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Company Secretary

**BRITISH AIRWAYS** 

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Dear Mr Hodge

## CONSULTATION ON THE REVISED UK CORPORATE GOVERNANCE CODE

British Airways is pleased to respond to the Financial Reporting Council's Consultation on the Revised UK Corporate Governance Code.

We support the FRC's findings that the Combined Code remains fit for purpose and acknowledge that there is scope for updating in some areas.

We support the change of name of the Combined Code to the UK Corporate Governance Code which, we agree, will be clearer for foreign companies and investors.

Subject to the proviso regarding the practicalities of its operation, we would support the FRC in taking responsibility for a Stewardship Code for institutional investors as recommended by Sir David Walker. We would also support the proposed initiative to produce guidance on good practice for engagement between companies and investors.

As the Turnbull Guidance was last reviewed in 2005, given all that has happened since, it would seem apposite to carry out a further review of its provisions. In particular, the Guidance should reflect the revised requirements found in Main Principle C.2.

Equally, it seems sensible to review and update the guidance given in the 2003 Higgs Report in relation to the roles of the chairman and non-executive directors.



We agree that good governance will support the long-term success of companies and support the conclusion that the quality of corporate governance ultimately depends on people and their behaviours rather than on processes. We agree that the proposed structural changes should encourage a greater focus on board behaviours in the way that the FRC intends.

## THE DRAFT REVISED CODE

### **Governance and the Code**

The new Code is intended to apply to accounting periods beginning on or after 29 June 2010. In the case of a March year-end company, this means that the first year of reporting will be April 2011 to March 2012. In the normal course of events it is proposed to review the Code again in 2012 by which time March year-end companies will have had only one year of operating under the new provisions. Might it not be better to allow companies at least two years of operating under the revised Code before reviewing its effectiveness?

Also, we believe that it would be helpful to set out more explicitly in this section of the Code the link to Listing Rule 9.8.6R rather than in the appendix.

### **Chairman's Preface**

We consider that the idea of having the chairman opine on how the Code principles have been applied in his or her annual statement (paragraph 7) is unhelpful. The effect of this will be to split the corporate governance reporting between two places in the annual report with this new requirement resulting in duplication of the company's statement made pursuant to LR9.8.6R(5) in the governance section of the annual report. The directors review and endorse their report before publication; there is little to be gained by having the chairman personalise this in his statement.

### **Comply or Explain**

Whilst a clear explanation of the "Comply or Explain" approach is to be welcomed, we have strong reservations about the use of the words "comply" and, even more so, "non-compliance". It would be better to follow the example set by South Africa's King 3 Code in using the terminology "apply or explain" to make clear that adequate explanation is compliance. Paragraph 5 of the Preamble to the June 2008 revision of the Code articulated this approach well:

"If a company chooses not to comply with one or more provisions of the Code, it must give shareholders a careful and clear explanation which shareholders should evaluate on its merits."

The problem may be to do with the tone of the explanation. Whilst it acknowledges that the Code is not a rigid set of rules, repeated use of the expression "non-compliance" in the third paragraph appears designed to negate that flexibility. A reasoned and sufficient explanation of an alternative method of satisfying the intention behind Code provision should be regarded as compliance with the relevant Main Principle. The use of the expression non-compliance implies that good governance achieved by other means is second best which, in the circumstances of the company in question, may well not be correct. The use of this language increases the tendency to a "complain or else" that can sometimes be displayed by institutional shareholders.

We appreciate that the Council is reluctant to move away from the well known "comply or explain" terminology. As a final thought on this point, one of our non-executive directors with extensive experience in the field of health and safety has pointed out that in that area the concept of "alternative means of compliance" is frequently used.

The third sentence of paragraph 2 of the Comply or Explain section articulates the expectation that companies will *apply* the principles (main and supporting) of the Code. This would appear to be a significant upgrading of the status of the supporting principles but one which has not been flagged as such in the consultation document. Paragraph 3 recognises that alternative ways of achieving good governance can be justified in the case of the provisions of the Code. These paragraphs do not dovetail with the current provisions of LR9.8.6R(5) and (6); LR9.8.6R(5) currently relates solely to "the Main Principles in Section 1 of the Combined Code" whilst (6) relates to the provisions of the Code. Clearly, LR9.8.6R will have to be adapted once the new Code is in place, however, unless it is intended to extend the scope of the revised version of LR9.8.6R(5) to include supporting principles, the status of "non-compliance" with the supporting principles of the Code will be unclear.

### **Section A: Leadership**

In relation to the new supporting principle, whilst it is clearly the case that directors of UK companies are fiduciaries, one wonders whether that is the case for all foreign issuers with premium listings. Might it be better to frame the provision such that directors are required to act as though they were fiduciaries who must act in the best interests of the company etc?

In section A.3, the supporting principle makes the chairman responsible for ensuring that adequate time is available for discussion on strategic issues. Whilst this is undoubtedly laudable, could the drafting be read perversely as **not** requiring the chairman to ensure that adequate time is available for other important issues?

Would it be useful to take this opportunity to clarify the position regarding chairmen and their independence in A.3.1? It would be helpful if the Code were to state that

provided a chairman was independent at the time of his or her appointment, the independence test is thereafter no longer relevant. We have found that governance commentators are confused on this and try to apply the provisions of what will become B.1.1 to chairman inappropriately.

We would not support the proposed changes in Code provision A.4.1 which expand the role of the senior independent director (SID). The requirement of the provision can easily be discharged by changing the SID's letter of appointment but this would not necessarily achieve anything. Whilst chairman frequently use their SID as a sounding board, is the intention of the new language to force a company to make disclosure if this did not happen for some reason? Similarly, if the SID finds himself in a position of having to intermeddle between the chairman and other directors, is it intended that this should be disclosed?

#### **B1: Effectiveness**

Might we make a minor observation about the drafting of the Main Principle B1. We believe that the language "with the appropriate balance of skills, experience, independence and knowledge of the company" is correctly interpreted as applying to the directors, whereas it is intended to apply to the board and its committees. Might it be possible to clarify this point by redrawing the principle as follows:

"The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable each of them to discharge their respective duties and responsibilities effectively."

Failing this, we would be concerned if "knowledge of the company" were to be included in the Main Principle because it was intended to become a criterion for recruitment of board members. It is sometimes extremely helpful to recruit a director who has little knowledge of the industry or the company but has other skills or experience that will bolster the board and improve its overall effectiveness.

#### **B4: Development**

Similarly, we believe that the new supporting principle should be refined to read as follows:

"All directors must have access to the company's operations and staff and the company should ensure that they have, or are given the opportunity to acquire, appropriate knowledge of the company so as to ensure that they can function effectively."

The new provision B.4.1 requiring companies to offer new directors the opportunity to meet major shareholders is not, of course, entirely within the company's gift and would require the cooperation of shareholders. It has not been our experience that shareholders are particularly anxious to meet non-executive directors in general unless they are chairmen of one of the main board committees such as audit or remuneration. Could the words "where appropriate" be added to this provision?

#### **B6: Evaluation**

We would refer you to our previous observations regarding external evaluation.

#### **B.7: Re-election**

British Airways does not support either of the FRC's proposed alternatives for Code provision B.7.1.

In relation to the annual re-election of all directors, we believe that this idea runs counter to sensible principles of risk management as espoused in the Turnbull Guidance. As you will be aware, the Guidance urges companies to adopt a system of internal control designed to reduce or eliminate reliance on the application of sense by individuals. The proposal for annual re-election of all directors opens up the possibility of a major company being unexpectedly left without a board. However remote this possibility, it runs contrary to risk management principles to expose the company to that risk in reliance upon the common sense behaviour of investors. Although we do not believe there is any real likelihood of an entire board failing to be re-elected at an AGM, it would create something of a constitutional crisis if this were to happen on top of what must already be a troubled situation.

There are certain situations where this risk is exacerbated. For example, during a hostile takeover, hedge funds with no long-term loyalty to the company frequently increase their holdings in target companies. Giving them the opportunity to remove a board which is defending the interests of its shareholders is not a sensible proposal. In companies where there is a significant employee shareholding, we believe annual re-election of the whole of the board would give the opportunity to disgruntled labour groups a greater incentive to disrupt annual general meetings in the hope of causing embarrassment to the chief executive or other executive directors. It would also allow mischievous reporting of votes withheld or not voted as indicating a lack of support for the management of the company.

If we have to support one of the FRC's options, we are by default, therefore, forced to support annual re-election of the chairman. The risk, however, with this option is that it threatens to undermine the leadership of a person who may

be a model chairman, solely on the basis that investors are disgruntled over an issue which is not directly related to his or her performance.

In considering both of these options, the ingenuity of activist shareholders should not be under-estimated. We believe that major shareholders have many channels for making their views known and for raising concerns with the company and that this would be an unnecessary change to the UK's already adequate governance arrangements.

#### **E1: Dialogue with shareholders**

There is considerable overlap in the drafting between the supporting principles and the first sentence of Code provision E.1.1 all of which are designed to emphasise the need for board members to be aware of the views of investors. We would suggest that there should be a single supporting principle as follows:

"Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman should ensure that all directors are kept in touch with shareholder opinion in whatever ways are most practical and efficient."

#### **E2: Constructive use of the AGM**

We believe that E.2.2 would be clearer if the second sentence were to read:

"For each resolution, where a vote has been taken on a show of hands, the company should ensure that ..."

#### **Schedule A**

Except as noted in the following paragraphs, we support the changes proposed to the schedule on the design of performance-related remuneration for executive directors.

We do not believe that the changes to the fifth paragraph are clear and would suggest that this paragraph be amended to read:

"Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria, including financial and non-financial performance metrics, compatible with the company's risk policies and systems and reflecting the company's objectives."

The Schedule should encourage Remuneration Committees to retain the ability to exercise judgment to vary awards so as to take account of circumstances at the time of vesting.

We are concerned that the last six words of the final sentence of the last paragraph can be read in a way which is not compatible with the Employment Equality (Age) Regulations 2006 (S1 1031).

### **Schedule B**

We believe that the existing Schedule B should be retained. It is helpful to potential non-executive directors to this exposition of their potential liability endorsed in the Code.

We would be pleased to discuss these comments or any other aspects of the Code with you if that would be helpful.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Alan Jones", followed by a horizontal line.