restaurant Group (The)
Ricardo
Robert Walters
Robert Wiseman Dairies
RPC Group
RSA Insurance Group
SABMiller
Safestore Holdings
Sage Group (The)
Schroders
Scottish & Southern Energy
Segro
Sepura
Serco Group
Severn Trent
Shaftesbury
Shires Income
SIG
Smith & Nephew
Smith (DS)

BPP Holdings
Brewin Dolphin Holdings
BRIT Insurance Holdings
British Airways
British Sky Broadcasting Group
BSS Group
BT Group
Cable and Wireless
Caledonia Investments
Camellia
Candover Investments
Capita Group (The)
Carillion
Carphone Warehouse Group
Centaur Media
Centrica
Charles Stanley Group
Charles Taylor Consulting
Chaucer Holdings
Chrysalis
City of London Investment Trust
COLT Telecom Group SA
Cookson Group
Daejan Holdings
Daily Mail and General Trust
Davis Service Group (The)
Dexion Trading
Diageo
Diploma
Drax Group
DSG International
DTZ Holdings
Dunedin Income Growth Inv
Dunelm Group
Imagination Technologies
Impax Environmental Markets
Imperial Tobacco Group
Inchcape
International Personal Finance
International Power
INVESCO Perpetual UK Small
Invista Foundation Property
ITV
Jupiter European Opportunities
Kesa Electricals
Lamprell
Land Securities Group
Lavendon Group
Law Debenture Corporation
Legal & General Group
Liberty International
Lloyds Banking Group
Lonmin
Luminar Group Holdings
Marks & Spencer Group
Mecom Group
Melrose Resources
Menzies (John)
Michael Page International
Misys
MITIE Group
Mondi
Morrison (Wm) Supermarkets
National Grid
NCC Group
North Atlantic Smaller Co Inv
Northern Foods
Northumbrian Water Group
Smiths Group
Southern Cross Healthcare
Spectris
Speedy Hire
Spirax-Sarco Engineering
SSL International
Stagecoach Group
Standard Chartered
Standard Life
Standard Life Equity Income
SThree
Stobart Group
Tate & Lyle
Taylor Wimpey
Telecity Group
Templeton Emerging Markets
Thomas Cook Group
Thomson Reuters
TR European Growth Trust
Trinity Mirror
UK Commercial Property Trust
UMECO
Unilever
United Business Media
United Utilities Group
Venture Production
Vitec Group (The)
Vodafone Group
VT Group
Weir Group
Witan Pacific Investment Trust
Wolseley
Xchanging
Xstrata

About the APPCGG

The All Party Parliamentary Corporate Governance Group was formed in 2004 to develop and enhance the understanding of corporate governance at Westminster and to influence future policy making in this area. The focus is on promoting the responsible leadership of business, so that the interests of shareholders and other stakeholders are properly protected.

Committed to supporting, rather than impeding, business growth, the Group's aim is the promotion of best practice in corporate governance. The Group acknowledges that there is no cast-iron template applicable to every business, and promotes the recognition that there are many ways for companies to create prosperity for their employees and shareholders.

The Group is facilitated by Jennifer Bryant Pearson who can be contacted at:

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About Lintstock

Established in 2002, Lintstock is a London-based corporate advisory firm that provides objective and independent counsel to leading European companies. Our services enable clients to reduce operational and reputational risks, meet the needs of financial regulators, enhance their profile with investors and add value to their equity operations.

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