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Dear Sir Christopher

I have been funded by the Economic and Social Research Council (ESRC) on three separate occasions (1987-1989, 1998-2000, 2008-2011)<sup>1</sup> over the last 20 years to conduct a series of interrelated studies into how small groups of people ‘run’ large, UK-listed firms (see Appendix 1 for brief details). In so doing, I have followed developments in the Combined Code since its inception and from this basis, should like to contribute to your Consultation on the Revised UK Corporate Governance Code.

Together with Dr Szymon Kaczmarek and Dr Satomi Kimino, my two colleagues working on the current project, we are broadly sympathetic to the assumptions underlying your proposals for change to both the structure and content (and also title) of the Code. However, we do have some questions and concerns which we should like to raise with you and hope you will find these helpful in your endeavour to bring about full engagement with both ‘the spirit’ as well as ‘the letter’ of the code. We should also like to preface our comments by saying that we strongly support the need for a Stewardship Code for institutional investors to be implemented concurrently.

#### **1. Comply or explain and long term interests**

- 1.1 We support upholding the ‘comply-or-explain’ principle, although we question whether or not the final outcome of these combined revisions will actually be to ensure shareholders will feel more comfortable with non-compliance.
- 1.2 We think it is an excellent move to insert reference to long-term interests at various points through the Code. However, this does also highlight the difficulty of generalising across a highly diverse array of interests: shareholders are not a homogenous group, are highly competitive in their share owning interests (even within investment firms) and have very different time horizons, leading to incompatibility of interests. (Probably the only way to shift the balance in this equation would be to recognise others’ longer-term interests in the company, such as employees, although we recognise this proposition raises much more fundamental

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considerations which lie outside of this consultation but should be borne in mind for some subsequent review of the CG Code.)

## **2. Board Leadership and the Chairman**

- 2.1 Widely known as the most contested concept in the study of organizational behaviour, a section on 'leadership' brings a new dimension to the Code. One key difference in many debates about leadership is the extent to which it is seen to be an individual or collective property. Clearly in the case of the Code, all reference to the board and its decisions reflect cabinet responsibility. Yet directors are usually appointed on their record as individual leaders and remain legally liable for their (board) actions as individuals. So while it is helpful to draw attention to the importance of the Chairman's role and assign this person responsibility for leadership of the board, the outcome will depend crucially on the extent to which the Chairman sees leadership as an individual property and responsibility of him or herself or a shared property, developed through collective board/group process and culture. Whichever of these pertains will in part depend on context (see 2.5) and will have significant consequences for the balance and exercise of power in board dynamics and will affect the quality of decision making and governance behaviour accordingly.
- 2.2 While the Chairman has the SID as a sounding board, s/he may often only have relatively tenuous relationships with shareholders as investors prefer to talk with the CE and FD, and yet bears responsibility for something which is ultimately a collective outcome. The Chair's ability to lead a group/ the board is at least to some extent, only as effective as the group allows and in this case, the group contains at least two different interest groups – executive directors and neds.
- 2.3 Thus we strongly urge that the ICSA commissioned good practice guidance takes account of our comments above in looking closely at relevant skills, background, ability and expertise of effective chairmen.
- 2.4 While recent experience in the banking sector might highlight the need for a strong chairman to counterbalance the might of a strong Chief Executive, where might meets might does not always lead to the most effective outcome. Accountability is key in this process together with the means for sharing power.
- 2.5 This is a classic case of one-size-does-not-fit all as companies have very different needs depending on a host of different characters, including the age/ stage of life cycle of both the board and the company as well as their differing sector circumstances.
- 2.6 For the Chair to undertake a regular personalised approach to training with each director, first assumes that directors need regular training and second, that the Chair is has the ability to do this. Either way, this increases the amount of time required in the Chair role which should be reflected in some overall indicator of contribution, perhaps akin to the Walker Review propositions. The ICSA guidance should also be designed to help ensure that this is not implemented in a tick-box manner, as key to improving the Code is about changing behaviour for the better.
- 2.7 The additional detail with regard to the SID role and specific reference to the non-executives' role in developing proposals on strategy are helpful amplifications of what should be expected of them. However, there should also be some indication of the time commitment that this will require of them (see 3.3).

## **3. Board Effectiveness, balance and composition**

- 3.1 As McCall and Lombardo (1988) put it, 'effectiveness is a function of who defines it', not least in terms of group effectiveness. The definition of 'appropriate balance of skills, experience, independence and knowledge of the company' is similarly vacuous.

- 3.2 Your Preface expresses the ‘hope that chairmen will choose to report personally in their annual statements’. We concur with this and that it should become a formal requirement.
- 3.3 We agree that being prescriptive in terms of the minimum time commitment (in days) for NEDs as recommended in the Walker Review may have a negative impact on, for example, the ability of executives at other companies taking a non-executive role. However, our research on panel data of UK FTSE companies, 1999-2008, provides evidence of the negative impact which overly busy NEDs have on firm performance (Pye, Kaczmarek & Kimino 2010a, Pye, Kaczmarek & Kimino 2010b). Similar to the JCA report on the ‘Corporate Governance and Shareholder Engagement’, we find that when NEDs combine more than 3-4 non-executive positions, the costs of such additional involvement may outweigh the benefits for the focal company. While recognizing the desire not to be overly prescriptive and also the potential lack of resource here, we suggest you may wish to reconsider being more specific about expected time commitment.
- 3.4 Annual re-election of directors seems to go against the grain of taking a long-term perspective and may potentially encourage directors to take a more short term, myopic view of the board rather than appreciating the long-term perspective of the firm’s operations. Hence we see the costs of annual re-election for all directors as outweighing any potential benefits, and do not support B7.1. For similar reasons, we have concern about B7.2 which proposes the annual re-election of chairman. Indeed, we see potential for this provision to be counter-productive in many cases where it may result in an annual tick-box exercise. If there is need to change an under-performing director or Chair, then assuming all other courses of action have failed, it should then be possible for shareholders to have a specific director re-election put on the AGM agenda, rather than being a more routine, annual affair.
- 3.5 Length of time served on a board is only a (rather imprecise) proxy for independence. While we understand why you might wish to have annual re-elections for NEDs with over 9 years of service, we should also like to highlight the importance of time and length of service as valuable ingredients in achieving a ‘balance of skills, experience and knowledge’ of a company. As holders of the corporate memory, long-serving directors may make a valuable contribution to shaping the future, not least by preventing reinventing the wheel: whether or not their contribution is seen as independent remains more a frame of mind than necessarily a matter of time served.
- 3.6 With regards to board evaluation, we suggest B6.1 should also include a provision to state how the board evaluation findings have been implemented and then evaluate the outcomes of that implementation action perhaps a year later, so it becomes a rolling record of continuous improvement with feedback loops, rather than a simple tick in the box of having done it or had external consultants do it in the third year.

#### **4. Risk**

- 4.1 We welcome the additional provision for defining the company’s risk appetite and tolerance and see this as a very important amendment. However, as we was evidenced in the recent banking crisis, what was most needed was some joined up thinking to bring about change in behaviour, hence we suggest you may wish to reconsider the rephrasing of C2.1 to include the word ‘appropriate *integrative* systems’.

#### **5. Remuneration**

- 5.1 Remuneration remains a highly sensitive topic and one with which shareholders continue to seem either reluctant or unable to grapple. In our view, remuneration also underpins many of the other sections of the code, including leadership, effectiveness

and accountability and is also reviewed on both European and international platforms. While the revisions endeavour to align performance-related elements of pay with shareholders' interests and the long-term success of the company, as noted above these may not necessarily be compatible.

- 5.2 During the previous sequel to our current research project (conducted in 1998-2000), a number of contributors commented on how there was 'too much debt sloshing around' or that there was 'too much leveraging' going on and that executive pay was ratchetting up. Although we are only part way through the current data collection (and appreciate this may also be fuelled by recent press coverage of bankers' pay in particular), there is a common view that executive pay levels are either excessive or out of balance or both. However, there is also the view that if shareholders are prepared to agree, there is little else one can do. While the new supporting principle gives a welcome emphasis to long-term success and the additional Schedule notes (about including non-financial performance metrics and potential for reclamation) endeavour to support this, on the basis of current evidence, these are unlikely to effect significant change.
- 5.3 To fulfil the board's responsibility for leadership and succession planning in the company, we propose these remuneration provisions could and should go further. At present, the board 'should also be sensitive to pay and employment conditions elsewhere in the group' and are instructed to take oversight of the first level of management below the board. We suggest that one way to slow down the exponential increases executive pay would be to develop some means of connecting this to front-line pay. If the board is serious in its setting of company values and standards (A1), then it should also have broad oversight of this key metric and driver which runs throughout the company and which indeed, conveys some measure of what (and who) is valued in the company and what behaviour is expected.
- 5.4 This oversight might also give the board a better sense of engagement with operations throughout the company as well as a clearer understanding of people development and capacity building throughout the firm which is an important element in building long term success. In turn, this would help their ability to perform the succession planning part of their role.
- 5.5 With regards to the role of non-executives and their pay, we feel there will need to be recognition of their increased role and responsibility and likely increased time commitment to be effective directors. They remain the one part of board composition for which one-size-fits-all as far as legal status is concerned although their contributions are expected – by definition (B.1) – to be different.

## **6. Disclosure**

- 6.1 As regular readers of annual reports, we strongly support the idea of maintaining the integrity and reliability of this document, as the formal annual statement of practice, signed off by auditors. Company websites are entirely company affairs, with variable degrees of detail of reporting and reliability. Web pages can also be 'lost' or blocked whereas the annual report remains accessible over time. Hence we are pleased to see that no current disclosure requirements are to be removed in the code and we strongly support retaining the corporate governance statement in the annual report.
- 6.2 We fully concur with the provisions to include an explanation of the company's business model and overall financial strategy, and see this as a welcome improvement.

## **7. Communication and Engagement**

- 7.1 We support the idea of the Stewardship Code and the relevant changes that would need to be introduced with regard to the section E of the Combined Code as a result of

that. We are only wary of the potential tensions on the part of both investors and investee companies, in face of investors' resource constraints (or lack of prioritisation), to credibly engage with all the companies that they have in their investment portfolios, as highlighted in the JCA report on the 'Corporate Governance and Shareholder Engagement'.

In conclusion, we fully concur with your opening premise and support your endeavour to tailor the Code to bring about change in behaviour rather than increasing degree of regulation, as the latter clearly only increases trust in the implementation of a system of rules (and sanctions for breach) rather than increasing trust in the behaviour of people in the UK's principles-based system of self-regulation. In order for these revisions to be most effective, they need support from the implementation of some form of Stewardship Code to help trigger wider, integrated and much needed, 'whole system' change. With this aim in mind, we hope you will find our comments make a helpful contribution and shall be happy to discuss this and our wider research in this subject with you at some future point, if /as appropriate.

Yours sincerely

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