

Comment by **Paradigm** Risk Limited

on

**Review by the
Financial Reporting Council of the
effectiveness of the Combined Code
Response to Second Consultation**

Prepared by

Peter Bonisch and Dr Mustafa Cavus
Directors

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Executive Summary

From the commentaries available, it would seem that corporate governance practice in the UK has improved considerably since the Committee on the Financial Aspects of Corporate Governance was convened in the summer of 1991. Since then, there have been numerous, considered reviews of corporate governance practice and of the Combined Code which emerged in 2000 from the review of the committee, then chaired by Sir Ronald Hampel, in early 1998. Over the intervening decade, the Combined Code and its predecessor have accreted rather than altered materially. We believe the backdrop of the current, severe economic crisis, albeit with its origins in the banking sector, provides the Financial Reporting Council (FRC) with an ideal opportunity to question the assumptions that have built up around the Combined Code and corporate governance more generally.

“Best practice” usually isn’t

In the debate about corporate governance and in the Combined Code and its predecessor documents, there is frequent reference to “best practice”. In the latest review, the FRC adopts the “demonstrable need for best practice” as one of its “guiding principles”. Inherent in the notion of “best practice” is the idea of corporate *perfectibility*. We do not believe that this idea is valid; each company must adapt its governance practices to its own unique circumstances of markets, competition, ownership interests and capabilities. Further, provision of guidance as “best practice” crowds out corporate attention to specific companies’ governance requirements, reducing innovation among companies and their advisors. As a result, governance and related corporate practice has not adapted as rapidly to changing market conditions and evidence of performance (strong or weak) as it should have. This is particularly evident in the areas of engagement between shareholders and companies, corporate risk management practice and internal control practice.

Governance principles

The claim often made of the Combined Code is that it is a ‘principles-based’ approach; this contrasts with a ‘rules-based’ approach such as that adopted by, for example, the US SEC. In the corporate governance debate in the UK, the former is frequently presumed to be superior to the latter. However, while the principles expressed in the Combined Code may be entirely valid, the Combined Code conflates principles of design with principles of a governance framework with principles of application with high-level statements of practice. We provide examples of this conflation in the body of our submission.

We believe the FRC should prepare a clearer expression of the current Code (or as amended by this review) with these different types of principles separated and made explicit, along with the assumptions (both about behaviour and about corporate practice) which underpin them. This forms part of our proposal for an alternative Combined Code regime (see below).

The Turnbull Guidance

While the Turnbull Guidance on internal control is, as written, a sensible document, its implementation has resulted in very conservative and unresponsive corporate practice in risk management and internal control. The latter practice is still firmly rooted in the perspectives of COSO, originally published 17 years ago. This represents a material failure of innovation. In corporate risk management practice, methods derived from

“best practice” standards and broadly advocated by professional advisors have led to the explosion of corporate practices the value of which is at best unproved and more likely simply irrelevant. To address this, guidance on risk management and on internal control should be separated; guidance on internal control, if provided at all, should be prepared with greater attention to the vital behavioural aspects of control; guidance on risk management should either be abandoned and left to the market to innovate or should incorporate far greater focus on analytical and behavioural dimensions of risk management.

Evidence-based reform

The debate on corporate governance in the UK has, historically, largely been informed by discussions with corporate directors and other market participants; the current review by FRC has been conducted using this approach. As a matter of research methodology, this approach inevitably introduces bias. Within the FRC’s excellent summary documentation, there is reference to areas of uncertainty that should be readily settled with empirical data. Particularly in the areas of risk management and internal control, **there is an urgent need for greater, focused empirical research** to establish actual corporate practice and to form an objective assessment of factors driving and inhibiting its effectiveness.

A proposal for introducing choice in to corporate governance regulation

As noted above, in order to encourage innovation, we believe the FRC should develop a clear and explicit statement of the principles and assumptions behind the Combined Code, where the different types of principles are separately and coherently presented in a hierarchy with statements of practice and detailed guidance separated. Further, the reporting requirements against the ‘alternative Code’ (really an alternative presentation of the same Code) should be limited to a more *laissez faire* approach – requiring reporting companies to explain the logic and application of their governance frameworks and approaches in each area of principle. Combined with a clear statement of support by the FRC for the need for innovation and adaptiveness to companies’ circumstances, we believe this approach could substantially improve governance practice in companies adopting the approach and would encourage, over time, greater differentiation between companies’ governance practices.

The broader corporate governance system will only operate effectively when corporate disclosures include enough substance to be differentiable by analysts and when analysts have the skill and the interest to interpret the impact of differing governance practices on firms’ potential for sustained value creation. Therefore, a design criterion for corporate governance disclosure should be to encourage companies to provide reporting of sufficient relevance that it is differentiable. This can only occur if firms are also encouraged by regulation and quasi-regulation to differentiate their governance activities. This, in turn, would encourage analysts and research houses to pay greater attention to the governance practices reported by firms adopting the ‘alternative Code’; that is, they would have something material to review and opine on.

An example might be requiring companies and boards to explain how they have determined the capabilities required on their board of directors, how they have satisfied those capability requirements and how they intend to attract additional capabilities in future to satisfy expected changes in their requirements over time.

Such an approach could be introduced in parallel with the existing Code and be offered as an alternative to companies who wish to adopt the approach. A thorough trial and review basis would be established along with the alternative Code. Alternatively, the FRC could prepare such an alternative Code for comment and consideration by interested parties as a subsequent consultation exercise.

Specific issues for consideration

In addition to the comments on the general framework of corporate governance, we have provided detailed responses to many of the specific issues raised by the FRC for consideration. These are contained in section 2 of our submission.

SECTION 1

The governance framework

Introduction

The famed wit of the Irish is captured by the story of the foreign visitor who asks a local the best way to get to Dublin. “Ah well,” replies the local, “you wouldn’t want to be startin’ from here, then.” Much the same dilemma confronts the FRC in reflecting on the structure and focus of the Combined Code.

Such has been the depth of the current economic crisis that the FRC confronts a real challenge and an historic opportunity. The crisis that started in the bond trading and securitisation departments of global investment banks and trading houses has spread to affect many spheres of economic activity and the companies that produce that activity; many have been found wanting in their preparedness or response. Naturally enough, attention has turned to the role of boards of directors, firstly in the banking firms afflicted, but also more broadly. The uncomfortable question that hangs in the air is: “Can the shortcomings revealed by the banking crisis in Britain’s prestigious bank boardrooms also be found in its non-banking corporate boardrooms?”

Depending on how serious one interprets the current crisis to be will also depend the depth of one’s introspection on Britain’s corporate governance framework, of which the Combined Code is part. Because corporate governance practice in the UK has accreted, albeit very rapidly, since the ‘Cadbury’ review in 1992, there has, in the intervening 17 years, been surprisingly little reflection on the entire structure of ‘how to get to Dublin’, in the corporate governance sense – how to achieve governance objectives – and even less on what those objectives should be.

It is worth, by way of a brief diversion, noting that the committee chaired by Sir Adrian Cadbury was convened by the London Stock Exchange, the FRC and, in Cadbury’s nebulous term, “the accountancy profession”. Its membership reflected this and included the then chairman of the FRC, Sir Ron Dearing; the current chairman, Sir Christopher Hogg, “acted as an advisor to the committee”. The report of the committee, *The Financial Aspects of Corporate Governance* (hereafter, the ‘Cadbury report’), has been widely lauded and widely imitated, the sincerest form of flattery (at least according to Oscar Wilde). The continuity of attention is similarly laudable, but it does introduce the concomitant danger that alternative approaches will not be sought out rigorously and that the underlying or tacit assumptions of the original work will not be questioned periodically to determine their continued relevance. If ever there were an opportunity for such questioning, that opportunity would be while the UK and world economy are in the grip of the deepest financial crisis since the 1930s (depending on measure used!).

We begin this comment paper by reviewing and questioning some of the fundamental (tacit and explicit) assumptions of the current ‘state of the corporate governance art’ and addressing some of the key issues raised in the FRC Progress Report and Second Consultation paper of July 2009. In section 2, we address the specific issues raised in that document for further consideration.

We have also submitted a very detailed comment to the Walker Review which addresses many of these points. However, the different focus of the FRC review and its different purpose, mean that this submission has been prepared separately, except where noted.

Both reviews are extremely important and worthwhile; the opportunity they represent to effect substantial improvement in corporate practice in governance. Contrary, apparently, to the views of many parties responding to the FRC's initial consultation on the Combined Code, we believe that to do so may require less prescription and guidance, rather than more. **At the end of section 1 of our submission (at pages 17 – 18), we include a practical proposal on enhancing the framework for corporate governance reporting.**

The convenience of 'best practice'

The Cadbury report contained a **Code of Best Practice**, later reviewed by the committee chaired by Sir Ronald Hampel, whose recommendations formed the basis of the later Combined Code. While the report of the committee chaired by Sir Ronald Hampel, the modestly titled *Final Report* (hereafter "Hampel report"), was rather more sparing in its use of the term 'best practice', the extensive use of the term in Cadbury (some 16 times) firmly established 'best practice' as both a statement and an idea in the minds of interested community in the UK, and more widely. The disciplinary backgrounds of the both the committee members and audience for the reports and the Combined Code – frequently professional accountants or lawyers – made such a notion attractive to them: that how the best companies practice governance could be codified. The Hampel report acknowledged the limitations of this approach explicitly: in discussing reviews of reporting on internal control, the Hampel report stated (at para. 6.12) its recommendation . . .

. . . would enable a more effective dialogue to take place; and allow best practice to continue to *evolve* in the scope and nature of such reports, rather than externally prescribing them (*emphasis added*).

With this minor exception (albeit we will return to the evolution metaphor shortly), the language of corporate governance in the UK and internationally, like much other in corporate business, has been dominated by the idea of *perfectibility* – that some corporate practice can be described as 'best', with the implication that other practice is inferior. This view shares much with the (necessary) accounting fiction that the financial position of a company can be explicitly stated at any point in time and its financial performance objectively determined over a defined period. Without wishing to examine the contractarian origins of perfectibility, its applicability in a corporate setting is clearly suspect. In the theory of corporate strategy, the need for effective adaptation is widely recognised, leading to contingency theory – essentially that organisations must adapt their management systems and decision-making to meet the demands of their external environment; that they must **adapt** and **innovate**.

The language of the Combined Code, with its Code of Best Practice, perpetuates the unhealthy and inhibitive belief in perfectibility, even if only by the language it uses. The FRC Review Progress Report and Second Consultation document published by the FRC in July 2009 uses the term 'best practice' 11 times and, while acknowledging the need for guidance on 'best practice' to change over time, further perpetuates the myth of corporate perfectibility. More worryingly, but not surprisingly, the FRC summary of responses to its March 2009 consultation includes call for greater clarification of best practice – for more codification.

What are ‘principles’?

This issue is not mere semantics. To have a robust ‘principles-based approach’, it is imperative to base the approach on sound principles. High-level statements of practice are **not** statements of principle. Within the Combined Code itself, these are routinely conflated. Before providing examples of that conflation, it is important to distinguish usages. In the Combined Code, the term ‘principles’ is used to define **principles of governance in application**. There is another, more fundamental, use of ‘principles’ which is salient: **design principles** for the governance framework. The Cadbury report identified three ‘principles’ for governance:

- openness,
- integrity and
- accountability

... on behalf of boards and directors. However, design principles were left unstated or implicit. Cadbury came closest to discussing design principles in the following statements:

[boards] must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance. (Cadbury, para. 1.1)

The Hampel report picked up on the definition of corporate governance from Cadbury and affirmed it:

We can accept the Cadbury committee’s definition of corporate governance as ‘the system by which companies are directed and controlled’ (Hampel, para. 1.15)

However, the full statement from Cadbury is considerably more meaningful and more useful:

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. (Cadbury, para. 2.5)

The Cadbury representation partly, but only partly, acknowledged the behaviour of boards and their role in corporate reporting was a component of a broader system for influencing corporate behaviour and performance. Again, the language of Cadbury is revealing. The use of the word ‘controlled’ is ambiguous; it could refer to the market for corporate control, but is more likely to refer to the concept of internal control, which the Cadbury committee discussed explicitly in its report. The remainder of the statement is internally focused. From that moment forward, at least in the formal reports on corporate governance, the systemic insight has been buried.

The greatest strength of the Walker report is to place governance squarely in a **systemic context** of the interaction of the market for corporate control, institutional investment and the buying and selling of shares, the responsibilities and incentives of institutional investors and pension fund trustees, auditors and

corporate boards and officers. In reflecting on the fitness for purpose of the Combined Code, the FRC should consider explicitly its impact on the entire system of corporate governance, broadly defined. Of course, this attention to systemic and behavioural factors that determine their interaction will not fit comfortably, and may conflict, with a deterministic view of corporate direction that is founded on perfectibility.

This conflict is where the importance of design principles is most strongly felt. For example, is it more important to pursue **comparability** (which favours standardisation) or **adaptation** (which emphasises responsiveness to environmental conditions and differences)? These design principles have never been acknowledged publicly (at least to our knowledge) nor have the trade-offs that would result from consideration at the level of design principle been addressed.

As noted above, the use of ‘principle’ in the Combined Code addresses governance in application. The conflation of principle and practice is simply illustrated by example:

Examples of principle and practice in the Combined Code

A.1 The Board Main Principle

Every company should be headed by an effective board, which is collectively responsible for the success of the company.

Statements of principle	Every company should be headed by an effective board The board should be collectively responsible for the success of the company.
Statements of practice	

A.2 Chairman and chief executive Main Principle

There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company’s business. No one individual should have unfettered powers of decision.

Statements of principle	No one individual should have unfettered powers of decision. <i>Implied: Respective responsibilities of the board and executive should be clear.</i>
Statements of practice	There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company’s business.

A.3 Board balance and independence Main Principle

The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.

Statements of principle	No individual or small group of individuals should be able to dominate the board's decision taking.
Statements of practice	The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors).

The importance of innovation

The Combined Code does not attempt to limit innovation in corporate governance practice. However, for complex systemic reasons, it has had that effect, most notably in approaches to risk management and internal control.

In his classic article in the first volume of the American Sociological Review in 1936, Columbia University sociologist Robert Merton identified two “methodological pitfalls . . . common to all sociological investigations of purposive action”: the first was “causal imputation” and the second “that of ascertaining the actual purposes of a given action.” Merton highlighted . . .

the difficulty, for instance, of discriminating between rationalization and truth in those cases where apparently unintended consequences are *post facto* declared to have been intended . . . just as in the classical instance of the horseman who, on being thrown from his steed, declared that he was “simply dismounting.”

So, for the FRC, there is the problem of identifying the contribution of the Combined Code to the current state of corporate governance in the UK and of separating it from the other influences on UK corporate governance practice.

The contribution of the Combined Code on corporate governance in the UK is limited, in Merton's terminology, by “imperious immediacy of interest”:

. . . where the actor's paramount concern with the foreseen immediate consequences excludes the consideration of further or other consequences of the same act. (Merton, 1936)

In this instance, we believe that the understandable urge by the FRC to codify and to provide detailed guidance has led to three unintended consequences (although they may not have been “unanticipated”):

1. it has ‘crowded out’ thinking by boards themselves about the best arrangements for corporate governance and how best to adapt their governance structures, processes and behaviours to their unique requirements;
2. it has promoted the role of the major professional advisory firms as interpreters of the governance canon; and
3. as a result, it has limited innovation among companies in the development and adaptation of their governance systems.

What is comply or explain?

The Cadbury report stated:

We recommend that listed companies reporting . . . should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance . . . Boards are not expected to comment separately on each item of the Code with which they are complying, but areas of non-compliance will have to be dealt with individually.

Throughout the report, the committee called on reporting companies to explain various aspects of their reporting . . . hence, ‘comply or explain’. This was reinforced by the Hampel report which called for:

a requirement to make a statement to show how they (i) apply the principles and (ii) comply with the combined code and, in the latter case, to justify any significant variances. (Hampel, para. 1.23)

The term ‘comply or explain’ appears first in the FRC’s own Combined Code documentation, originally published in May 2000. In Derek Higg’s 2003 report *Review of the role and effectiveness of non-executive directors*, he attributes the phrase to the Cadbury report (actually to Sir Adrian himself) but, at least in terms of the literature of governance, this was incorrect. The error is only material in that it demonstrates a degree of mythologizing about the phrase, its import and its utility; the phrase is only useful to the extent that its use supports achieving **governance objectives** – that is, for the effective and efficient operation of a system of and framework for corporate governance. The difficulty is that, in all the official and quasi-official literature on corporate governance, there have been remarkably few expressions of such objectives.

One clear exception is the discussion in the Hampel report on the difference between shareholders and stakeholders. Hampel states that it considered “the aims of those who direct and control companies”. It concluded (paras 1.15 – 1.17):

The single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders’ investment. All boards have this responsibility and their policies, structure, composition and governing processes should reflect this.

Yet, even this falls short of a comprehensive consideration of the **design principles** of a governance framework or even of **governance principles in application**.

The distinction between “comply or explain” and “apply or explain” is subtle; we believe it is too subtle. The difference between *application of* guidance and *compliance with* guidance is, in practice, likely to be minimal. The **design objective** should be to encourage companies’ boards of directors to understand what the range of governance settings are for their structural governance arrangements (in the Hampel report’s words: “policies, structure, composition and governing processes”) and to communicate that understanding to disclosure report users, as well as to provide for users an assessment of the governance framework’s and the board’s performance against the company’s governance objectives. This in turn requires an understanding of the audience: who uses companies’ disclosures and why. Understanding the relationship between the company’s board and major audiences is an essential part of designing a robust governance framework both at market and company level.

The major board relationships are shown in the table on the following page.

Table 1
Board relationships

Board to . . .	Terminology	Key issues
society	licence to operate	<ul style="list-style-type: none"> Usually addressed by management Chairman as spokesperson Board held to account legally and publicly
market	corporate governance	<ul style="list-style-type: none"> market for corporate control long-term performance
investors	corporate governance	<ul style="list-style-type: none"> beneficial ownership stewardship voting rights communication to board / management risk-adjusted return (EVA)
debt-holders	financing	<ul style="list-style-type: none"> attention to leverage; interest cover corporate financial performance usually delegated to management
board	board management	<ul style="list-style-type: none"> board performance management agenda control meeting control balance of constructive challenge to management
auditors	assurance	<ul style="list-style-type: none"> accuracy and completeness of reporting internal financial control
executive management	board relations	<ul style="list-style-type: none"> information flow to the board strategy reserve powers / business case approval risk tolerances & targets firm competencies execution oversight adequacy of commercial infrastructure
subsidiary boards	internal governance	<ul style="list-style-type: none"> alignment of subsidiary risk/return expectations with corporate position alignment with role of geographic/business line management
company	internal governance	<ul style="list-style-type: none"> communication of the role of the board and guidance from the board within the company relates especially to risk, ethics programmes
assurance functions	governance, risk & internal control	<ul style="list-style-type: none"> effectiveness of control systems

By providing detailed guidance on governance issues, the FRC has limited the requirement for boards to understand in conceptual and practical detail their own governance frameworks and how these should be adapted to their specific needs. Because their governance frameworks are expected, by boards and by market observers, to comply to guidance, companies have turned to compliance advisors – lawyers or audit firms – to help them to interpret and apply the guidance (to the extent they have looked anywhere). The result has been to limit innovation and adaptation. The effects of this are two-fold:

1. Companies have not sought to innovate and the guidance has become a *de minimis* expectation of practice. Firms that have deviated from that practice have often been criticised and have risked having their value discounted by institutional or other investors;
2. The firms that interpret corporate practice – equity research houses and analysts – have under-developed expertise in understanding differences in governance practice or their potential impact on firm performance and hence value, thus muting almost entirely market-based feedback on governance structures and frameworks.

Quite why innovation in corporate governance should be less important or desirable than in other areas of corporate endeavour has never been satisfactorily examined or explained.

Internal control, risk management and the Turnbull Guidance

Nowhere are these rigidities more pervasive than in interpretation of section 3.2 of the Combined Code on internal control. Here, the guidance provided by the FRC has had consequences so unintended that its application in practice has even been disavowed publicly by the Chairman of the committee drafting the guidance, Nigel Turnbull.

We believe the guidance on internal control and risk management should be separated. While there are common areas, differences of emphasis, language and disciplinary focus between the topics are material. More importantly, governance requirements should encourage and endorse far greater innovation in both internal control and risk management practice within companies. It seems highly unlikely that this can be achieved through detailed guidance, such as the current Turnbull guidance. Rather, there should be a clear distinction between the principles of governance, statements of practice expectations, guidance on practice and examples of practice.

The problem is not, or was not originally, in what the guidance, *Internal Control: Guidance for Directors on the Combined Code* (or “Turnbull Guidance”), said about internal control. Although it was apparent from the shortly after its publication that the Turnbull guidance would produce perverse results, much of it was and is, on paper, sound and sensible. The problem initially was that the guidance strayed from a statement of expected reporting on financial internal control in to the infinitely more behaviourally complex area of corporate routines for risk-related decision-making and management of risk. Using terms such as “embedded” and “culture” to an audience that typically lacks advanced training in behavioural analysis was

always going to be fraught with potential for unintended consequences. The result in practice has been of limited value to boards of directors or to the institutional investor audience.

The commentators quoted in the FRC's excellent summary document (July 2009) express a range of views on risk management and internal control most of which, even when contradictory, are valid. And that is the heart of the problem. Seeking to draw on leading practices, the Turnbull committee drew heavily on the work of the Committee of Sponsoring Organizations of the Treadway Commission (the 1987 US National Commission on Fraudulent Financial Reporting) which published in September 1992 its report titled *Internal Control: Integrated Framework*. The COSO Framework, as it has become known, has now been further entrenched by the US PCAOB which has used COSO as the basis for its interpretation of the SEC's requirements for §404 of the Sarbanes Oxley Act on internal control.

While legal compliance and financial internal control lend themselves to an unwavering routine for interpretation and assessment (through regulatory and accounting frameworks respectively), understanding of control over the effectiveness and efficiency of operations does not; corporate- or enterprise-level understanding of internal control certainly does not; in understanding or assessing enterprise-level risk management, such an approach is counter-productive.

The approach to internal control on which Turnbull is based has been widely propagated by the major chartered accounting firms and is at the heart of compliance with SEC registrants' financial reporting requirements over internal control. It has not altered nor has it evolved in understanding since 1992 – a period of 17 years. Applying a COSO-compliant framework for internal control has demonstrably not been effective in helping avoiding corporate failure in the banking system; it has long outlived its usefulness. Worse, its regulatory endorsement by FRC and by the SEC and PCAOB has inhibited the development of other internal control frameworks or approaches to internal control which may have produced better results in practice. This is not the fault of the regulations propagated by those agencies, each of which provides for companies to adopt other practices; companies, which are, in this area, advised by leading global accounting firms and/or law firms, have simply not chosen to develop or adopt them. The leading chartered accounting firms have done little or nothing in that time to encourage innovation in internal control frameworks for or by their clients.

In corporate risk management, the failure is, in our estimation, even greater. There is a body of argument, backed by a mounting body of anecdotal evidence, that approaches to corporate risk management propagated by standards bodies and by the leading chartered accounting firms and supported by numerous software applications are of little inferential utility and offer results that are little above random decision-making (Cox, 2008).

We find these conclusions overly tentative. From working with numerous clients on enterprise risk management, we have found even supposedly "leading" approaches have added little to corporate understanding of risk and systems have offered executives unsubstantiable (and sometimes even false) reassurance of control over risk. Many are predicated on the highly dubious assumptions that risk is undesirable or that risk can be effectively controlled; while both can be true under certain assumptions or conditions, both are far from universal. Some corporate approaches we have observed were, supposedly, based on "best practice" but were unsuitable for the firm or its operating or financial conditions; many, though compliant with 'best practice' standards, contributed little or nothing to corporate executives'

understanding of or marginal decisions concerning risk. However, in each and every case, the extant solutions were regarded as ‘Turnbull-compliant’ and presented to boards of directors as reducing risk and improving control. In our experience, no board has disagreed with such dubious assertions, however much skepticism was harboured by individual board members.

Despite the renewed emphasis placed on enterprise risk management by Standard & Poor’s enhanced review methodology, it seems implausible that sophisticated institutional investors pay great attention to companies’ narrative risk reports. Certainly none we have spoken to indicated anything but polite disinterest in companies’ risk statements. If this selective sample is generalisable, that suggests that the reporting on risk and internal control and the processes to support it in firms are of limited practical utility both internally and externally. This conclusion would certainly argue for change.

A system view

The Combined Code forms part of a system of governance that includes a wide range of actors and motivations. These include, but are not limited to:

- regulators and quasi-regulators
- professional bodies
- institutional shareholders as agents
- institutional shareholders as principals
- sell-side firms & investment banks
- equity research houses
- pension funds
- savers through pension funds (beneficiaries)
- private investors
- private equity firms
- banks
- industry bodies
- consultancies and advisors
- corporate executives
- corporate non-executive directors
- academics & think tanks
- exchanges
- market information providers

The interests of these actors are not aligned. Even within categories interests will differ. None are purely passive observers. The Cadbury definition of corporate governance – “the system by which companies are directed and controlled” – is valid only in so far as *system* is interpreted in the broadest possible sense and *controlled* is interpreted both in terms of corporate market for control *and* internal control. All the actors indicated can influence the system in some way through their several or joint actions.

A principal design stage for the Combined Code should be to understand the roles of each of these actor types and the range of interests within the actor types. Key to optimal design of the Combined Code is an appreciation of:

- a. the transmission mechanism from governance regulation to corporate action
- b. the transmission mechanism from corporate action to institutional investor and other investor response
- c. the constraints and limiting factors on investor response
- d. the feedback processes from investors to corporate directors (executive and/or non-executive)

The role of professional advisors in (a) was discussed above. The role of equity research on (b) is also important, and was also introduced above. At present, we contend that governance and related disclosures have limited impact on investor behaviour. In part, this is due to the low quality of information typically provided about the board, management, their activities, interactions and behaviours and performance. However, some blame must also fall on analysts who, collectively, have been weak at differentiating governance practice or its impact on expected future corporate performance. (Note that it may be entirely valid actively to assert that there is in general or in specific cases no impact). The corporate governance system will only operate effectively when disclosures include enough substance to be differentiable by analysts and analysts have the skill and the interest to interpret the impact of differing governance practices on firms' potential for sustained value creation.

Therefore, a design criterion for corporate governance disclosure should be to encourage companies to provide reporting of sufficient relevance that it is differentiable. Of course, this can only occur if firms are also encouraged by regulation and quasi-regulation to differentiate their governance activities – to innovate – as discussed above.

Empirical evidence

In several places in this commentary, we have made assertions about corporate practice based on our experiences as advisors. In undertaking primary research for its review, the FRC has spoken to a wide range of market participants and corporate chairmen. Also, there have been many and varied responses to earlier consultation. The FRC summary document on the earlier consultation round states:

The FRC believes that the strength of the response means that what we have heard can reasonably be assumed to be representative of the view of market participants as a whole.

However, as noted above, each of these will have its own perspective and none will be free from bias, particularly in relation to their own actions and interests. The plurality of opinion received is likely to have canvassed the range of issues of concern to market participants. However, there is little or no basis for an assumption that the assertion of efficacy of the framework by participants is supported or verified. By way of contrasting examples: It is only in the last six hundred years that the Earth has not universally been regarded as the centre of the universe; it is only in the last two years that credit default swap concentration has been understood to present a systemic financial risk – prior to that CDSs were almost universally presumed to distribute risk efficiently.

We believe the opinion-based research is not a substitute for sound empirical research of corporate practice; nor is it possible to use the results of such inferentially. There has been a startling lack of robust empirical work on what is effective and what is not in corporate practice in governance in the UK (or elsewhere).

Greater attention to empirical research on governance, risk, internal control and assurance is urgently required. If properly constructed, such research would, we believe, yield results the benefits of which would substantially exceed the costs of the exercise.

Solving the practical problem of changing the Combined Code

Much of the discussion in our comment has assumed starting ‘with a clean sheet of paper’. However, we can only ‘head to Dublin’ from where we find ourselves now. Any practicable recommendations for change must be sensitive to the disruption that wholesale change would cause. Hence, the objective should be to seek to achieve the maximum desirable impact, and the minimum undesirable impact, with the minimum possible disruption.

Before addressing our proposal for change, we recognise the case for change must be compelling. Without clear, empirical evidence, this is problematic. Many of our concerns about specific provisions of the Combined Code and aspects of corporate governance are addressed in the following section. Here, however, we will limit ourselves to the problem of inadequate innovation in corporate practice in governance, in management of risk and of internal control and assurance.

Our argument is simple. Governance, management of risk, and non-financial aspects of internal control are not accounting nor can they be rules-based. They are fundamentally behavioural challenges where solutions are required to be pragmatic and adaptive. Imposing a set of rules or a single process boundary on human or behavioural systems inhibits innovation. Innovation is vital for improvement, as is failure for change which supplies improvement. A principal condition of learning from failure is the ability to test counterfactuals – the ‘Kuhnian’ process of imagining an alternative paradigm in which the observed facts can be better explained. The strictures of current guidance, and its ‘policing’ by analysts and institutional investors (themselves rarely experts in governance, risk or internal control), limits this process of adaptation and change. We would argue that the limits on innovation are imposing a greater systemic cost – greater ‘deadweight loss’, technically – than would periodic failure through overly ambitious or innovative governance arrangements.

What is needed is a solution that permits corporate business to retain both the ‘baby’ and the ‘bathwater’. We propose that the FRC:

1. develop . . . (i) the existing code in to a truly principles-based framework where the ‘principles set’ is explicit – at the design level, at the framework level and principles in application; and (ii) . . . and include a substantially revised set of reporting requirements emphasizing explaining the logic and principles of governance settings adopted by the company
2. retain the current Combined Code largely in its present form
3. present listing companies with an option of the code approach they follow – either the revised principles (the ‘alternative Code’) or the current Combined Code (as amended from the present exercise)

In the first case, the FRC could and should emphasise the benefits and value of innovation and establish the option for firms to enter a ‘system trial’ which will be evaluated rigorously after, say, two annual reporting cycles. The FRC could support the approach with a programme of seminars and briefings for market participants to ‘raise the game’ of governance, risk management and internal control in ‘UK plc’.

We believe this approach will offer certainty to those firms who seek it, via the Combined Code, as well as offering flexibility and adaptiveness to those firms who feel other arrangements would provide better for

their specific circumstances and requirements. It would also be self-selective; those firms that feel strongly about their governance and related arrangements would, in all probability, be diligent and attentive enough to the governance settings to provide robust arguments for their preferred approaches. Those that were unsuccessful would risk penalty in the marketplace.

Most importantly, this approach would break companies, their advisors and regulators out of the unhelpful assumption of 'best practice' and force them to address thoughtfully what they really require and why and how to persuade analysts and investors that their view is justified; in short, it would revitalize the governance system in UK corporate business.

A less radical alternative

If the radicalism of this approach is unattractive to the FRC, a less radical alternative would be to

1. confirm the Combined Code for a set period, say, three years
2. develop and publish as a consultation paper a framework as advocated above for comment and consideration as an possible subsequent alternative for listed companies

This would require the FRC to acknowledge in its final document from this consultation exercise that the current approach is failing to produce adequate innovation in corporate governance practice and that the analyst community is failing to provide adequate differentiation of corporate governance performance by companies and to analyse the impact of differing performance on the sustainable creation of value.

A framework may include considerable detail – the same or more than is currently provided – but it should be presented in a form that does not specify requirements for approach or reporting content. As an example, this may be structured as follows:

Governance principle	The business should be operated and decisions taken in the long-term interests of ultimate shareholders.
Corporate governance framework principle	No individual or small group of individuals should be able to dominate the board's decision taking.
Statement of practice(s)	The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors).
Guidance on practice	Discussion of issues that may influence a company's governance approach on the board's decision-making
Example of practice	An example of a board policies, processes, activities or disclosures
Example of disclosure	A worked example of disclosure selected so as not to be readily imitable Example(s) of a related disclosure produced by a reporting company

In each case, the board would be required to explain how it satisfies the governance principle and how the governance framework principle is used or applied in the business (the principle in application). The firm would be expected to confirm the logic for its position and changes it has considered in the past period.

SECTION 2

Specific issues raised by the FRC

Comments in this section respond to the specific issues raised by the FRC in its *Progress Report and Second Consultation* paper from July 2009.

The guiding principles in relation to changing the Combined Code

- **Where there is a demonstrable need for best practice to be clarified or strengthened, this will be addressed either through amendments to the Code or additional, non-binding guidance;**

For the reasons outlined above, we believe this approach is flawed on two bases:

- The notion of ‘best practice’ is illusory and unhelpful. In human and human-dependent systems or other complex systems, it is not possible to define practice which is universally superior.
- The greater the guidance that is provided, the more likely are firms **not** to innovate to develop frameworks, systems and processes which are best adapted to their own operating requirements

If a framework is to be principles-based and operate as such, it should be limited to statements of principle. By incorporating detailed guidance, the has FRC established a half-way house between principles-based regulation and rules-based regulation which has inhibited innovation ‘within rules’ or based on principles.

- **Where not constrained by regulatory requirements, we will seek to rationalise disclosure requirements in the Code to encourage more informative disclosure on the issues of most importance to investors and to discourage boiler-plate and box-ticking; and**

This can only be achieved by emphasising open-form reporting against principles. Firms should be required to explain the logic and application of all their governance arrangements and how they fulfil explicit principles of governance.

- **We will seek to avoid an increase in the overall level of prescription in the Code and to preserve its principles-based style.**

We believe that the current approach to principles-based regulation requires careful disambiguation of the types of principles stated. Examples are provided in section 1, above.

The responsibilities of the chairman and the non-executive directors

- **Would it be helpful to give further clarification of the role, key responsibilities and expected behaviours of the chairman, the senior independent director and/ or the non-executive directors, either in the Code or in non-binding guidance?**

Based on the commentaries provided by the FRC on its consultation exercise, it seems likely that many parties will call for additional guidance. However, it is questionable that this is the role of a regulator. As a regulator, we believe FRC should stipulate the principles by which companies should abide and leave others to provide interpretation. Also, see our recommendation in the previous section.

- **Whether it would it be helpful to provide further guidance on the time commitment expected of the chairman, senior independent director and / or non-executive directors?**

We do not believe so. The requirements of non-executive directors should be determined by companies themselves and each will have different requirements. However, we believe the requirements agreed with NEDs should be available for investor scrutiny.

Board balance and composition

- **Whether the Combined Code gives sufficient emphasis to the need for relevant experience among the non-executive directors collectively.**

This is, arguably, the most important section of the Combined Code. We believe disclosure requirements should include a requirement for the board to explain its experience and capability requirements, how these have been determined, how they have been met and how any gaps are intended to be filled in the forthcoming period – a ‘competencies and composition’ report, or equivalent.

- **Whether the independence criteria and the way they have been applied by boards of companies and investors have unnecessarily restricted the pool of potential non-executive directors, and in particular whether the so- called “nine year rule” has resulted in a loss of continuity and valuable experience.**

The independence criteria are illusory and illogical; no director, paid by the company, is truly independent. Objectivity is far more important; independence is far easier to demonstrate. Current requirements represent the triumph of the visible over the important.

Whether or not the nine-year rule has resulted in a loss of continuity and experience is purely an empirical issue. That it is a matter for consultation illustrates the limited empirical information available to the FRC on governance.

- **Whether the recommendation that the boards of FTSE 350 companies should comprise at least 50% independent non-executive directors has resulted in fewer executive directors sitting on boards and/or boards becoming larger.**

Again, impact of current guidance on board composition should be simply an empirical issue; the consultation requirement illustrates again the paucity of empirical information in this area.

The issue of composition is vexed and multi-faceted. The balance of executive versus non-executive directorship is not overly difficult; it should be a matter for judgement by the chairman in consultation with major investors and with the nomination committee. We do not believe there is a strong *a priori* argument for greater ED or NED representation. Rather, this will depend on the sector, the circumstances of the firm, its stage of maturity and the skill sets available internally and externally.

Far more difficult is the role of executive directors. EDs, other than the CEO, owe a dual loyalty on the board: as directors, to shareholders; and, as employees, to the CEO. Similarly, the loyalty of the CEO will be split between his or her role and statutory responsibilities as a director *in pari passu* with other directors and NEDs and as the employer and titular superior of other executive directors. This duality of role is inherently problematic and, in our experience, when combined with the information asymmetry between EDs and NEDs, the source of many of the greatest tensions or dysfunctions in board behaviour and performance.

We will address the resolution of these issues under *Board information, development and support*, below.

- **Whether more guidance is needed, in the Code or elsewhere, on succession planning and the need to ensure that board composition is aligned with the present and future needs of the business.**

We believe this should form part of the competencies and composition reporting described above.

Frequency of director re-election

- **Annual re-election of the company chairman.**
- **Annual re-election of the chairs of the main board committees.**
- **Annual re-election of all directors.**
- **Binding or advisory votes on specific issues, or on the corporate governance statement as a whole.**

In all cases, there is a trade-off between desirable continuity and focus on company performance and the rights of investors and mechanisms available to investors to depose non-performing boards. There should, as a matter of principle, be steps available to investors between impotence and sale (an, *in extremis*, the market for control) to influence boards. Other commentators will be better placed than us to advise on what those mechanisms should be. However, we believe strongly that these matters should be addressed at the level of principles rather than plurality of opinion.

Board information, development and support

Many commentators on the review highlighted the need for the non-executive directors individually and collectively to have sufficient knowledge of, and information about, the business to be able effectively and constructively to challenge the executive. This could be obtained in a number of ways:

- Through prior relevant experience, which the sections of the Code dealing with board balance and composition should facilitate;
- Through the information they received, whether from the executive or from independent sources. Some commentators felt that the Code could encourage non-executive directors to make more use of independent sources of advice;
- Through greater contact with the operational activities of the company. Some commentators felt non-executive directors could be more proactive in this respect, and that it was the responsibility of the chairman and CEO to facilitate these contacts, while recognising the implications in terms of the overall time commitment required of non-executive directors; and
- Through induction and ongoing professional development.

The role of the company secretary was considered important to the effective functioning of the board. Various proposals were put forward for increasing its effectiveness, for example through greater resource, more clearly defined responsibilities or a change of reporting lines. There was not a great deal of support for the proposition that the secretariat should be completely divorced from the executive, with the majority of those who commented taking the view that this would reduce rather than increase effectiveness and might undermine the unitary board.

As noted above, we believe these issues are among the most vexed in the governance debate; they cannot be considered separately from the information asymmetry between EDs and NEDs or the duality of roles of EDs in relation to their statutory and directorial duties and obligations and loyalties as executive employees.

That there was not majority support among submissioners for increasing the role or authority of the secretariat is unsurprising. Nor is it especially relevant. The more important issue is how best the secretariat can be deployed to assist EDs to understand and fulfil their directorial duties (as distinct from their executive responsibilities) and assist NEDs to overcome the inherent information asymmetry between EDs and NEDs, given the limited time available to NEDs to commit to their duties.

Here, perhaps, the considerations of the Walker review can be instructive. By recommending the creation of chief risk officer (CRO) roles in banks and other financial institutions with equivalent reporting structures to those of internal audit directors, Walker has, in effect, established (or consolidated) the idea of governance-related officers whose position is different from other senior officers in terms of appointment and accountability. The secretary can and should be such an appointment – responsible to the chairman jointly with the CEO as well as his or her “appointment and removal . . . [being] a matter for the board as a whole,” as provided for in Code provision A.5.3.

In our submission to the Walker review, we stated:

“The role of the company secretary is pivotal to the effectiveness of board. Effectiveness of the board depends crucially on the extent to which it can see into the company; as a senior company executive, the secretary can play an important role in facilitating that process. The role of the secretary is a function of the board as much as a function of management, and is an essential conduit of information to the chairman, committee chairmen and other non-executive directors.

“We endorse the views expressed by ICSA – the Institute of Chartered Secretaries & Administrators (at least to the FRC review of the Combined Code):

1. The company secretary's role should be extended to include to procure, and advise on, all the information necessary for the chairman and directors to discharge their obligations.
2. Through the chairman, the company secretary should have the power to call for any document or information he requires from executive management.
3. Amend the board evaluation process to require the board to consider whether the company secretary and the secretariat team are effective and adequately resourced to meet the needs and expectations of the board.
4. Require the company secretary to report to the chairman. He will often have a second reporting line into the CEO, but his reporting line should not be solely to executive management.
5. To further protect the company secretary's independence, require the remuneration of the company secretary to be set by the remuneration committee in consultation with the chairman.
6. To ensure effective interrelationships between the board and its committees, require the company secretary, or his nominee, to be secretary to the board and the principal board committees (audit, remuneration, nomination).

"Indeed, in relation to (1), we would go further and advocate that the company secretary should have the authority to require directly any information he or she considers necessary for the board should be required to be provided, on request, to his or her office."

The question remains as to the best means of furthering these arrangements. We have advocated a more *laissez faire* approach to regulation based on expressions of principle. Our advocacy of a strengthened role for company secretaries needs to be viewed within our higher-level advocacy for a framework which will support greater flexibility and adaptiveness of governance arrangements of listed companies.

We find the idea of such arrangements undermining the unitary board approach as fanciful and a little paranoid. Indeed, we would go far further and encourage companies to consider the creation of a non-executive committee of all NEDs. Among the mandate of such a committee should be the performance criteria for executives and their performance, concerns about the conduct of executives including executive directors at the board (should any arise) and the adequacy of reporting to NEDs and the board. Executive directors have almost unlimited opportunities for discussion and meeting on such terms; non-executives should also. As with other committees, it would be appropriate to have the company secretary act as secretary to the committee with other executives attending only at the explicit invitation of the committee for briefing or questioning as they see fit. This may help NEDs to identify additional information requirements for the board.

Above all, the company's executives, as directors or otherwise, should maintain a constant awareness that it is the board that is legally constituted as the company, with its powers delegated to management to effect the business and operations of the company. In the debate on governance, that rather fundamental point is all too often overlooked.

In a related point, boards should be receive from executives proposals such that they occasionally decline recommendations of management or refer them back to management for re-consideration or amendment and re-submission. Without such periodic rebuttal, executives will expect endorsement and resent the board

for withholding it. Similarly, if they do not routinely decline or defer approval, the board will hesitate to exercise that prerogative when it may be required. To use a physiological metaphor, a muscle that is not exercised will be more painful and more problematic to deploy suddenly under stress; well exercised and well practised, its use will be reliable.

Board evaluation

- **Whether the Code should be amended to recommend that board evaluations should be externally facilitated at least every two or three years for some or all companies.**
- **Whether the recommendation that the effectiveness of all the main board committees should be evaluated every year should be relaxed in some way, for example to recommend a rolling cycle of committee reviews. Some commentators considered that after the initial evaluation there was limited value in subsequent annual reviews.**
- **How disclosures in the annual report might be made more informative, either in relation to the process that was followed and/ or the outcomes of the effectiveness review.**

These issues demonstrate the danger of a pragmatic and accretive approach to regulation. The utility of the periodic review is now a matter of cant. Some boards undoubtedly find them useful. For others they are a pointless distraction. For still others, they are a rote exercise in which real findings are necessarily omitted either for reasons of commercial self-preservation or simply limited understanding by the external evaluator, or must go unreported for reasons of potentially prejudicial discoverability in litigation, especially if the company operates in the US.

The objective is to improve the effectiveness of the board through feedback on its performance as a board wholly or in committee. There are surely other, more contributory processes than a periodic external evaluation. Where a report on board evaluation was to be disclosed, it would surely be positive and fulsome in its praise; in such a structure, there is no commercial incentive on the examiner to report honestly on poor or mediocre performance. A reputation for unfailing honesty as a reviewer is hardly likely to be commercially advantageous.

More likely to be constructive, for a host of reasons, is a robust, timely (meeting-by-meeting) process for feedback of:

- board (or committee) to the chair on his or her performance
- board to committee on reports received
- board members to board on the conduct and result of the meeting
- board members to executives on the quality and utility of papers prepared and the presentation by the executive of the material put forward
- executives to board on the quality of deliberation and penetrativeness of questioning on the paper submitted
- board and committee members on the performance of governance-related officers

Much of this can and should be provided on-line. If combined with a secure portal for delivery of papers to the board, such a feedback system would attract on-going use and would be very useful for supporting the

chairman and secretary to support director development and executive improvement. The idea that NEDs should not be subjected to such feedback or review is, frankly, antiquated.

Risk management and internal control

Our views on risk management and internal control are spelled out in section 1. Here, we make specific comments in response to these questions only to provide clarification or amplification of those observations.

- **Whether the board's responsibility for strategic risks and setting risk appetite – as set out in the Turnbull Guidance - should be made more explicit in the Code, and whether the current balance between the Code and the Guidance is the right one.**

Directors who do not understand the responsibility of the board for strategic risk and setting the risk appetite of the company should not be appointed. Doing these things, however, is a very complex and demanding exercise that, in our experience, few companies seriously attempt and fewer achieve. If there is to be guidance, it should be considerably more sophisticated and demanding than that provided in the current Turnbull guidance. It should encourage innovation and risk-taking and avoid conflating risk management and control which are distinct (though, in some circumstances, related) practices.

- **Whether there is a need for all or parts of the Turnbull Guidance to be reviewed.**

The Turnbull guidance has outlived its usefulness and has foundered on a broad shoal of unintended consequences. It must be thoroughly reviewed and recast, probably as separate guidances covering risk management (if such guidance is believed to be required – which we do not believe) and internal control. To repeat, it should encourage innovation and development of approaches which conceive of control beyond compliance and financial internal control; the COSO approach should be recognised as contributory to the debate on control rather than an end point.

- **To what extent the particular mechanisms recommended for banks and financial institutions would also be appropriate for other listed companies. For example, there were mixed views among commentators about whether separate risk committees were necessary for companies with less complex business models.**

We believe that risk committees will be beneficial for some companies and not so for others. This should be one of the elements of innovation that companies should be encouraged to consider. It is a matter for the chairman and the board to determine the utility of such an approach.

- **How reporting on risk might be improved, for example by rationalising existing disclosure requirements or providing guidance on good communications tools.**

In either case, the board should be required to specify how it seeks to understand the firm's risk preferences (especially in relation to shareholders' risk preferences for the firm), its comparative advantages in risk holding and its risk-holding capacity, and its risk tolerance. The expression "risk appetite" has never been properly defined and is of limited utility; as a practical matter, firms cannot have a single risk appetite as risk is not reducible to a singular construct, even in financial services – at-risk capital (at some measure of

probability and horizon, viz. VaR or earnings at risk) can be a complete **financial risk** measure, but cannot incorporate all risk classes, such as threat to human life (at least without considerable simplifying assumptions).

Also, the firm should be required to report on the governance approach it has taken to risk-related issues as well as commenting on the dimensions of the firm's risk management system. In our governance-related work with firms, we have developed an approach which acknowledges three dimensions of risk governance:

- **structural** dimension – the committee structure; board organisation, policies and procedures; responsibilities; accountabilities and delegation/limit structures; and so on;
- **analytical** dimension – the use of data and analysis of data to substantiate a proposal or proposition or to set or assess performance against a metric (interactive control) or to assess fitness for purpose and suitability of performance metrics or identify causal relationships (diagnostic control);
- **behavioural** dimension – the impact on individuals' and groups' behaviour of the other dimensions, and behavioural expectations and boundaries of behaviour

For completeness, we have provided, in Annex 1, a table showing these dimensions against the board : audience relationship set shown in table 1, above.

Requiring firms to identify key risks has some benefits but also some problems associated with it. The repetition of requirements across governance report and the statutorily-mandated business review is unhelpful, as is the focus and content of the business review itself.

It is our opinion, based on our work with clients, that current regulatory and statutory requirements have created hopelessly unrealistic expectations among investors and the public, and also among some directors, of the potential efficacy of risk control approaches (such as use of risk registers and crude risk matrices). As stated in section 1, these approaches are methodologically questionable and may occur in parallel with effective management of risk, but, at least in our observation, there is little or no causal relationship. To the extent it can be observed, the causality is indirect (through increased saliency) and inevitably transitory.

Therefore, requiring firms to report on risk management in detail, when there is considerable division, even among expert opinion, on the utility of "best practice", seems futile. More realistic would be to encourage firms to explain why the risk management approach they have adopted is best suited to their operating environment.

Remuneration

- **Whether to revise the Code to ensure consistency with the European Commission's Recommendations and, where appropriate, the FSA's proposed code of remuneration practice for financial institutions and the recommendations of the Walker Review.**
- **Whether any other changes to the Code, or additional guidance, are required to reflect developments in best practice.**
- **Whether shareholders should be given a more direct role in setting remuneration and, if so, how this might be achieved.**

Our previous comments around “best practice” apply equally in relation to the FRC’s observations of remuneration.

In our response to the Walker review, we made the following observations in relation to the Draft Report’s recommendations on remuneration:

“Economic versus accounting profit

“While the logic of recommendations rests on deferral of income for traders (in essence), this masks a more important and fundamental point: that **accounting profit recognition conventions mask economic reality**, which forms the more reliable basis for remuneration to minimize moral hazards of misalignment of interests between principal (ultimate beneficial shareholder) and agent (trader). Here, there are two issues:

1. Failure to attribute or allocate fully the funding, risk and operating costs of desk and/or instrument to traders’ profit and loss assessment; as a sub-issue, many institutions have defaulted to applying the regulatory capital charge rather than undertaking a comprehensive, fully-costed approach to allocation including economic capital, and
2. Based on accrual accounting assumptions, recognizing the profit of trades at execution, rather than over the economic life of the asset and adjusting for realised cash flows

“The FSA’s Remuneration Code, finalized in August 2009 . . . assumed (sic) that it is not practicable simply to pay for performance as it is realised, rather than as it is booked for accrual accounting purposes, as is current practice. The key issue is not one of arbitrarily deferring income from trading activity, but aligning performance assessment with realised economic profit rather than booked or accounting profit, and ensuring that profit assessment includes rigorously all costs

“There is no reason, other than administrative simplicity, why all remaining payouts need to be ‘cashed out’ as a trader or executive leaves a firm. It would be relatively simple to provide (in the accounting sense) for remaining remuneration assessable, then pay this in to a separately-constituted ‘bonus trust’ to be paid out based on the original rules of the bonus structure. This would then be both independent of the firm and eliminate the possibility of some retributive action or credit performance.”

Comparability

While the terminology may differ, we believe the issues we raised are equally applicable outside the financial sector.

In relation to the other proposals of the Walker review:

Remuneration committee

We believe the extension of the remit of the remuneration committee to cover “all aspects of remuneration policy on a firm-wide basis with particular emphasis on risk” is clearly appropriate; it is difficult to see how the failure to do so historically can be justified.

While we do not necessarily advocate that all companies establish risk committees, the need for a linkage between risk and remuneration structures should be so obvious as to be unnecessary as a recommendation; that it has not automatically been linked in the past represents an astounding failure of professionalism in advice on remuneration.

Remuneration consultants

In relation to the Walker review's recommendations 38 (professionalisation of remuneration consultants) and 39 (commitment of remuneration consultants to a code: FRC to maintain register), we stated

"The advice provided to remuneration committees and senior human resources personnel by remuneration consultants relates to four principal areas:

- Remuneration levels in the sector in the UK and in international markets in which the relevant personnel can operate
- The likely tax effectiveness of proposed structures and the impact on comparative net incomes of the relevant personnel and costs of living in the competitive jurisdictions
- The appropriate incentive structures and behavioural impacts of proposed structures to achieve the objectives of the client firm in relation to business generation, trading activity, profitability and reward for trading personnel, and
- Demand and supply conditions in markets for relevant skill sets

"If remuneration consultancies cannot provide these services either themselves or in collaboration with another service provider, they cannot provide the services and information required to support firms to establish sound compensation structures. The creation of and adherence to the Code described is a secondary point; it should not be necessary."

The quality of disclosure by companies

- **The extent to which it would be possible and desirable to rationalise the disclosure requirements set out in the Code. We would particularly welcome the views of investors on what information is of most value to them, and the views of companies on what information is most costly to produce.**

Our views on this were made clear in section 1.

- **Whether it would be appropriate for the FRC or the FSA to undertake greater monitoring and enforcement of "comply or explain" statements, and if so what form this might take.**

There are three potential classes of transgressions

- i. failure both to comply and to explain non-compliance
- ii. failure to comply with an unsatisfactory or ambiguous explanation of non-compliance
- iii. failure to comply with a misleading explanation of non-compliance
- iv. failure to comply with a false explanation of non-compliance

In case (i), sanction may be justified. In case (ii), the market is the appropriate forum for sanction, though discounting corporate value, if relevant. In case (iii), there is a legal question relating to intent, and sanction without due process of law would be arbitrary. In case (iv), there is a statutory breach and sanction is required.

The extent of monitoring depends on the perceived risks associated with non-compliance. It is not enough to allow the presence of regulation to strengthen the case for civil suit in the event of loss. As a matter of regulatory principle, it is pointless to establish regulation without effective enforcement, especially where the market cannot provide effective sanction.

Engagement between boards and shareholders

- **The framework proposed by Sir David Walker, and the appropriate role for the FRC.**

As we stated in section 1, Sir David's review was notable for its attention to the system of governance and investment in companies by institutional shareholders. *Prima facie*, his recommendations appear sound. It is a matter for the FRC to judge the suitability of the role proposed for it by Walker review. However, the FRC should be very alert to distraction from its principal purpose.

- **What role, if any, it would be appropriate for the FRC to play in encouraging collective engagement.**

Other than the role proposed by the Walker review, the principal role of the FRC should be to provide a framework for governance disclosure that maximises the requirement for firms to consider their governance framework and report the logic and application of that framework and the structures, policies and settings they adopt to shareholders. Prescription of approach should be eschewed in favour of statements of principle.

Only by providing firms with the opportunity to differentiate themselves through innovating in their governance arrangements will the FRC support the emergence of self-reinforcing cycle of adaptation, analysis and response by investors. As stated in section 1, we believe current arrangements crowd out innovation by firms in their structures, policies and routines for governance, risk management and internal control.

- **Whether further guidance on best practice for companies, investors or proxy voting services would be helpful, either in the Combined Code or elsewhere, and whether the practices currently recommended in Sections D and E of the Code continue to represent best practice.**
- **What other steps might be taken, by the FRC or others, to encourage both companies and investors to be more proactive about regular engagement and with a longer term focus than the annual results presentations.**

Other firms will be better placed to opine on these matters than we are. However, we believe that Sir David's proposed changes to the system of governance will only be effective to the extent that analysts and research houses adopt a more active approach to analysis of governance performance and its impact on value. This, in

turn, will only occur if companies report substantively on their governance, risk management and internal control structures, policies and routines. They will only do so to the extent that they have a differentiable ‘story to tell’ – to the extent that they are required and able to explain their innovations in these areas and the logic for them.

Annex 1

Board : audience relationships

In our governance-related work with firms, we have developed an approach which acknowledges three dimensions of risk governance:

- **Structural** dimension – the committee structure; board organisation, policies and procedures; responsibilities; accountabilities and delegation/limit structures; and so on;
- **Analytical** dimension – the use of data and analysis of data to substantiate a proposal or proposition or to set or assess performance against a metric (interactive control) or to assess fitness for purpose and suitability of performance metrics or identify causal relationships (diagnostic control);
- **Behavioural** dimension – the impact on individuals' and groups' behaviour of the other dimensions, and behavioural expectations and boundaries of behaviour

These can be mapped against the **board : audience relationships** identified above; example elements are as follows:

see overleaf

Table 2
Dimensions of board relationships

AUDIENCE	DIMENSIONS		
Board to . . .	Structural	Analytical	Behavioural
society	transparency	allocation of uncorrected externalities	legality probity propriety sustainability
market	market for corporate control as performance discipline	setting risk / return parameters consistent with market valuation of risk	avoidance of anti-competitive practices communication with the market / analysts
investors	formal ‘corporate governance’ activities; voting, election of officers, etc.	setting risk / return parameters consistent with shareholder expectations for compensation for risk held	communication with investors ‘investor relations’
board	reserve powers oversight of delegated authorities review of limit breaches	expectations of risk analysis to support business cases economic performance analysis (EVA, etc) linkage of performance assessment to risk tolerances / preferences periodic review of limits stress testing the business model	agenda management board performance assessment managing gaps in knowledge between execs / NEDs tone / formality of meetings expectation and acceptance of challenge reaction to limit breaches
management	reserve powers consistency of delegation of authority with board model accountability processes	Establishing risk tolerances / preferences for board approval based on market / investor analysis extent of effort at preparing a firm-wide analysis of risk / capital position use of stress test information for decision-making	control of information flow to the board defensiveness of management team to challenge cohesiveness of management team in meetings deference of exec directors to CEO defensiveness of CEO to criticism of executives engagement with and feedback to executives influence of the secretary

AUDIENCE	DIMENSIONS		
Board to . . .	Structural	Analytical	Behavioural
subsidiary boards	alignment of subsidiary board accountabilities to organisational management structure (or reconciliation thereof) involvement of group-board or other NEDs in subsidiary boards	cascading risk / return parameters to subsidiary companies consistency of analytical approach on analysis of risk-adjusted performance	influence / autonomy of subsidiary boards relative to management
company		objective application of board-level risk / return parameters in analysis throughout the business	awareness of the board and its role visibility of board members in operating businesses communication of board-endorsed programmes for ethics, compliance . . .
assurance functions	formal charters for risk / audit / compliance with access to committee chairs reporting relationships / control over senior assurance officers (independence) reporting of outstanding audit points to board	on-going oversight of risk and capital position of the firm preparation of a periodic opinion on internal control review by audit committee (or equivalent) of internal control framework	ease of access for senior assurance officers extent of engagement with senior assurance officers on periodic risk / control reporting follow-up expectations on audit points outstanding