**Review of the Effectiveness of the Combined Code**
Submission from Odgers Berndtson

## The UK corporate governance regime

As a leading search firm advising the boards of UK listed companies of all sizes and operating in all sectors, our experience is that the Combined Code is widely respected.

Today's chairmen and chief executives understand that an effective, cohesive board adds value to their business, enhances the quality of strategic thinking and provides an essential element of oversight.

They recognise that board composition must be aligned to the business's objectives, and that quality non-executive directors who understand their role and are committed to sustained business success can make a vital contribution to long-term outperformance.

The Combined Code has played a significant part in helping to win the argument that good governance matters. We engage daily with the key people responsible for creating effective boards – chairmen, executive and non-executive directors, and company secretaries. The Combined Code is an essential reference tool in these conversations.

The combination of intelligent principles and practical provisions offers the right mix of flexibility and best practice guidance to be useful to all companies, regardless of size, sector or maturity. The principles-based approach, as opposed to a more prescriptive rules-based regime, is an essential part of what makes the Combined Code valuable, allowing companies to devise for themselves a governance structure and processes that are most relevant.

The last 18 months have seen catastrophic business failures, particularly in the financial services sector, but it would be a mistake to conclude that the UK governance regime has therefore failed beyond repair. Some boards did indeed fail, but so too did regulators, central government, advisers and even investors who were happy to back strategies that we can now see were reckless.

Our view is that the content of the code remains effective and relevant. Although some board practitioners expressed concern at the time of the Higgs review that the proposed changes would make boards more risk averse, we see little evidence that that has occurred. The 'comply or explain' regime continues to work well for the most part, and we see little cause for extensive new principles or provisions.

That said, the scale of the crisis in the financial sector and the severity of the current downturn mean that there can be no room for complacency. We have seen how a board's failure to direct and govern a company appropriately can destroy value. Directors and shareholders must be aware of the consequences of failing to get governance right.

Good governance can never be a one-size fits all, tick-box compliance exercise that somehow guarantees sound strategic thinking and effective oversight. Mere code compliance does not ensure good governance.

Governance and board effectiveness are about creating the right culture and environment that enables qualified, well-intentioned directors to put accountability and transparency at the heart of the board's structure and operations. The goal is a truly unitary board where the executive and non-executive elements together have a bond of trust and a common purpose.

It follows that improvements can be made in the way that the Code is applied. The governance regime enshrined in the Combined Code is admirable; it can be made to work better in practice. Our specific proposals are offered with this objective in mind.

**Specific recommendations**

***Support for the non-executive directors***:

The role of non-executive director remains acutely difficult to do well. Relative to their executive colleagues, independent directors spend relatively little time on the company's business, and to avoid potential conflicts of interest, they are frequently drawn from outside the industry of the company on whose board they sit. Finally, they depend for their information largely on their executive colleagues, whose performance they are collectively responsible for overseeing.

These disadvantages can make it hard for non-executive directors to pick up strategic or leadership issues sufficiently early to head off later problems, a disadvantage that can be exacerbated by 'groupthink' and the requirement to maintain a cohesive unitary board. In particular, it can be all but impossible for the non-executive members of the board to challenge the direction of the company when the chief executive can claim shareholder support for the strategy.

The best non-executive directors have a subtle mix of skills that allow them to assist, challenge, motivate and mentor the executive team. Most importantly, they need the courage to question assumptions and speak out when they perceive a problem.

But they also need the right support network to overcome the time, knowledge and information deficits that they face. There is a case for strengthening the secretarial function that supports the board, so that non-executive directors can gain broader industry knowledge or gather financial or other information that might inform their views. Good chairmanship and the support of a strong company secretary or senior independent director can supply much of the answer, but it may be time to seek a more formal approach with a properly staffed 'office of the board' providing an independent information or research resource.

Non-executive directors also need support in terms of induction, appropriate training and continuing professional development. Our experience is that directors are hungry for updates on relevant legal, financial or regulatory developments. A strengthened secretariat would be the right forum to organise and administer knowledge-building of this kind.

Such a secretariat would also take some weight off the shoulders of the company secretary, who is typically expected to provide the board with the support they need. Our experience is that companies are increasingly combining the role of company secretary with that of general counsel. This can streamline communication and improve risk management, but also provides its own complications – as company secretary, this individual reports to the chairman/board, but as general counsel they report to the chief executive. It is vital that the board can draw on a resource that is resistant to pressure from the executive team.

It may be argued that strengthening the board secretariat is an overly bureaucratic approach, but at the least, we would like to see more disclosure from companies on how the board is resourced and supported.

There is a role for long-term investors. Many companies are reluctant for their non-executives to hold separate meetings with investment institutions, and many investors do not have the time or resources to attend such meetings anyway. But the recent failures in UK banks have been as much a failure of ownership as of governance. Investing institutions must appreciate that judging the quality and effectiveness of the board is as much a part of fundamental analysis as a conventional assessment of the company's financial position.

***Role of the Senior Independent Director***

The most controversial of Sir Derek Higgs' recommendations in 2003 was that boards nominate a senior independent director (SID), a proposal that attracted considerable criticism for being unnecessary, divisive and duplicative.

In fact, the role has proved an important and welcome addition to the board and companies that have put effort into getting this role right have found that it greatly enhances board effectiveness. Rightly, the SID is not simply seen as the default title for the chairman in waiting or longest-serving non-executive director.

The current Combined Code states that the SID is principally there to act as an alternative conduit for shareholders who have concerns that cannot be resolved through contact with the chairman. In practice, the role has additional dimensions, which should be arguably be articulated in the Code more clearly.

For example, the SID should chair the nomination committee in the appointment of a new chairman, take the lead in appraising the performance of the chairman, and act as the focal point for non-executive directors in the event that they are dissatisfied with the chairman's performance.

SIDs should not see themselves as the chairmen-designate. When a clearly defined successor to the chairmanship is appointed to the board, it should be with the title of deputy or vice chairman. It may seem unnecessary and ambiguous for a board to have a chairman, deputy chairman and SID at the same time; this will usually be for a short period only until the chairman-designate takes the chair.

It would be wrong to suggest that the SID should never become chairman, but boards should recognise that it is a different yet vital role which supports and complements the chairman rather than understudies him or her. Our experience in board search tells us that many non-executive director candidates have identified the SID role as having its own specific function with its own rewards.

***Nomination committee***

Next to the audit and remuneration committees, the nomination committee must not be seen as the poor relation though it may meet infrequently and be discussed only briefly in the annual report. We recommend that nomination committees be active rather than passive, and plan succession including discussion of contingencies. Getting the right, best qualified people to serve on the board is at the heart of good governance. The structure and processes of the board should make this happen.

It is accepted best practice that the chairman should not lead the search process for his or her successor in order to facilitate new thinking and perspectives in the boardroom; we believe the same principle should apply as far as the selection of the SID is concerned.

***Risk management***
The recent corporate collapses in the financial services sector were caused at least partially by a failure of risk management. Compliance with the Turnbull guidance has been seen as a convenient box ticking exercise.

The informed assessment, management and taking of risk is an essential part of any company's business and entrepreneurially enhancing when done well. We recommend that companies above a certain size consider forming a dedicated risk committee which could be comprised of both executive and non-executive directors.

Many financial services companies, including ones that collapsed, had such a committee, so this is not by itself a complete solution to the need for improved risk management. To be effective, the risk committee should not duplicate the work of the audit committee, but be capable of taking a fresh look at the risks being undertaken by the company and challenging existing assumptions.

***Diversity***
UK boardrooms have long been criticised as being the last bastion of the 'old boys' club.' Indeed, the Higgs review of non-executive directors recommended a further enquiry into how the talent pool for director candidates could be widened. Dr Laura Tyson offered admirable recommendations in this area. Considerable progress on diversity has since been made, though undoubtedly more can be done.

The issue of diversity is explicitly not a question of tokenism or political correctness – the criterion for making a board appointment is whether the individual in question is the best person for the job. Board diversity means more than appointing more women or those from an ethnic minority – it means diversity of experience and understanding. Large companies today operate in global markets. They have hugely diverse customers and employees. Boards that fail to reflect such diversity are divorced from the business's fundamental drivers and are unlikely to succeed in the long term.

This is particularly true for executive appointments. From a talent-management perspective, multinational businesses need to demonstrate to their brightest staff in rapidly-growing markets like India and China that the very top jobs are open to them.

Boards that restrict themselves to appointing exclusively in their own image run a greater risk of adopting a 'groupthink' mentality. They are in danger of cutting themselves off from the talent, innovation and energy that will deliver tomorrow's business success in the increasingly competitive global marketplace.

**Conclusion**

From our experience working closely with boards, we feel the Combined Code continues to work well. There is no evidence to suggest that a more prescriptive governance regime would have headed off the financial crisis, and flexibility should remain a central principle of the Code. For flexibility to work, however, it is incumbent on companies to use the governance section of the annual report as an opportunity to communicate with shareholders about how the board is structured, appointed and supported to succeed – the ideal is that companies both comply *and* explain.

Odgers Berndtson Board Practice: Virginia Bottomley (Chair), Ian Odgers, Anna Ponton and Kester Scrope