



Review of the impact of the Combined Code

PIRC's response to the FRC consultation paper

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Introduction

We welcome the opportunity to respond to the consultation on the implementation of the Combined Code. Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £750 billion and include some of the largest pension funds, investment management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other active shareholder initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

Does the Code support better board performance over time?

PIRC considers that the Code provides a broadly positive framework within which effective modes of governance may be utilised to the advantage of all shareholders as a class. We do not consider that boards of companies should regard consideration of the Code as a key *raison d'être*, and agree that companies should avoid falling into this possible trap. However, Code compliance is a UK listing requirement and we regard it as a *sine qua non* of a UK listed company's license to operate. We also agree with chairs that the Code has contributed to boards becoming more professional and deliberative bodies.

It is fair to say that compliance with the Code is increasing over time, though full compliance is still a minority trait – 33% of companies we examined in 2006 claimed full compliance, though that was up from 23% the year before. Increasing compliance over time as regards board independence, separation of roles at the head of the company and committee membership, with larger companies leading the way, is the norm. For example, the percentage of companies with an executive chair has dropped to 11.6% last year from 21.5% in 2001, according to the data we collate.¹ The introduction of the Code has overtime led to a push towards the corporate governance structures and approaches that it recommends. In this sense, the Code has certainly been effective at promoting the standards it recommends. We take the view that these standards have supported better board performance over time.

We consider that the strengthened governance procedures engendered by the Code are in the interests of all stakeholders, and especially shareholders and should serve to protect and enhance shareholder value. Care should be taken to avoid denigrating the achievements of a code of conduct in this area. We believe that it is fair to state

¹ Corporate Governance Annual Review 2006, PIRC Limited, London 2006
PIRC Ltd March 2007

that poor governance procedures, philosophies and approaches can be correlated with poor business outcomes.

Certainly, this would appear to have been the case when the WM Morrison board decided to acquire the Safeway business. At the time that decision was made, the company had not a single non-executive on the board, which was itself dominated by Sir Ken Morrison in the position of executive chairman. Similarly, in the case of Misys – very much the creation of former chairman and chief executive Kevin Lomax – a concentration of too much power in the hands of one individual also seems to have resulted in policy decisions going largely unquestioned, with the possible concomitant weaknesses in the healthcare business resulting in the need to bring in an entirely new management team. At iSOFT, accounting irregularities placed at the door of the then Commercial Director, Steve Graham, contributed to a precipitate decline in share price, leading the company to drop out of the MidCap. The firm had seen a triumvirate of directors, who had been the original partners when the business was under the auspices of KPMG and who held 20% of the company between them, exercise a substantial degree of control over it.

Strong and transparent governance structures are necessary in all instances, but particularly where influence might be expected to be concentrated in only a few hands. In order for company strategy or processes to be capable of being questioned in an effective manner – which was clearly needed in these cases – it is necessary to have effective processes that encourage constructive debate and discussion and that encourage rational justification for policy decisions.

Of course, in the absence of effective boardroom governance, shareholders will need to remain vigilant and the Code provides a benchmark for best practice that now commands market-wide investor confidence.

A corollary of the need for appropriate and constructive debate is the need, as PIRC sees it, for further diversity of experience on boards. This is an area where the Code could be improved through the introduction of a further principle regarding the value of diverse opinions borne of differing experiences. We consider, for example, that a great deal of talent from the management of the voluntary sector could be utilised effectively as non-executive directors. The Code should encourage this sort of cross-fertilisation of ideas and experiences, as indeed the government does.

PIRC does think that, despite the sometimes quite dramatic advances made regarding good governance over the last few years, the Code could be more robustly enforced. There is no formal official basis upon which companies' compliance or otherwise with the Code can be assessed, or their explanations found adequate or wanting.

Is the “comply or explain” approach working effectively?

It should be noted that the nature of the “comply or explain” process creates an inherent degree of flexibility. This is an entirely desirable outcome, but the

explanation is an integral part of this approach. Companies do have a choice. They may either comply with the Code, or they may provide a legitimate explanation for non-compliance. It seems to us that this is at the heart of the way in which the Code operates and that any attempt to dilute the requirement upon companies to at least explain the nature of their non-compliance and the reason for it would negate much of the value that resides within the *modus operandi* of the Code.

We do take the view that some companies fail to adequately explain why it is that they have not applied the Code. There is a tendency for largely boilerplate statements to be made in annual reports which do not adequately reference a company's individual circumstances as to why it is felt inappropriate to apply the Code in a particular instance. We accept that there may be instances where compliance with every last aspect of the Code may not be entirely appropriate, particularly in circumstances of substantial board turnover, or where there is an immediate need to ensure stability and continuity, but we would expect explanations made to focus on relevant issues. Company secretaries and board members are often better at discussing the specifics of such matters verbally, but we seek to promote better public disclosure so that all shareholders and other stakeholders can make judgments as to the validity of company explanations on such matters.

On the whole, however, PIRC considers that the comply or explain approach has served companies and shareholders well. The trend data towards compliance with the Code is positive over time and companies can justify non-compliance if they see fit not to comply; this approach should remain the cornerstone of the governance regime.

What impact has the Code had on smaller companies?

PIRC takes the view that good governance procedures and structures should not be a matter of market capitalisation. If companies wish to be listed on the regulated stock exchange of the UK then certain minimum requirements of practice should be encouraged.

Of course, it is the Code's position that smaller capitalised companies should adhere to most of the suggestions of the Code, but not all. The requirement that a smaller company should have two independent non-executive directors, rather than that half the board excluding the chairman should be independent, is the major difference that the Code sanctions. Even here, more than a quarter (26.6%) of smaller companies complied with the requirements as laid down for larger companies last year, according to our assessment of independence.² Appropriate governance procedures may use more resources to put in place, but PIRC considers the argument that these costs are likely to be substantial as lacking in persuasiveness.

Some of the more substantial costs might be considered to be those associated with the appointment of non-executive directors. The role of non-executives has been expanding over the course of the last few years, and it makes clear business sense

² PIRC Limited 2006, *op cit.*
PIRC Ltd March 2007

for smaller as well as larger companies to take advantage of sound advice and opinions from those not directly involved in their day to day management. It is also important to have sufficient representation to staff board committees appropriately, and to consider suitable remuneration in order to create appropriate expectations of non-executives' performance.

Further, given the nature of the "comply or explain" regime, smaller companies may choose to explain non-compliance if they see fit not to comply. We do not consider that the time or cost taken to explain non-compliance is material.

It would be a retrograde step to reduce the requirements on small companies at a time when compliance with the Code is in general increasing.

Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?

Disclosures as regards the Code are useful in as far as they go, but there is a tendency as previously mentioned for disclosure to be made in a manner which is less than informative. PIRC would like to see an emphasis in the Code, as a principle, in favour of better and genuine disclosure as regards specific circumstances, and discouraging generic statements which shed little light on the actual rationale for a company's non-compliance with the Code.

In addition to what we see as the need for better explanations under the "comply or explain" principle, there are some specific areas where we would be keen to see the Code take a lead in terms of stronger disclosure. An increasing number of companies – though still not a majority – are engaging in proper reporting on committee activities during the year. The Code (and in the case of the remuneration committee, the Directors' Remuneration Report Regulations) already requires that companies report on committee activities during the year, but the majority of such reports are in reality often little more than reiterations of the committee's terms of reference. PIRC believes that the Code needs to reinforce the fact that what is sought is an informative description of the work covered during the year, rather than a general statement of responsibilities.

We would also welcome a Code statement as regards disclosure of executives' service contracts. PIRC considers that the Code should encourage contracts to be disclosed on company websites as a matter of course, as is the case regarding terms of reference for board committees.

In summary, it is our view that the Combined Code has encouraged stronger disclosure in many areas, but that an opportunity could be taken to emphasise the value of good narrative reporting in terms of processes and activities undertaken during the year. This would itself fit with the approach which is being engendered by the Companies Act 2006 and the Business Review.

PIRC would be happy to discuss the points we have made in our submission in more detail. Please contact:

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