


# Review of the Effectiveness of the Combined Code

**A Response to the Second Consultation**

October 2009

## Introduction

We welcome the opportunity to comment on the second phase of the FRC's review of the effectiveness of the Combined Code.

As we said in our first response, we believe the Code continues to work well and that attention should be focused less on adding to the content of the Code than helping companies implement it in a way that contributes to board effectiveness and company performance.

We support the FRC's guiding principle to rationalise disclosure requirements and encourage more informative disclosure. The objective should be to reduce prescription in favour of helping companies strengthen the day-to-day practice of good governance.

We believe that robust and rigorous board evaluations are the best means of achieving this objective. Evaluation can help to embed good governance, foster appropriate behaviours, and reduce the reliance on box-ticking and boilerplate. Detailed guidance on carrying out a thorough evaluation is conspicuous by its absence, however.

Our most substantive recommendation to this consultation, therefore, is that the FRC establish a standalone enquiry to review existing approaches to evaluation, gather evidence and offer detailed, non-binding best practice guidance. Our reasoning is explained in detail below, as well as our response to some of the specific questions posed by the FRC.

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### **The responsibilities of the chairman and non-executive directors**

We do not believe there is a pressing need to clarify further the role, key responsibilities and expected behaviours of the chairman, the senior independent director and/ or the non-executive directors.

There is a sizeable library of available literature on these points. The Higgs review remains an excellent summary of the roles and responsibilities of non-executive directors, and numerous sources of advice are available for those who are still unsure.

As far as chairmen are concerned, the best guide to carrying out the role will be their own experience serving under both good and poor chairmen, which is always likely to be a more practical form of education than written advice.

Of course authoritative, non-binding guidance can always be useful, but we do not see this as a priority for the FRC.

Equally, we believe it is difficult for the FRC to offer much detail on the time commitment expected of the chairman, senior independent director and / or non-executive directors, simply because the requirement tends to be company-specific.

The time required of a director will depend ultimately on the company and its circumstances, so that 15 days a year may be plenty of time for one position but wholly inadequate for another.

We would prefer a case-by-case approach that saw directors' time commitment as a standard topic for the annual board evaluation. This is the appropriate forum to gauge how much time individual directors are devoting to the role, and whether it is sufficient.

### **Board balance and composition**

We support the FRC's proposal to review section A.3 in its entirety, although we believe the formal statement of independence in this section is valuable. The definition of independence has prompted boards to think more widely about the kinds of candidates they might appoint and how diverse experiences and perspectives can add value to the board.

We also believe that the 'nine year rule' has helped to refresh boards, and is a useful safeguard against 'groupthink.'

We also note that we have had no experience of a client rejecting an otherwise preferred non-executive director candidate because the individual 'failed' the independence test.

We agree, however, that the principal focus for companies appointing non-executive directors should be their relevant skills and experience, and the value they bring to the board.

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If the best candidate happens to be non-independent according to Section A.3 of the Code, then companies should take the route of explaining and justifying the decision to shareholders rather than appointing a less qualified candidate.

Equally, it is up to investors to treat such explanations on their merits and not apply a tick-box approach.

Formal guidance on board composition ought to be unnecessary since best practice is well established. The right route is to review the balance of skills, competencies and experience on the board, match those against the company’s strategy and objectives, and identify any gaps. A considered job specification should be drawn up, and professional help sought in locating the person who best meets the brief. We believe this describes the approach of virtually every large company.

Properly executed succession planning is one of the most critical parts of the board’s role. It should be a continuous, long-term, dynamic process, and one that takes place well before any vacancy arises – one FTSE 100 chairman told us that it can take seven years to complete a seamless succession.

The process should involve broad scenario planning that touches on a wide range of potential strategic challenges and opportunities. This planning will in turn inform the profiles of possible future executives.

While we believe most companies have leadership development strategies in place and have succession planning as a regular item on the board’s agenda, authoritative guidance can only be helpful.

Finally, we believe that the question of whether the board is correctly composed or succession planned appropriately should be a topic for the annual evaluation. If these topics are gaining insufficient attention at board level, or if succession is not being thoughtfully considered, then such oversights should be revealed by a properly-conducted evaluation.

### **Frequency of director re-election**

We see little justification for the chairman, committee chairs or all directors to face annual re-election.

In our response to Walker, we expressed our concern over the proposal that chairmen of banks and other financial institutions should be subject to annual election, arguing that this created an unwelcome short-term focus. We believe the same is true for annual election of committee chairs or indeed all directors.

There is an established process for investors who are concerned about the performance of chairs or other non-executive directors. They can liaise with their fellow investors to see if their views are widely shared, approach the Senior Independent Director to communicate their views, and, if necessary, take their arguments to the non-executives as a whole.

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If this measured, proportionate approach fails, investors still have the option to vote against the report and accounts, or where relevant, the remuneration report.

Voting shares is a useful way for investors to ‘send a signal’ to companies that they have concerns, but using the shareholder vote as a tool to remove directors is likely to be highly public and disruptive, and should be the option of last resort.

### **Board information, development and support**

In our submission to the first round of consultation, we argued that non-executive directors in particular need better support and more formal professional development. We suggested that the company secretarial function be strengthened to support the board.

We further believe that an effective board evaluation will expose any shortcomings in terms of board information, new director induction, and ongoing professional development.

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### **Board evaluation**

Board evaluations provide a forum in which a broad range of questions relating to the quality of a company’s governance can be addressed. The quality of information flow, the chairman’s performance, the relationship between chairman and chief executive, succession planning, and whether non-executive directors are contributing as expected – all are topics which can be assessed and debated via a thorough evaluation, with the aim of improving practice.

While internal performance reviews have their value, an expert external evaluation can help challenge assumptions, root out problems and provide an opportunity for directors to speak their mind without fear of the consequences.

For that reason, we believe the Code should be amended to recommend that board evaluations should be externally facilitated every two or three years, at least for FTSE 350 companies. Evaluations should also be performed with outside support at times of considerable corporate upheaval, such as the completion of a large merger or change programme.

At present, however, companies are feeling their way on how best to conduct board evaluations. The Code covers the subject in a few paragraphs, while Sir Derek Higgs’ review of the effectiveness of non-executive directors provides less than three pages of guidance.

The result is that while some companies do undertake penetrating and value-adding reviews, there is little consensus about what constitutes good practice. Further guidance is required to enable all companies to follow the lead of the best.

**“It is important that disclosures relating to evaluations be made more informative.”**

We recommend that the FRC put in place a review akin to The Tyson Report on the Recruitment and Development of Non-Executive Directors to gather evidence, review existing company practices, and offer best practice guidelines on how board evaluations can best be carried out.

We believe this step will serve broadly to enhance the quality of board evaluations and ultimately drive improved implementation of the Code.

(Please note that, in making this recommendation, we are not ‘talking our own book’ – Odgers Berndtson does not currently offer board evaluations).

It is also important that disclosures relating to evaluations be made more informative. It would be naïve to think that companies will ever disclose glaring weaknesses or declare that they are ineffective but, equally, a bland statement that ‘our board is effective’ is of little use. As a minimum, boards should disclose how they conducted their evaluation, the name of any external facilitator used, and the conclusions reached about how board performance could be strengthened.

A good model is the BAE Systems’ annual report, which sets out the board’s objectives from the previous year and describes whether and how they were achieved. Objectives for the forthcoming year are also stated.

### **Risk management**

We do not believe that it should be a Code principle for non-financial companies to have a dedicated risk committee. For most companies, the existing Turnbull framework should offer an appropriate regime for determining risk appetite and the effectiveness of controls.

However, in light of recent market events, it is surely sensible that the Turnbull framework is reviewed.

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### **Remuneration**

We do not think it is appropriate for investors to have a more direct role in setting remuneration.

Top-level pay is rightly the remit of the board remuneration committee. If investors feel their interests are not being represented, they should use their voting and engagement powers accordingly.

## Engagement

The Walker review recommended that the Institutional Shareholders Committee guide on good ownership/stewardship should be adopted more formally by the FRC, and that large institutions be required on a comply or explain basis to disclose how they applied the Principles.

We support this approach in principle, and believe that the FRC could extend its remit to include a statement of Principles of Stewardship. In the same way that the FRC tests the content and application of the Combined Code on a biennial basis, we believe any reform in this area should include a commitment regularly to test whether the Principles are being applied and with what results.

## Contact

- Board Practice – Virginia Bottomley (Chair), Kit Bingham
- 11 Hanover Square, London W1S 1JJ; Tel 020 7529 1111