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## **Review of the impact of the Combined Code**

### **General comments**

Nearly fifteen years after the publication of the Cadbury report, it is clear that the UK corporate governance regime is working well.

By favouring principles instead of fixed rules, the combined code gives directors the necessary flexibility to balance essential risk-taking with appropriate oversight. The 'comply or explain' model has stood the test of time and been copied extensively worldwide.

Fears were expressed, following the 2003 revision of the Combined Code in the wake of the Higgs review, that the UK regime was moving too far down the road towards fixed rules instead of flexible principles, and that corporate governance was in danger of becoming an industry. Those fears have not been borne out. The current governance regime works better than many people anticipated in 2003, and is certainly a clear winner compared to the rigid prescriptions of the US regime and the Sarbanes-Oxley Act.

No governance regime can ever be perfect but having worked extensively with both UK and international boards, we have found that the UK's Combined Code is effective and widely admired.

In terms of specific recommendations, we favour the following amendments to the code:

- Provision A.4.3, which suggests that no individual should chair two FTSE 100 companies, is too restrictive. There may be examples where it is not possible for one person to hold two FTSE 100 chairmanships, but such situations are rare. The very best chairmen are in short supply, and their talent should not be needlessly constrained. We would suggest easing this provision to say that it may sometimes be inappropriate for one individual for chair two FTSE 100 companies, and that any company wishing to appoint a person to a second FTSE 100 chair should justify the appointment

- Board evaluation has been a success, but there is insufficient reporting round what lessons the board learned from the process and subsequent changes made. We would like to see a provision calling on companies to disclose the name of any external evaluator used
- The London Stock Exchange main market and Alternative Investment Market has proved a popular destination for overseas companies in recent years. Most of these listings, however, are in the form of derivative securities such as depositary receipts, meaning that the company is not bound by the Combined Code. We believe that any company issuing securities on the London Stock Exchange should be required to comply with the code or explain areas of non-compliance

### **Does the code support better board performance over time?**

Strong corporate governance cannot make bad companies into good ones, but it can make good companies better.

Academic studies have argued both sides of the argument in seeking a link between good governance and outperformance. In our view, such objective ‘proof’ will always be elusive. Good governance is an intangible quality that relies on able, curious and courageous people working well together; it cannot be reduced to a few handy metrics or key performance indicators.

However, it is surely intuitively right to argue that a company is more likely to perform when it is led by a board of talented individuals who create a supportive yet challenging environment that offers a management team encouragement but also insists on accountability.

The vital ingredients in fostering such an environment are a strong chairman and the appointment of the right people to the board. By placing people, rather than rules and procedures, at the heart of the governance regime, the Higgs review and the subsequently revised Combined Code, have given boards the right foundation to operate effectively. We do not wish to see corporate governance become an industry, and we believe this focus on chairmanship and people ensures that it will not.

A welcome reform has been the recommendation that companies carry out regular board evaluations. Companies have embraced this provision, undertaken serious reviews of their own performance and made adjustments. By focusing on how a group of talented individuals works together – a vital ingredient of good governance – the board evaluation principle has delivered real improvements to UK boardrooms.

One area of weakness continues to be non-executive director induction. The guidance on induction contained in the Combined Code is excellent, but companies do not appear to follow it closely. We should like to see compliance in this area strengthened, with companies reporting more extensively on how new directors were inducted.

## **Is the ‘comply or explain’ approach working effectively?**

Flexibility is an essential ingredient of an effective governance regime, as boards seek to keep risk-taking and risk management in balance.

Striking the right balance will depend on the company’s size, maturity, sector, market and the stage of the business cycle. With this in mind, it is clear that a prescriptive rules-based governance regime cannot be effective. The Combined Code, through the “comply or explain” mechanism, offers both flexibility and meaningful accountability to shareholders, which is why it has stood the test of time and been copied so extensively worldwide.

Concerns have been expressed that shareholders are inclined to take a ‘black and white’ approach to non-compliance, and are deaf to sensible justifications. From our discussions with UK chairmen and directors, we do not believe that is the case. Both companies and investment institutions have developed a meaningful dialogue over what constitutes sensible departures from the Code. This is one of the areas of greatest improvement in recent years.

## **What impact has the code had on smaller companies?**

A ‘one size fits all’ approach to governance imposes disproportionate costs on smaller companies, which lack the resources to attract and retain several quality non-executive directors or put in place independent oversight procedures that would be expected at a large company.

However, most governance principles apply as well to smaller companies as large ones, and the more governance disciplines that a smaller quoted company can adopt the better. Flexibility, and an intelligent approach to compliance, is essential.

There is a danger that directors of smaller companies feel that they have to do more than they need. The code provides for a great deal of flexibility, so long as companies are flexible for the right reasons and can justify it to investors.

Companies that complain they are spending a disproportionate amount of its time on corporate governance are probably suffering from poor chairmanship. A strong chairman will ensure that entrepreneurship and oversight is kept in balance, and will ensure that the latter never stifles the former.