P H I Associates
CORPORATE STRATEGIC MANAGEMENT

103 Camberwell Grove
London SE5 8JH

'phone
+44 (0)20-7708-0052
fax
+44 (0)7005 802 479

pjh@phiassociates.com

www.phiassociates.com

Sir Christopher Hogg
Chairman
FRC
71-91 Aldwych
London
WC2B 4HN

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Dear Sir Christopher

The Combined Code

You have already seen, at last week's meeting of the Chairmans Club, the paper that Leslie Dighton and I wrote entitled Power to the Elbow of Non-executives Directors. In a nutshell this describes the situation as we see it. This letter is to suggest what the FRC could do to stiffen support of the Combined Code.

It is a pity that the Combined Code is championed by the FRC which is overwhelmingly concerned with financial reporting and the policing of corporate performance, and not enough with strategy, development and risk evaluation and tolerance, or with corporate behaviour and ethics. The very word 'governance' is being thought of as compliance, when it really means 'leadership', and the Code is not effective at delivering leadership behaviour. In parallel, Boards are better at numerical things rather than uncertainties and behaviours. Could you not form a department within the FRC which is clearly branded as something behavioural or at least less numerate?

The Code has not delivered good governance, in the sense that the recent major corporate failures 'complied' with the Code. Simply having the non-executive cadre in place at the Board does not empower them to perform. This is the problem – giving equivalent power to the non-executive. The recent Treasury Select Committee endorsed the view that non-executives need to know the details of the business better. This is, in my view, misguided – the executive at the Board should know all the business detail, their markets, their competitors, and be able to explain, promote and argue it. For the non-executive to be persuaded to compete on this same knowledge ground does not help. The non-executive need to deliver a different perspective – 'so what?' 'why is it relevant' 'how does this fit into the scheme of things?' 'look at it in a different way' and judge how well the executive are in command of their brief, and appreciate the risk profiles. The wisdom and scepticism that the non-executive ought to have from their individual backgrounds is not going to be improved by competing for business information with the executive.

Boards are necessarily private in their work, and their effectiveness judged on corporate outcomes. If the non-executive's primary task is to improve the decision-making of the executive, then it is impossible to judge whether the non-executives in the major banks were achieving this or not. It is easier to think that they were not achieving, either not good at critique, or not sufficiently involved in strategy conversation, or not powerful enough to influence tough-minded CEOs.

The key non-executive is the Chairman. His role is to lead the enterprise, project its character and standards, lead and manage the Board, supervise and monitor both performance and future development, partner the CEO. The behaviour of the Board – the way that power and influence is broad to bear – time and space for discussion and time for decision, is in the Chairman's hands.

I would recommend that Combined Code adherence needs additional feedback mechanisms aimed at bolstering the power of the non-executive and the Chairman:

1. Comply or explain – needs to be strengthened. For example, explaining why a CEO should take over Chairmanship should not be just to an audience of shareholders or institutions. Could not the FRC have such issues referred to them and hold open hearings on the subject?

2. Boards should be required to have performance monitoring and reporting by independent professionals (and as with Audit, published independent reporting) that would observe, take feedback from individual directors, evaluate and recommend any remedial action.

3. Non-executive directors should have a body (perhaps within the FRC) that formally debriefs those who resign their positions (and publishes the findings if necessary).

4. Chairman need to show that they are supported by independent means – either by active involvement in a peer group, being mentored, or other forms of professional development. Again could not the FRC hold individual Chairman to account for themselves?

Publishing the findings of these reports and briefings, or of recommendations made, would be market sensitive, and therefore a last resort. However, the FRC could compile and publish league tables that preserved the anonymity of the subject enterprise or individual, but with the subject knowing their own position. The threat that recommended remedial action not being taken could result in publication would be a powerful incentive to compliance.

These would have two effects: the public assurance of objective scrutiny and recommendation for improvement being given to our largest corporates, and the very threat of exposure concentrating the minds at the Board.

Finally, I do think it is very important for the country, and particularly for the financial services sector, that corporate governance and market ethics are of the highest international standards, and can be seen and judged to be so. It is important to continually emphasise the focus on principles and not prescriptive rules.

The Combined Code is necessarily aimed at the large Plcs, but the Code is used by the Public Sector, Private Equity, and smaller companies, and trickled down to all sorts of organisations. It is important to continually emphasise the focus on principles and not prescriptive rules, so that the Code is sensibly adapted wherever it is used.

I hope these comments are useful.

With best regards

Yours sincerely

P Haighton

Patrick Haighton

Power to the Elbow of NEDs

The Treasury Select Committee pinpoints NEDs for particular censure for the astonishing failures of major British banks. They want changes to the rules and governance systems to ensure more diversity of viewpoints, professional qualifications and dedicated secretarial support.

Would this help? Perhaps, although professional qualifications imply that more 'trained eye' is what is needed to engage with the executive on level ground. This may make for better management interaction but does not address the problem of direction. Quite the contrary, NEDs need to use their 'raw eye' on management information to get different perspectives on what is going on and the full extent of the risks they are supporting.

Real power to the elbow of NEDs will only come from a more basic reworking of the Board in three areas:

The first is to do with what the role of the Board is and what it is not. It is not the most senior executive body of the company and its agenda is not to rerun the detailed conversations the executive have already had about making money with their present business model better than competitors. NEDs cannot have an equivalence of arms at that level and even if they could one or other of the parties would be redundant. Their job is to see things from a different angle than the Executive to make sure that opportunity and especially risk is fully factored into the strategy so that any potential wounds to the body corporate are flesh wounds rather than mortal. Some damage is inevitable in volatile markets. The unique added value of NEDs is damage limitation, seeing things coming and encouraging sidestepping smartly enough. Some major bank boards obviously failed to do that. Having more professionally qualified NEDs on the boards of the banks that failed might just have improved the debate, but would not have altered the dynamics of power with the Executive.

That would require a deeper engagement in strategy than more detailed product understanding. The extent of the collapse of major financial institutions suggests there is a more fundamental flaw at the heart of governance systems. Since Cadbury, the role of the Chairman has been deliberately weakened to prevent abuse, and the role of the CEO has consequently gonflated. As long as the mantra runs that CEOs are responsible for strategy the non-executives are essentially powerless to determine acceptable levels of risk. The extreme powers they have to appoint and dismiss the incumbent CEO in times of crisis make no recognition that knowledge of the need to change course arises progressively from constant interaction and conversation about strategy in the context of its risk environment. To really help in that process, the NEDs need to be the equivalent of a glove around the hand of the Executive at all times, closely supporting their actions, but flexing to adapt with external volatility.

It is the Chairman's job to make sure that the right conditions of both respect and tension prevail in the boardroom and beyond, for debate to take place as a matter of course, not in gladiatorial combat when concern has become crisis. Inevitably there are external-facing responsibilities, but internally, the duty of 'managing the board' means ensuring there is continuing 'line of sight' to the heart of the business and its context, and encouragement of the independent 'voice' of NEDs, to bring their critical imagination into play without resort to acquiescence or resignation.

The Chairman is absolutely key to creating that culture. It will not happen automatically but has to be designed and guided, frequently uncomfortably. The simple truth is that NEDs, regardless of their individual quality, can't be better as a group than their Chairman allows. The clear lessons from the collapse of half the key banks in London is that Chairmen either did not understand that role or were insufficiently skilled to carry it out.

Skilling is the more likely culprit than experience or personal stature. Consider that 94% of men rank themselves in the top half according to athletic ability. It is unlikely that Chairmen are any different as self-evaluators. Although you do not get to be Chairman of a major company without lots of experience, there is nothing in the typical evolution that prepares fully for the multi-facetted nature of the job. Indeed much background as an ex-CEO, CFO or investment banker, can be positively unhelpful. The crucial skill required is to run a group of individuals with different appetites and powers, and make sure all of their voices get heard and valued. It is not trite to say that it is a complex and lonely job, and one that requires great personal courage and sensitivity, supported by the best possible all-weather friends to maintain the necessary independence. From a good governance point of view dedicated specialists such as Company Secretaries and consultants are important, but they do not have the unique vantage point or independence that Chairmen could draw from peer groups and personal mentors who have been there before, and are outside the formal structure.

So the Treasury Select Committee may be right to censure the NEDs and the argument for improved professionalism is always worthwhile in almost any circumstances, but it is not the solution to the problem. The real focus should be on the role and skills of the Chairman in the joint role as partner to the CEO and leader of the NEDs in both 'piloting' and 'policing' the business.

Leslie Dighton

Founder of The Chairmans Club – a London based forum for Board effectiveness