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## **Consultation on the revised UK Corporate Governance Code**

Dear Chris,

Thank you for giving the Institute of Directors (IoD) the opportunity to comment on your consultative document, published on 1 December 2009. Issues surrounding corporate governance are of considerable interest to the IoD and its membership. We are therefore pleased to present our views on your proposed changes to the Combined Code on Corporate Governance.

### **About the IoD**

Founded in 1903, and granted a Royal charter in 1906, the IoD is an independent, non-party political organisation of 50,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies.

### **Initial remarks**

The Institute of Directors is a long-standing supporter of the Combined Code and the associated “comply or explain” principle. We believe that the Code has made an important contribution to good governance in the UK over the last two decades.

Although the financial crisis has highlighted weaknesses in financial sector governance, we remain convinced that the Code provides an appropriate regulatory framework for large listed companies in the wider UK economy. Outside of the financial sector (where a robust regulatory framework is necessary in order to protect the interests of taxpayers), we would not favour a shift towards a more prescriptive approach to corporate governance regulation.

We are broadly supportive of the proposed changes to the Code (although see below for detailed comments). In particular, we appreciate the caution that has been exercised in incorporating the recommendations of the recent Walker Review into the Code.

In our view, several of the Walker recommendations would not have constituted best practice for non-financial companies, e.g. the proposals relating to risk committees and chief risk officers. Given that the objective of the Code is to outline best practice for companies in all sectors, it is appropriate that such recommendations have not been included in current proposals.

Notwithstanding its positive contribution, the Code is not a panacea for UK corporate governance. Just because best practice appears in the Code, there is no guarantee that it will automatically translate into “appropriate board behaviours” at the level of individual enterprises.

Going forward, we believe that attention should shift away from the wording of the Code and towards its improved implementation. Greater focus should be placed on the mechanisms through which the content of the Code is transmitted into real-life boardroom behaviour.

For example, the induction and training of directors provides an opportunity to increase director awareness of the Code and its implications for board behaviour. However, there is currently no explicit requirement for the directors of large listed companies to receive training on the application of the Code and other key issues of applied corporate governance. In our view, such a training requirement should be explicitly reflected in the Code.

A further obstacle to better implementation of the Code is the disengaged ownership approach of the shareholders of many large UK companies.

A key component of the UK’s “comply or explain” regime is the willingness of shareholders to monitor the application of the Code. However, the diffuse nature of UK company ownership dilutes the incentives of many fund managers to actively engage with boards. This reduces corporate accountability in respect of the implementation of the Code.

The proposed Stewardship Code for Institutional Investors will hopefully encourage greater shareholder engagement, and we welcome this initiative. However, its likely impact should not be overplayed. The preference of institutional shareholders for “exit” rather than “voice” as an ownership strategy is likely to persist as long as ownership stakes in individual companies remain small.

**In summary, further thinking is needed from policy makers and market participants alike in order to improve the transmission mechanisms through which the Code translates into improved board behaviour.**

## **Detailed comments on proposed changes to the Code**

### **1) Change in the name of the Code to “The UK Corporate Governance Code”.**

We agree.

### **2) Structural changes to the Code**

We agree with the creation of two new sections on the functioning of boards: Leadership and Effectiveness.

We agree with the reversal in the order of the Remuneration and Accountability sections.

We agree with the removal of the former Section E, which applied to institutional shareholders. This ground will be covered by the proposed Stewardship Code for Institutional Investors.

We agree with the removal of Schedule B on the liability of non-executive directors.

### **3) Introductory section**

We agree with the overall structure of this new section.

#### **i) Governance and the Code**

The word “objectivity” in the fifth paragraph is not a term that is generally presented as a key principle of good governance. You may wish to replace it with the word “effectiveness”.

#### **ii) Chairman’s preface**

The expression “the fungus of boiler-plate” is a mixed metaphor which you may want to re-consider.

#### **iii) Comply or explain**

This section states that smaller listed companies may consider it “appropriate to adopt the approach in the Code and they are encouraged to do so”.

In our view, caution is required in advising smaller listed companies to adopt the Code (even alongside the caveats expressed in the preceding two sentences).

In many instances, aspects of the Code will not be relevant for such enterprises. Furthermore, such enterprises may lack the specialist in-house expertise necessary to evaluate how it should be implemented.

The objective of the Code is quite specific: to provide a regulatory framework of corporate governance for large listed companies. This should be the focus of the Code.

### **4) Section A: Leadership**

#### **i) Principle A.1: The role of the board**

We agree with the changes in section A.

### **5) Section B: Effectiveness**

#### **i) Principle B.4: Development.**

We agree with the inclusion of the new supporting principle: “To function effectively all directors need appropriate knowledge of the company and access to its operations and staff.”

However, knowledge of the company is not a sufficient knowledge basis for directors. In addition, directors should have appropriate knowledge of applied corporate governance, including the nature of their legal duties as directors.

Specifically, all directors of large listed companies should receive practical induction and training on the contents of the UK Corporate Governance Code, associated guidance, and relevant legislation relating to directors’ duties and responsibilities. This process should include active consideration of how the Code – and other relevant best practice – can be translated into “appropriate board behaviours”.

We also believe that it should be regarded as best practice for all directors to provide an annual update to the company secretary of the training and professional development they have undertaken in the previous year. We would normally expect such training to be not less than 10 hours per annum.

We view induction and training as representing a key part of the transmission mechanism between the Code and actual director behaviour. It is just as important as the actual wording of the Code.

We do not wish to prescribe in the Code how directors should obtain the necessary induction and training. The IoD offers the Chartered Director professional qualification. However, other induction/training routes may also be appropriate.

**In summary, there is a basic need for the directors of large listed companies (i.e. public interest entities) to obtain a common understanding of how to fulfil their governance responsibilities.** This should be recognised alongside the need to obtain company-specific knowledge as a supporting principle in the Code.

## **ii) Principle B.7: Re-election.**

Our preference is for the version of provision (B.7.1) which advocates annual election of the Chairman, rather than annual election of each of the directors.

We believe that an annual vote on the Chairman could encourage shareholders to engage with the board on its overall governance stance and on specific governance issues.

As the board member with responsibility for leading the board, it is appropriate that the Chairman is the central point of accountability for shareholders in such matters.

We also view an annual vote for the chairman as being preferable to the introduction of a series of separate votes on individual governance issues, e.g. relating to risk, the governance statement or other governance topics (although a separate vote already exists for remuneration).

Shareholders should utilise the Chairman's vote as a focus for their governance discussions, although engagement should go well beyond voting at the annual general meeting.

We do not agree with the introduction of an annual vote for each of the directors.

The board is a collective decision-making body. A separate vote on individual directors implies that the responsibility for specific decisions can be attributed to specific individuals. This is not the case, and serves to undermine the integrity of collective decision-making.

The board is collectively responsible for all key decisions, regardless of whether individual board members or board committees are particularly involved in deliberations on specific issues.

In addition, an annual vote on individual directors creates a risk that individuals become targeted with respect to matters for which they are not fully responsible.

In those unusual cases where a board is unwilling to deal with issues relating to individual directors, shareholders already have sufficient weapons at their disposal, e.g. the right to call a General Meeting and remove the director through an ordinary resolution of members.

We agree with the other changes in section B.

## **6) Section C: Accountability**

We agree with the proposed changes to this section.

## **6) Section D: Remuneration**

## **i) Principle D.1: The level and components of remuneration**

We wish to suggest a change to the wording of the new supporting principle: “The performance-related elements of executive directors’ remuneration should be stretching and designed to align their interests with those of shareholders and to promote the long-term success of the company.”

We would prefer the following wording: “The performance-related elements of executive directors’ remuneration should be stretching and designed to promote the long-term success of the company”, i.e. without mention of aligning the interests of directors with shareholders.

Shareholders are not necessarily a homogeneous group with a single easily identifiable interest. Shareholders have a diverse range of objectives and ownership strategies.

Experience suggests that attempting to align the interests of management with those of shareholders may encourage the adoption of inappropriate measures of management performance – such as the stock price – over which management has limited influence.

Furthermore, the linkage of management remuneration to the maximisation of the stock price may incentivise a short-termist orientation in management behaviour, i.e. not consistent with promoting the long-term success of the company.

We do not wish to prescribe the performance measures that should be utilised by individual boards in setting the remuneration of executive directors. These will vary, depending on the circumstances of individual companies. However, the primary consideration for boards should be the long-term success of the company (to whom directors owe their fiduciary responsibilities).

We agree with the other changes in section D.

## **7) Section E : Communication**

We agree with the changes to section E.

## **8) Schedule A: Provisions on the design of performance related remuneration for executive directors**

We would like to see a slight re-wording of the second sentence.

The current wording is as follows: “Performance conditions should be relevant, stretching and designed to enhance shareholder value and to promote the long-term success of the company.”

We would prefer a wording as follows: “Performance conditions should be relevant, stretching and designed to promote the long-term success of the company, including the enhancement of long-term shareholder value.”

The revised wording emphasises the relevance of long-term shareholder value creation for executive remuneration, not shareholder value maximisation *per se*.

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

R. Barker

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