

REFLECTIONS ON THE REVISED UK CORPORATE GOVERNANCE CODE

By Professor Ian Percy CBE

[Speech given to a conference on 12 March – Professor Percy sent an advanced copy on 1 March and asked that it be treated as his response to the consultation]

It is a privilege to be a party to this conference as President of the Foundation for Governance Research and Education and my congratulations go to the University and Bristol Business School for taking the initiative in this important area.

There could not be a more appropriate time in our history to examine our Governance framework in the UK following on the dramatic events of the last two years and view what change is needed for the future. The papers written by the FRC, namely the “Consultation on the Revised UK Corporate Governance Code” and the “2009 Review of the Combined Code: Final Report” are excellent pieces of draftmanship and in my view express a significant and fundamental message that Governance is about oversight of management behaviour rather than a system of controls and compliance thereof. Also, the drafting of the Code in accordance with a number of principles rather than rules, its continuing status of a Code rather than legislation, and the concept of ‘comply or explain’ are important standpoints if we continue to support the concept of the capital market where entrepreneurial freedom is a prerequisite to adding value.

When one sets about reflecting, one is naturally drawn to past experiences and I have had the pleasure of being involved in this subject since the Cadbury Committee was formed in 1991. During 1994 I had the privilege of chairing a task group of the International Capital Markets Group who studied, “Who Holds the Reins” in various countries such as Japan, USA, Canada, France, Germany, South Africa, Italy and the UK, and the one constant theme that emerged from all those different countries was the conclusion that “Any corporate governance system should respond clearly to the need to encourage good corporate behaviour and the creation of value in the interests of all stakeholders; excessive regulation and bureaucracy should be avoided”.

In 2004 when speaking on the subject of good governance, Paul Volker, then Chairman of the IASC and former Chairman of the Board of Governance of the US Federal Reserve System said in seeking the truth in tomorrow’s business environment that “a corporate board should

recognise that its indispensable role is not to manage the company, but to oversee its management, to assure itself of the appropriate corporate values, including its ethics, to demand strong financial contracts and to independently determine remuneration policies”.

These I believe are important statements when reflecting on the changes proposed at this time and I would add that profit and adding value in a capital market is the result of taking risks and change does not come about without experimentation, innovation and entrepreneurialism. It is all too easy when we have experienced a crash such as we have seen to batten down the hatches, try to eliminate risk and second guess every decision. Those of us experienced in business realise that such a practice merely leads to an uncompetitive environment.

To me the great value of the FRC’s work is that it is not an overreaction and by putting the emphasis on principles of behaviour it responds to the very problem of greed and excessiveness that we have witnessed over the past few years, coupled with the creation of complex business instruments and technological advancement that none of us foresaw twenty years ago.

Let me comment on some of the analysis and outcomes of the FRC review and use the same headings.

- Responsibilities of Chairman and directors
- Board balance and composition
- Frequency of director re-election
- Board information, development and support
- Board evaluation
- Risk management and internal control
- Remuneration
- Quality of disclosure by companies
- Engagement between boards and shareholders

As regards the role of Chairman, Directors and composition of the Board, I feel more should be made of the Senior Independent Director. I liked the Recommendation 11 in the Walker Review, “The role of the SID should be to provide a sounding board for the Chairman, for the evaluation of the Chairman and to serve as the trusted intermediary of the NED’s when necessary. The SID should be accessible to shareholders in the event that communication with the Chairman becomes difficult or inappropriate”.

In my view the SID is akin to an old fashioned governess in Victorian times whose role it was to quietly behind the scenes govern the behaviour of the family as a cohesive unit and deal with the tension prevalent in a society where the father and mother had their own eccentric behaviours. A good SID has no aspiration to be Chairman and in many ways is the unsung chair of Governors sitting or attending each of the Governance Committees and being the eyes and ears for the Chairman when necessary.

On the subject of board balance and composition, I have little to add to the proposal but I do worry about the idea of annual election of Directors or Chair. What will happen if each year the voting varies on individuals, will this not seek, no doubt with the journalist help, to undermine the authority of the individuals and cast doubt on shareholder and institution support. More importantly possibly undermine the respect and confidence of the staff in the Board. What will happen to succession planning inside a Board and to the difficult balancing act in ensuring that individuals are groomed to take over roles such as audit or remuneration duties in time. What attitude will a director take to constructive challenge if he knows his position can be undermined by press interest in reappointment. What happens if suddenly Chairs of Committees are voted off or undermined by the process as it is not easy finding Chairs of Audit or Remuneration Committees in a hurry who understand the company.

Might I suggest that the answer lies on better communication between shareholders and Chairs and SIDs and shareholders using their present influence on a three yearly basis or putting more pressure on the Board to bring in new blood. Indeed annual election has the risk of becoming a rubber stamping operation, whereas three yearly election requires serious consideration. Finally, I am old fashioned enough to believe that the board should have the responsibility of ensuring it has the right Chairman and there are ways of soundings being taken with the city, if proper shareholder engagement practices are in place. Institutional shareholders need to find improved methods of communication and engagement and trust their processes rather than becoming too hands on with annual election.

One cannot take issue with the concepts behind boardroom development and the good practice of one to one development plans between each director and the chair. However, the requirement of a three yearly external facilitator worries me if the facilitator does not have board experience and understands the culture and strategy of the company going forward. I worry that we are going to generate a new era of consultant fees without real value. I would prefer to see a practice of a new Chairman as part of his or her development of the Board use an

external facilitator when appointed to help them and the SID ensure the proper composition and efficiencies and effectiveness for the future.

On the subject of Remuneration, I would like to see some way of getting back to a team bonus rather than individual. I wonder whether the emphasis now on individual performance and performance related pay is not part of the disease that needs attention rather than to satisfy envy by capping or taxing bonuses. The concept of deferment in the long term interests of the company are good. I rather like the idea of shareholders agreeing a total bonus pool which can be used at the discretion of management with the overview of the Remuneration Committee, such a pool to be determined as a percentage of super profits.

I applaud the proposal to enhance the whole area of engagement between shareholder and directors. As a Chairman, Deputy Chairman, Senior Independent Director, I have always felt this most unsatisfactory. As a Chairman of Pension funds and therefore investment one is at the mercy of the fund managers and their corporate governance departments and I would like to see some mechanism for proper engagement on governance between investors and company and welcome the proposed developments.

I hope we can get away from the boilerplate wording and encourage Chairmen to report on Governance as it is. I would encourage companies to consider better ways of doing things and explaining rather than just complying. For instance why could smaller companies not just have a Governance Committee of the non executives with one person taking responsibility for audit, one for remuneration and the Chair and SID Nominating and evaluation. More efficient and effective in small companies than having a secretary prepare three set of minutes for different committees etc. Just an idea but we must exercise flexibility of we do really mean that we should have a Code and encourage good behaviour and good practice.

I look forward to our discussions and thank you for listening.

J P Percy

March 2010