



Financial Reporting Council

Comply or Explain

20th Anniversary of the UK Corporate Governance Code



London
Stock Exchange



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Foreword



The Corporate Governance Code, with which UK listed companies “comply or explain”, has come a long way in 20 years. It’s a good moment to take stock; and this collection of short essays does exactly that.

It brings together the views of a wide range of people – directors, investors, academics, lawyers and the media – from different markets. From their diverse perspectives, some common themes emerge.

One is that the pioneering work of Sir Adrian Cadbury has resonated around the world. Codes have been introduced in countries as different as Switzerland and Bangladesh. Even in the US, where the company law framework makes “comply or explain” codes more of a challenge, there is starting to be discussion about how one could be made to work.

In continental Europe, meanwhile, there remains some uncertainty about the right balance between a code-based best practice approach and formal regulation. But even here, a theme emerges of general recognition that the UK approach has brought benefits. This is not to say “job done”. Many contributors still see the Code as a work in progress, with much more left to achieve.

Our own assessment is that, for all these reservations, the Code has made a big difference to our corporate culture, and continues to do so. Companies, on the whole, want to comply with agreed best practice, even when their initial instinct may be against change. Take, for example, the widespread take-up of the provision calling for annual election of directors, which we introduced a couple of years ago.

When we look back, we can see how the Code has been instrumental in effecting change. In 1992 it was still common for companies to combine the role of Chairman and Chief Executive. That is now highly unusual. Often the Code has moved practice faster than law could ever have done. For example, the UK introduced audit committees long before the European Union got

round to its statutory directive. Moreover, the UK committees operated to a higher standard of independence than the European law was able to require.

In some areas the Code has driven innovation – for example, in the development of board evaluation. This is not an area where regulators can wave a magic wand, and create expertise out of nothing. The Code is flexible, and can use aspirational language to drive change, as our new encouragement to diversity in the boardroom shows.

Codes cannot replace all regulation. But they can reduce the need for it, especially where the objective is cultural and behavioural change over time. So we are glad that, after debating the issue for a couple of years, the European Union seems set to reaffirm its acknowledgement of the role played by codes. But this debate has put the onus on us to demonstrate real action rather than box-ticking. This is why we have been focused on improving the quality of explanations and why the FRC, through its annual report on developments in corporate governance, is monitoring more closely what is actually being achieved.

The prize is a healthy capital market, in which companies are responsive to the needs of the shareholders who provide their capital and hold it for the longer term. This not only makes them better companies, but also better placed to raise new capital when they need it. The purpose of good governance is to manage risk and channel entrepreneurship, equipping companies to survive and grow.

So much is owed to Sir Adrian for launching us on this road. This small volume, which we are happy to have produced in collaboration with the London Stock Exchange, merely illustrates how much serious thought still goes into developing what he started. With the exception of Ira Millstein's piece, which takes pride of place as a personal tribute, they are presented by author surname in alphabetical order. I hope you find them as enjoyable as I did.

Baroness Sarah Hogg

Chairman, Financial Reporting Council

Introduction



Good governance is as much about relationships, trust and transparency as it is about codes and regulations. This is embodied in the flexible nature of the UK's strong governance framework, celebrated in this collection of articles to mark 20 years of the UK Corporate Governance Code.

At London Stock Exchange Group, we firmly believe that high standards of corporate governance make an important contribution to companies' long-term performance, a theme echoed by many contributors to this publication. By regularly reviewing and developing appropriate corporate governance practices, both UK and international companies on our markets can ensure they are better placed to execute their strategy, manage their growth and drive value, whatever the prevailing macro-economic conditions.

The UK's principles-based approach to corporate governance, and the option for companies to "comply or explain", continues to deliver strong and effective governance and ensures the UK regime is valued and respected, by both companies and investors. Companies benefit from visible, strong corporate governance practices by attracting more investors, and so reducing the cost of capital for all. This strength and flexibility makes the UK a beacon of transparent investment opportunities.

With an ever-increasing range of global investment options, and an uncertain economic environment, companies need to focus on building long term relationships with investors founded on trust and regular communications. In doing so, companies will maximise the full benefits of being publicly listed and there is a well-trodden path of international, as well as domestic, companies who have chosen to list on our markets and adhere to the UK's very highest standards. For example, BHP Billiton, SAB Miller, Xstrata, Anglo American and Old Mutual have all restructured to access London Stock Exchange's Main Market. These companies have

come to our markets, not only to access the deepest pool of international equity capital in the world, but also because of the quality and transparency of UK governance systems. The design of London Stock Exchange's markets reflects the City's international character and the broad range of companies and investors who make London their home. We offer a choice of markets and market segments. If a company is domestic or international, small or large, new or established, focused on retail or professional investors, or both - there are a variety of markets, across asset class, and corporate governance structures to suit.

This tiered offering is a key part of our success, and the success of the companies we serve. A primary listing on the Main Market means that companies have met the UK's highest standards, above and beyond those set out in European directives. This core regulatory framework for those Main Market companies with a Premium Listing is set out in the UKLA's Listing Rules and the UK Corporate Governance Code. AIM, our market for growth companies is operated and regulated by London Stock Exchange rather than by the FSA. The AIM rules are tailored to the needs of early stage companies whilst maintaining an absolute commitment to effective disclosure standards. Companies on AIM are supported on market by their Nominated Advisers, who lend their expertise and reputation to the company and assist companies with the application of corporate governance guidance.

Part of the strength of the UK's corporate governance regime is in its constant evolution, which is a sign of its maturity, robustness and adaptability. The dynamic nature of global markets make this is especially important in a post financial crisis world where the expectations of corporate behaviour are under scrutiny. So this new collection of insightful articles demonstrates a healthy market of ideas and points of view that signal a welcome debate on the future of the Code.

Dr Chris Gibson-Smith

Chairman, London Stock Exchange Group

Sir Adrian Cadbury



Adam Smith in his *Theory of Moral Sentiments* (1759), preceding his *Wealth of Nations*; described members of his subsequent “market” to be, hopefully thus:

“Man... ought to regard himself... as a citizen of the world, a member of the vast common wealth of nature... [viewing] ourselves... in the light in which any other citizen of the world would view us”

“turbulent... passions are restrained... by prudential considerations of the bad consequences which might follow from their indulgence.”¹

Sir George Adrian Hayhurst Cadbury’s ethics are, in my opinion, a direct line from Smith’s *Moral Sentiments*, set in a far more complex world economy. His accomplishments, still ongoing, mark no indulgence of passionate ideologies; rather a concern for other cultures, other choices, and the need for flexibility, yet based on fundamental prudence and justice. His firm belief is no one prescription is “right” for all times and all places.

I first witnessed this in the Cadbury Report². There, for the first time to my knowledge, the need for flexibility and experimentation in corporate governance appeared in the policy of “comply or explain”. This policy has had a profound impact on worldwide corporate governance; Sir Adrian abjuring ideologically fixed rules, and favoring concerns for other choices and other cultures, within general guidelines. No question, it became a principle, a watershed in thinking, which has endured in academia, regulation, and practice.

¹ *Theory of Moral Sentiments*. Adam Smith. 1759. Library Fund Edition, 1984. pp 2, 3, and 7.

² Report of the Committee on the Financial Aspects on Corporate Governance (aka Cadbury Report). 1 December, 1992.

We worked together in issuing *A Report to the OECD* by the Business Sector Advisory Group on Corporate Governance. The Report articulated the simple “reason” for good corporate governance: “...Access to capital through improved corporate governance”³.

Rather obvious now, but then, a light bulb to societies worldwide.

An appealing concept to citizens of the world and another of Sir Adrian’s sentiments – simplicity and enduring truths. Equally important, that Report dismisses passionate ideologies, and opts for “...adaptability of corporate governance arrangements to shape a corporate governance environment compatible with societal values... not necessarily fit for all companies at all times ... operating in a rapidly changing world.”⁴

Clearly Sir Adrian’s views infused the Report.

Then came the *OECD Principles of Corporate Governance* emanating from the *Report to the OECD*. Again Sir Adrian’s thoughts infused the result.

As a participant with Sir Adrian in the development of the *Principles*, I remember well the constant need to calm passionate ideologies in order to reach consensus. These international benchmark principles, in the words of the *Principles*:

“build on....common elements and are formulated to embrace different models [they] are non-binding and do not aim at detailed prescriptions...they seek to identify objectives and suggest means for achieving them... a reference point...frameworks for corporate governance that reflect [each cultures] own economic, social, legal and cultural circumstances.”⁵

³ Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets: A Report to the OECD by the Business Sector Advisory Group on Corporate Governance. March 27, 1998. p 13-15.

⁴ Ibid. p 33.

⁵ OECD Principles of Corporate Governance. May 1999. p 13.

The line from Adam Smith's *Moral Sentiments* to works which Sir Adrian infused seems direct: prudence, abjuring absolutes and turbulent passions, adopting flexibility to suit citizens of the world who must live together in that world.

Ira M. Millstein

Senior Partner, Weil, Gotshal and Manges LLP

Comply or just explain?



If the gambling reverend Charles Caleb Colton was right when he asserted that “imitation is the sincerest form of flattery” then the Cadbury Code and the “comply or explain” concept have received many compliments. Since its first publication in 1992, the Cadbury Code has been copied, transposed or adapted in every Member State of the European Union and in more than 60 other countries elsewhere in the World – with the notable exception of the United States. The European Corporate Governance

Institute’s database of corporate governance codes, generally accepted as the most comprehensive and up-to-date record, currently contains over 350 codes, code revisions or code-like documents (www.ecgi.org/codes). At a peak in 2002, over 30 such documents were published in a single year.

The “comply or explain” concept has been hailed as a pragmatic tool that can improve corporate governance without the need for inflexible, burdensome and misguided rules, laws or regulation. An initiative that started as a response to some, with hindsight, minor UK scandals has become a global phenomenon. Against his own wishes, the Cadbury Committee’s chairman has acquired global corporate governance iconic status.

What explains the universal appeal of the Cadbury Code? Its substantive recommendations were an unlikely candidate. They were conceived as a supplement to UK company law and listing requirements in the institutional investor-dominated setting of the London market in the early 1990’s. The Code deliberately focused on the working of one-tier boards and on the role of auditors in the United Kingdom. It came as a surprise that some of the Code’s suggestions found an immediate following on the Continent, in particular the pronouncement that “the majority of non-executives on a board should be independent of the company”.

The idea of populating boards and board committees with independent directors clashed with continental realities, laws and culture. Family block-holders were reluctant to have the guardians of the family's interest replaced by directors who were supposed to exercise independent judgment. In the largest German corporations, employees appoint half of the supervisory board members. There was great reluctance to “dilute” the shareholder side with potentially disloyal individuals.

Resistance was futile. Country after country and code after code adopted a variant of the independent director concept. In 1999 the OECD elevated the ability of a board “to exercise objective judgment on corporate affairs, in particular, from management” to an internationally applicable Corporate Governance Principle.¹ More countries adopted codes and their issuers too were invited to appoint independent directors or to explain. Many of them did, without an explanation. Even among the reluctant, peer pressure and the threat of regulation resulted in high levels of compliance.

Nonetheless, the widespread acceptance of this Cadbury Code provision did not mean that Europe embraced UK corporate governance standards altogether. Interested parties all over the Continent developed their own corporate governance codes or recommendations while the UK regularly revised its own. The “comply or explain” principle facilitated the adoption of the OECD Principles through these codes, but within limits. The UK code, for example, did not adopt the OECD recommendations on employee involvement. It is likely that most UK issuers would have explained why they did not wish to comply. Having to explain non-compliance does cause embarrassment.

The Dutch (“Tabaksblad”) Code of 2003 and the South African (“King III”) Code of 2009 sought to emancipate “explain” by replacing “comply” with “apply”. It was felt that “apply or explain” would allow issuers to deviate from a code's benchmark without shame. The new phrase implied less emphasis on best practice and more emphasis on pure disclosure. Its effectiveness is debatable.

¹ To include independence from large shareholders the 2004 revision dropped the reference “in particular, from management”.

European market developments complicated matters further. National code makers have been confronted with increasing heterogeneity between issuers. The latest version of the German code covers the Aktiengesellschaft with its mandatory two-tier board, but also the growing number of German SE's (Societas Europaea) that can have a one-tier structure. More companies have become widely held on the Continent, while block-holders have started to make an appearance in the UK. Issuers with cross-listings could become subject to several codes. More problematically, companies incorporated in country A but listed in country B had to choose between a code issued in B that does not fit the corporate law of A or a code issued in A that does not fit the listing requirements of B.

To solve these cross-jurisdiction problems, the European Commission amended the Fourth Company Law Directive on annual accounts (Council Directive 78/660/EEC as amended by Directive 2006/46/EC). The Directive formally adopts the “comply or explain” principle as “apply or depart and explain” at the European level. Issuers admitted to trading on a regulated market in the European Union must include a “corporate governance statement” in their annual report, or in a separate report that is incorporated by reference (Article 46a). The corporate governance statement must include reference to “the corporate governance code to which the company is subject” and/or “the corporate governance code which the company may have voluntarily decided to apply” and/or “all relevant information about the corporate governance practices applied beyond the requirements under national law.” Departures from the provisions of a code must be explained. If a company decides not to apply any provisions, it must give a reason. The UK has implemented the Directive in DTR 7.2 of the FSA Handbook. Flattery has come full circle!

The European Union has solved the legal problem of codes incompatibility but in the process, it created a disclosure monster. Investors today are confronted with a multitude of codes and corporate governance statements that can be difficult to read. The statement of a major issuer with corporate governance that differs from the norm can run to over a hundred pages.

It is filled with somewhat tedious explanations of deviations from one or more of many possible benchmarks. The statement of a company that fully complies can be one sentence, as can be the statement of a company that does not comply at all.

The experience of the last twenty years has shown the quasi-impossibility of formulating a meaningful “best practice” standard across different issuers and markets. At the national level, embarrassing companies into conformity with a code has threatened corporate governance diversity. At the same time, Europe has given itself a defective non-financial disclosure standard. Paradoxically, flexibility and best practice across Europe might be better served with a comparable corporate governance statement that does away with “comply” but insists on “explain”.

A natural way of setting this disclosure standard would be to imitate the US Securities and Exchange Commission and to provide detailed instructions for explanations that must be furnished accurately, completely and in a timely fashion. The better way for Europe might be the British way of setting out the principles of the disclosure. Perhaps the FRC should take the lead on “do not comply but just explain”. Then the UK might, once again, bask in the sincerest form of flattery.

Marco Becht

Goldschmidt Professor of Corporate Governance, Solvay Brussels School of Economics and Management, Université libre de Bruxelles (ULB); Executive Director and Fellow, European Corporate Governance Institute (ECGI).

Adherence to the spirit



In response to every corporate catastrophe codes, rules and regulations have been developed and expanded in order to ensure the same error is never repeated.

The catastrophes may vary in nature but the causes have common roots: excessive concentration of power, lack of transparency in reporting, and insufficient interest by owners, until it is too late.

To address these issues, Sir Adrian Cadbury led the committee that developed a core set of principles – modified and amplified by others over the years – that has stood the test of time as the UK Corporate Governance Code.

In the UK we have been wise to adopt the principle of code not law and “comply or explain” – a far cry from the American and European focus on legislation, which has often brought bureaucracy and cost rather than resolution.

In its favour, the Code provides an antidote to the risk of corporate failure by accident or arrogance – it will never beat criminal intent but continues to guide the inexperienced, focus the ambivalent and control the adventurous. Most importantly, it encourages adherence to the spirit of the rules rather than simple obedience to the letter of the law.

Its weakness is the lack of prescriptive definitions against which the rule may be implemented and enforced.

Compliance and explanation are only effective tools if judgement and challenge are carefully applied by those in the position of ownership.

To complete the process therefore, shareholder engagement is essential where stewardship becomes a mindset – not an afterthought.

One shareholder spring doesn't mean that all owners are engaged. Hedge funds and short term traders have little interest in governance – their 'raison d'être' is performance.

Whatever the good intentions, short term performance continues to be the priority for many and long term partnership perspectives for the enlightened few.

It is up to business leaders therefore, working in partnership with owners, to convert the few to the many and to ensure that doing the right thing in business is viewed as the right thing to do.

The UK Corporate Governance Code provides the route map. The depth of compliance and quality of explanation are the milestones of effectiveness.

At the end of the day however, companies and shareholders must remember that rules and regulations will not work without the right corporate culture. This is about values.

It requires management to know instinctively the difference between right and wrong, and having the courage to follow it through.

It needs organisations that set a standard at the top – not by what is said, but by what is done. It means ensuring that acceptable behaviour is understood to be not what you do in public – but how you act in private. It requires pressure testing the actions and deals done behind closed corporate doors against a benchmark of potential front page tabloid visibility.

It is not rules and regulations alone that make good business. It is good people – operational, advisory, executive and non executive.

A diverse board of gender, nationality, skill set and mind set. A board comprising members with integrity, enthusiasm, experience and courage – and independence of mind – up to speed on the rules and willing to stand up for their enforcement. It takes skill, knowledge but, most of all, it takes character.

Performance and governance must go hand in hand. The Code based on “comply and explain” is a valuable handbook.

In business however, we should never forget: rules provide the framework – people make the difference.

Sir Roger Carr

Chairman, Centrica plc, and President, Confederation of British Industry

Comply or explain



BlackRock is a fiduciary investor, which means that all of the money we invest belongs to others. As such, we have a keen sense of responsibility to our clients to protect and enhance the value of the assets they entrust to us. Our corporate governance programme is an integral part of this, not least because we invest in 12,000 companies globally and a significant portion of our equity investments are made on an index-tracking basis. This means that many of our clients are locked-in, long-term

investors in public companies. It also means we have the incentive to engage actively with companies on their behalf given the outcomes of the process can take a significant amount of time to materialize.

The flexibility offered by “comply or explain” is attractive to us because corporate governance is not a science – it is a reflection of human behavior and, in practice, is rather nuanced. Our 20-person corporate governance team has extensive experience in engaging with a diverse range of companies, from those in mature markets such as the US or UK to those in emergent ones such as China and Mexico. One thing they all have in common is that they believe their circumstances to be unique and to warrant shareholder support. As an international investor, we’ve found it helps to accommodate a “comply or explain” philosophy, whether derived from the regulatory framework or as a market-led initiative. Equally, it helps us as shareholders understand the merits of an explanation when companies go beyond reporting non-compliance with governance codes and provide context and situation-specific justifications rather than assuming we are familiar enough with the company to determine those for ourselves.

Our starting point is to be supportive of management, which arguably is an implicit premise of “comply or explain”. Companies adopting non-compliant but well explained approaches to corporate governance, which we assess to be consistent with shareholder interests, will normally get our support. When we aren’t convinced by an explanation, we communicate our concerns in private only. If we believe change is necessary we tend to support

companies while they bring it about – something we are sometimes required to explain to observers who believe we have not complied with our own, published policies on corporate governance, engagement and proxy voting. The key point is that we don't believe reflexively voting against management, selling shares of companies with whose management we disagree or publicly expressing our differences represent the best way of protecting our clients' interests. And, of course, with index-tracking strategies, selling shares for this reason isn't an option.

In 2012 BlackRock took its own steps to promote “comply or explain”. Our CEO Larry Fink wrote a letter to 600 of the companies in which we have the largest holdings to encourage them to engage directly with our Corporate Governance team in advance of their annual general meeting. Generally, we were concerned that companies were not explaining ambiguous or non-routine matters thoroughly and some were forced into reactive changes at the eleventh hour when it became apparent that a significant number of shareholders were planning to vote against a related resolution. Although the letter focused on the AGM it has broader implications. Boards and management that anticipate shareholder concern and engage in advance have more opportunity to reflect on shareholder feedback and make any changes that seem warranted, either in approach or in the explanation given. Companies have responded positively, and even those who were aware of the letter only indirectly have initiated engagements, which have increased markedly year-on-year.

BlackRock will support unconventional approaches to corporate governance in the short to medium term when market conditions and company-specific circumstances indicate that would be more effective. In essence, our assessment of corporate governance is based on the quality of leadership demonstrated by the board and the quality of management demonstrated by the executives. This can clearly be achieved in numerous ways and we recognise that company insiders ought to have a better sense than outsiders as to what is appropriate. However, we advocate following market best practice standards in the longer term because they are a distillation of practices that have proven to be successful in protecting shareholder

interests. The explanation provided for taking an alternative approach to accepted best practice is critical – companies should not presume that we will be supportive. There is an outmoded view that index-tracking investors are passive. The reality is that our locked-in investment style in some portfolios means we can take a long-term view, being patient where appropriate and persisting to achieve change where governance and performance issues coincide.

Explanations given for a particular corporate governance stance provide a window on the extent to which boards and management are attuned to their shareholders' viewpoints. Engagement helps uncover and explain any mismatches.

Shareholders can help companies anticipate mismatches by disclosing publicly their thinking on corporate governance, engagement and long-term investing. In markets like the UK, the Netherlands and South Africa the requirements of investors in this regard are spelled out in stewardship or responsible ownership codes within the regulatory or 'best practices' framework. Even where this is not the case, shareholders with expectations of companies in terms of "comply or explain" can voluntarily set out the code of conduct they apply to themselves independently and report against it in order to help companies to understand the investor perspective.

We recognize that "comply or explain" has its limitations – poor explanations, differences of opinion between management and shareholders, different views as to the right approach amongst shareholders, lack of resources for engagement, and limits on the scope of some shareholders to be pragmatic. Nonetheless, "comply or explain" offers more flexibility than the alternative. Companies have the opportunity to set out their case and, whether agreement is reached or not, engagement helps build mutual understanding. Communication about the future involves indicating plans to adapt and improve, which for shareholders - the institutions and the private savers amongst our clients - provides reassurance that companies are being run for the long-term and in the interests of the shareholders.

Michelle Edkins

Managing Director, Corporate Governance and Responsible Investment, BlackRock Inc.

Grudging acquiescence



Christopher Fildes, undoubtedly one of the finest observers of the Square Mile ever to work in financial journalism, used to observe fondly that the City often did things which were so good that no other country in the world would copy them. His gently made point was that such practices, born for the most part when finance was still a gentleman's club, lost out when they were confronted by the realities of the modern Americanised world and its ever more brutal business practices.

Is “comply or explain” heading the same way, and should we care very much if it is? The City thrives on the Wimbledon effect, by providing a playground for the best talents in the world to strut their stuff. Is it therefore realistic for the rules to be developed according to a very British set of cultural norms, or is the modern world right to expect more certainty... “comply or else” rather than “comply or explain”?

There are reasons to resist its passing. The United Kingdom has a world lead in corporate governance – a lead which is being celebrated this autumn with the 20th anniversary of the publication of the Cadbury report which was the first and arguably the most far sighted of the codes on which today's guidance is founded. We have come a long way in the intervening time and “comply or explain” was very much part of why the path was so smooth – even if it did not always feel so at the time.

The point was that “comply or explain” helped prevent people digging in around differences of opinion and bringing the whole process to a halt. “Comply or explain” was a bolt hole which meant that opponents did not have to be overwhelmed or vanquished in the name of progress; refuseniks could be bypassed, quarantined and left with their old ways of doing things. If they really did not like a proposal they did not have to follow it provided they were willing to explain why.

Or at least that was the pretence. The reality however was that it was difficult to hold out for long. Whatever the great and the good may have said in public the emphasis in the media and the markets was on “comply.” Non-compliance, even when explained, was tolerated initially as a curiosity but it was seldom accepted for long.

An organisation which did not follow the letter of the Code, and persisted in not doing so for more than two or three reporting periods, found markets ran out of patience. Boards risked creating a governance discount with a permanently lower share price which in turn damaged their long term job prospects. Relatively few companies were prepared to run the risk of non compliance for long. “Comply or explain” was usually a brief prelude to “saving face with grudging acquiescence.”

Grudging acquiescence is rather different from winning hearts and minds and it probably matters if it means that the culture of good governance is not as deep rooted as it would have been had all the arguments been fully thrashed out along the way. Progress might have been slower, but it might also have put down deeper roots – in that huge murky area below the FTSE 250 and private equity. “Comply or explain” helped avoid damaging confrontation but perhaps worked against changes in board behaviour and culture becoming as widely accepted as they need to be.

There is a more obvious weakness of what in essence is a very reasonable doctrine. When the decision is taken not to comply, the explanation should be as full as possible. The board ought properly to engage with the issue.

Sometimes that happens, but not often. Indeed a recurring disappointment is the thinness of the explanations. One can almost see behind them chief executives who are not accustomed to explain their actions. Or perhaps British boardrooms just do not like confrontation.

If it is misunderstood at home it certainly is abroad. The view from most of Europe, is that “comply or explain” was the hand maiden of “light touch” regulation. The perception is that light touch regulation allowed the financial

system to run out of control and ultimately to blow itself and everyone else up so it is now discredited in favour of a new world of clear rules, robustly enforced and with no exceptions. In such a world there is little room for “comply or explain”. It is seen as a loophole through which too many might be tempted to slip.

Clearly the British remain wedded to the concept. They like high level principles; they are by nature sceptical about the effectiveness of detailed rules particularly in a world where innovation is rife and rule makers struggle to keep up. There is a belief that flexibility in regulation delivers better outcomes. “Comply or explain” helps create that flexibility.

But if there were ever a time when politicians and public could be persuaded of this that time is not now. The public desire is for revenge - a desire kept alive by the inability of the leaders of the banking world to do contrition with any credibility or sense of self blame. The politicians are not going to confront the public on this issue. Tough unambiguous rules are part of the belief system that this must never happen again.

It won't work of course – it never has in the past and it won't happen in the future because greed and fear, manias and panics will always defy rigid rule making. But these things go in cycles. After the next financial panic – a decade or so hence - some may decide that over prescriptive rule making does not deliver the goods and a more flexible system is to be preferred. Then “comply or explain” will make a comeback. But that time is not yet.

Anthony Hilton

Columnist, London Evening Standard

Flexible and responsive



The Cadbury Committee was formed in 1991 to look at various issues relating to financial reporting and accountability and to make recommendations on good practice. It focused on directors' responsibilities for reviewing and reporting on performance to shareholders, the case for audit committees, auditors' responsibilities and the links between shareholders, boards and auditors – all topics

that are still keenly debated today. There were already statutory and common law responsibilities that applied to directors, both as to their general duties and their particular responsibilities for preparing reports and accounts. There were also statutory rights for shareholders to call shareholder meetings and remove directors. However, there was concern about standards of financial reporting and accountability, heightened by various corporate scandals including BCCI and Maxwell, and there was controversy over directors' pay. The Cadbury Report in 1992 emphasised the importance of boards being free to drive their companies forward but also being accountable. It therefore proposed a voluntary Code, reflecting then existing best practice, which was designed to achieve high standards of corporate behaviour. The London Stock Exchange required all UK incorporated listed companies to state whether they were complying with the Code and to give reasons for any non-compliance.

One of the benefits of this approach, which the Cadbury Report identified at the outset, was its flexibility. It allows the standards set by the Code to be set at a high level even though some companies may not be able or willing to meet those standards. Experience over the years has shown that changes to the Code have often been resisted when they are first introduced – the separation of the roles of chairman and chief executive, the annual re-election of all directors – but that, over time, most companies apply the standards advocated. If the Cadbury Committee had proposed a statutory code with penalties applying for a failure to comply, the pressure for the Code to set lower standards which most companies could meet immediately upon implementation would have been much greater.

Another aspect of flexibility has been the speed with which the Code has been able to take account of particular concerns or situations and the way in which it has been able to raise standards. The Code has been reviewed at fairly regular intervals – the Hampel Report in 1998 looked at both the Cadbury and Greenbury Reports and the Financial Reporting Council has conducted regular reviews since assuming responsibility for the Combined Code (now the UK Corporate Governance Code). This would not have been possible if a statutory approach had been adopted. Finding legislative time to amend statutory provisions can be very difficult and there is a greater risk that political considerations will have an undue influence, particularly where a proposed change arises from a high profile topic or incident. The voluntary nature of the Code, which is possible because of the “comply or explain” approach, means the Code can be reviewed when companies or shareholders feel it is appropriate.

The attractions of the “comply or explain” approach – its flexibility, responsiveness and encouragement of high standards – have led to it being widely adopted in Europe and elsewhere and so it has contributed to higher governance standards in many jurisdictions. When the European Commission commissioned a study of corporate governance codes in 2002 “comply or explain” was already used in Brazil, China, Indonesia, Korea, Malaysia and Mexico, as well as many Member States. The EU High Level Group of Company Law Experts recommended the “comply or explain” approach as a more flexible alternative to legislation in their report on corporate governance in 2002, suggesting a European requirement for companies to identify the code by reference to which they complied or explained in an annual corporate governance statement. This led to a change in the directives dealing with accounting requirements for listed companies, requiring them to explain any parts of the relevant corporate governance code they do not follow and the reasons why.

Further support came from the European Corporate Governance Forum in 2006 when it published a statement strongly supporting the approach as being best suited to take account of companies’ particular situations and of the different national legal and governance frameworks.

All proponents of the “comply or explain” approach have recognised that there are limits to what it can achieve. To work well, it depends on the explanations given by companies being sufficiently clear for shareholders to make a judgement on the company’s approach and on a sufficient number of shareholders engaging with the company. Sometimes companies have complained that shareholders have taken a box-ticking approach to the Code and have not paid sufficient attention to explanations when given. These topics of explanations and shareholder engagement have been the focus of considerable attention in recent years amidst concerns in the UK and EU that explanations are not always of sufficient quality and that not enough shareholders engage. It is important not to lose sight of the benefits of the “comply or explain” approach. Most respondents to the EU consultation on corporate governance in 2011 thought it was still an appropriate approach and opposed a role for monitoring bodies, whilst agreeing that better quality explanations are needed. The Financial Reporting Council’s report earlier this year on what is an explanation also indicated that most FTSE 350 companies either comply fully with the UK Code or explain with a meaningful level of detail if they do not.

The risk is that some failures may undermine support for the “comply or explain” approach. However, no approach – including legislation – can ensure that all companies will conform to particular requirements or that the requirements will ensure that there are no failures. The question is – or should be – whether the “comply or explain” approach provides a better way than other methods to encourage more companies to adopt higher standards in a way that adapts quickly to a changing business environment and encourages companies to engage with shareholders on how best to run the business for the benefit of investors. I think the answer is that it does.

Vanessa Knapp OBE

Principal Consultant, Freshfields Bruckhaus Deringer LLP

Explaining without stigma



The order in which companies have been asked to consider their corporate governance policies has, I believe, driven too much of board activity in the last 20 years. By demanding that companies should “comply” and if not, “explain” why they have chosen a different route from previously set out principles, companies have spent many man hours (possibly weeks, months and even years) in considering whether what they really wanted to do was sufficiently “robust” enough to not only warrant a departure from the norm, but warrant being seen to depart from the norm.

“Comply or explain” purports to give companies a choice – in reality it is Hobson’s Choice since the stigma attaching to the latter route pushes companies, almost rigidly, into the first option. It has been interpreted as “obey the law or break it and make a plea for clemency”. It is not a balanced choice. This is not simply a matter of words or word order. The consequences for corporate governance and board efficiency have been detrimental. A better approach would be simply “explain” – explain how your approach meets corporate governance objectives, including the extent to which you have adopted or not adopted the guidelines.

The creation of the Cadbury Code 20 years ago was years ahead of the US Sarbanes-Oxley Act and the subsequent refining, improvement and development of this has meant that the UK has suffered none of the major governance scandals that we have seen elsewhere – Enron and Worldcom to name but two. That is to be rightly applauded – it meant that companies, investors, governments could see that the UK was serious about being a place to invest. Perhaps we were “lucky” that we had BCCI, Polly Peck and Robert Maxwell so early on to show us the need for something in this area.

The subsequent attempts to build upon Cadbury should also be applauded – we didn’t get it fully right first time, but let’s not pretend we did and be blind to the possibility that there are ways of getting better. And we always

had the flexibility to diverge from the rules if they didn't fit our circumstances didn't we?

Well, without question the most common complaint from non-executive directors about their 'jobs' is that they spend far too long on corporate governance matters and ensuring compliance with the Code instead of concentrating on the business, its development, its strategy, succession planning etc.

The Preface to the latest incarnation of the Code in June 2010 recognised this when encouraging Chairmen to report on how the principles relating to the role and effectiveness of the board have been applied by admitting "...it may make investors more willing to accept explanations when a company chooses to explain rather than to comply with one or more provisions".

In other words, investors have generally been hitherto unwilling to accept explanations when a company does not comply and tries to explain. The Code then goes on to state in the "Comply or Explain section" that "...departures from the Code should not be automatically treated as breaches."

It also demeans investors – do they need a simple set of rules to work out whether the governance practices at a given company are in line with the principles? And if the procedures aren't in line with the rule then do they need a detailed explanation of how what does happen fits into a principle?

Maybe if an investor invests in lots of companies this spoon feeding is required. Isn't this one of Professor Kay's points (in *The Kay Review of UK Equity Markets and Long Term Decision Making*, July 2012) – that investors invest in far too many companies and that they should reduce the number to a more manageable level, that they are focussed on short term performance and share price, so restricting the long term development of the business. This has led to his recommendation to "develop the stewardship Code to encompass a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance."

The very first paragraph of the Cadbury Report 20 years ago stated in setting out the context for the report:

“The country’s economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain’s competitive position. They 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.”

The latest incarnation of the Code is much more focussed on the principles and the framework within which good corporate governance should happen than before and the spirit of the Code is paramount. But the question is this - if the Cadbury Report had headed up paragraphs 3.7 to 3.10 as “Statement of Corporate Governance Practices” instead of “Statement of Compliance” and a narrative that stated:

“...explain how their [company’s] corporate governance practices comply with the principles of the Code. Where such practices comply with the detailed provisions of the Code, an explanation of how the practices comply with the principles is not required”

would it have taken 20 years to get to this stage, and would boards have spent so much time on such matters?

Business decisions are what a board is charged to do, using its collective judgement within a framework that should provide for checks and balances being effective. In my view the ability to explain anything outside the guidelines without any stigma would have allowed for a more intelligent and sensible application of those principles.

David Mayhew CBE

Vice Chairman, J.P. Morgan

A basis for dialogue



Our corporate governance system has helped make the United Kingdom a “centre of excellence” in the world’s capital markets. In recognising that effective governance contributes to long term company performance, the system has enhanced the country’s attraction as a destination for domestic and international investment capital.

To me, the system is based on two simple propositions:

- 1) Boards are responsible for the effective governance of their companies;
- 2) In fulfilling this function, they are answerable to the shareholders who elect them.

In various roles as a company chairman, senior independent director and institutional investor, I have witnessed the development of this system over the past two decades.

It has proved remarkably resilient, adapting to a changing investment, economic and public policy environment through steady evolution, in close consultation with market participants.

One of the great strengths of our governance system is the concept of “comply or explain”. The system is not prescriptive. It provides a clear template for best practice, but recognises that companies are different. It allows boards to occasionally adapt provisions of the Code to meet specific company needs, while honouring its fundamental principles.

The non-prescriptive nature of the Code has not hindered a high, and rising, level of compliance with its provisions. Compliance is very much the norm, not just in larger listed companies, but across the FTSE 350. Over the years, even guidelines which met some initial resistance (the split of

Chair and CEO roles, the introduction of the Senior Independent Director concept, and the more recent annual election of directors) have become established features of the system.

I think this is because the Code provides a consensus view of best practice, which enjoys broad acceptance and support in the market. In practical terms, it is simply easier for companies to comply, unless an important company concern dictates otherwise.

Where companies choose to “explain”, recent developments have added weight and substance to the process. “Comply or explain” is an obligation to shareholders (not regulators), and it is a key part of the annual report process and other shareholder interaction. Companies are expected to offer a clear rationale for exceptions in the context of the company’s business model and to identify mitigating factors. “Boilerplate” explanations are not sufficient.

Not all explanations have reached this standard, but pressure to improve is growing.

The new Stewardship Code strengthens this process through encouraging institutional shareholders to be involved in important governance and strategic matters, and by urging companies to actively engage with them.

Formalising this process is a welcome development. As a company chairman, I have found personal engagement with institutions and shareholder organisations very helpful in identifying and addressing potential shareholder concerns.

As with the UK Corporate Governance Code, the strength of the new Stewardship Code lies in influencing attitudes and behaviours. It aims to encourage and empower, rather than to proscribe.

A failure to grasp this spirit sometimes leads to the so called “box ticking” approach to compliance. This approach, which is evident in

certain organisations, risks sacrificing the flexibility and resilience of our governance system to a formulaic approach.

Fortunately, it is neither widespread nor particularly credible.

The current economic and political climate has brought new challenges for our corporate governance system. In this difficult environment, issues relating to company performance, remuneration, corporate finance activity and reputational risk have heightened tensions between some companies and their shareholders.

I am confident that our system can adapt to these challenges.

Effective governance, buttressed by a robust “comply or explain” culture and proactive engagement with shareholders, offers the best chance of resolving these issues in a constructive manner.

Glen Moreno

Chairman, Pearson plc

Increasing interaction



In the twenty years since the enactment of the Cadbury Code, it is clear that the rules of shareholder engagement have changed dramatically. Many more investors have donned the garments of owners rather than short-term leaseholders in making their voices heard on a wide range of governance issues. Rubber-stamping management proposals is no longer the guaranteed norm as recent, highly visible proxy ‘no’ votes have demonstrated. This is as true in the

US as in the UK but the paths toward this greater shareholder involvement were not always smooth, or in lock-step or equally effective.

Looking out over the US governance landscape, it is fair to say that many of the advances (as well as the setbacks) resulted from unfortunate events: the Enron fraud which eroded confidence in corporate balance sheets, the distorting effects of newly emerging stock options plans that diluted shareholder value, outsized executive compensation packages, some based on very mediocre or even poor performance, and of course, the market meltdown of the Great Recession and ensuing bailouts that exposed deep fissures in financial sector governance. Legislation, state and federal regulations, and public outrage were the results, some for the good and others less so but all resulting in an inexorable, gradual move forward toward more shareholder engagement and more transparency.

The US did not take the UK path of non-binding “comply or explain” codes nor is it likely to given its vastly more complex regulatory structure and a host of diverse players who have different cultures and different agendas. Nevertheless, the principles behind these codes and other proactive governance initiatives have served to inform and guide, often resulting in concrete actions. The introduction of the Cadbury Code, for example, had a big impact on subsequent initiatives by the NYSE and Nasdaq to put corporate governance on the map for listed companies.

Today, as a result of SEC regulations and other legislative requirements, shareholders have access to more and better public information than ever before. As a result, they are better organized and more focused on achieving constructive dialogue with companies that will minimize excess and result in enhanced long-term shareholder value. That at least is the goal of large long-term investors and companies have taken note, greatly increasing the engagement of CEOs and top managers who are taking proactive steps to initiate frank discussions on pay, proxy access, the separation of chair and CEO roles, and other hot button governance issues.

In this respect, the US Say-on-Pay initiative was a game-changer. Not only did it increase interaction between companies and their largest shareholders but it also provided access for many others and facilitated the growing trend of direct investor contact with corporate board members on key governance issues. Say-on-Pay proposals appeared on most US proxies in 2012 now that the majority of companies (absent small cap issuers who are exempt until 2013) have adopted non-binding annual shareholder votes on compensation and disclosure. It is a process that is by no means perfect or as far-reaching as many would like but it nonetheless reflects the spirit if not actual practice of the UK Stewardship Code. Companies who fail to receive majority support or see their approval ratings dropping from the 95 percent range are more likely to engage, explain and even negotiate change.

That said, it would be a mistake to regard the US as a vast corporate governance wasteland over the past twenty years of real if uneven progress. This I can attest to personally based on my role as a trustee of the American Funds and close interaction the funds' adviser, Capital Research and Management Company (CRMC). CRMC manages over \$900 billion globally, and that has a 30-year track record of robust proxy that included investment professionals from day one. CRMC takes proxies seriously, regarding them as valuable sources of information and insight that can help achieve long-term shareholder value. Analysts are on the front lines, evaluating company policies and procedures, engaging in-depth

discussions with management in a two-way dialogue that reflected long-term ownership, not needless confrontation.

Today, most large fund groups and other institutional investors have followed suit, devoting significant resources to their proxy/governance programs. The result has been a more transparent system of procedures and votes than can be tracked easily on investor websites. Although some of these investors might agree on generic principles, each retains an individual culture and set of goals not likely to translate into group resolutions.

At the American Funds, for example, independent directors have delegated proxy-voting authority to a CRMC coordination group that includes investment teams of analysts, portfolio counselors, and other governance professionals. They work together to submit votes at over 2,000 shareholder meetings globally, and engage with hundreds of management teams on various governance and compensation issues each year. Their case-by-case approach to proxy voting is informed by an internal set of guidelines that are reviewed annually and discussed regularly with a Joint Proxy Committee of independent fund directors who perform oversight.

The guidelines can trigger more intense scrutiny of outlier proposals that test acceptable bounds and result in more frequent interaction with company management. Increasingly, corporate board members are included in this dialogue as was the case in a recent initiative by an analyst who contacted every single trustee of a large technology company to express his concern that a high profile CEO's pay was not justified by lackluster performance. The message to board members was non-confrontational but clear. They share responsibility.

This quiet approach to constructive corporate engagement is not shared by all the diverse players clustered under the US governance umbrella. There are activists like the Harvard Law School Shareholder Rights Project who target pet issues like staggered boards and team with like-minded

institutional investors to get rid of them. There are activists on the pension side who like to go public and use the media and their formidable voting power to effect change. There are short-termers – IPO investors, hedge funds and ETF investors – who care little about corporate governance and offload their responsibilities to third party proxy advisory firms. There are the Mom and Pop smaller investors who would have no representation at all without these same advisory firms who are often criticized for adopting generic industry measures and a one size fits all approach to important proxy issues. The bottom line is that there is room for all of these diverse players under the governance tent as long as their efforts result in a better playing field for shareholders. The trend lines point in this direction but if you look at the actual numbers, it is only the committed few long-term investors who are intent on making a difference.

Bailey Morris-Eck

Trustee, the American Funds Group of Mutual Funds/Capital Research and Management

If not, why not?



Using typically blunt Australian terminology, the “comply or explain” regime operating in the Australian corporate governance world is known officially as “If not, why not?”.

In 2003, this reporting standards regime was introduced into the Australian market. The Australian Council of Superannuation Investors (ACSI), representing 39 not-for-profit pension funds which collectively manage more than \$350 billion in funds for almost half the

Australian population, has been closely involved with the corporate world in developing this form of reporting. ACSI believes the regime, which balances out various stakeholder interests to create an agreed and practical middle ground, has led to greater and more productive contact between company boards and the institutional investor.

The early 2000s saw a raft of corporate governance reforms in the Australian market. One of the key reforms emerged with the formation of the Australian Securities Exchange (ASX) Corporate Governance Council. The ASX Corporate Governance Council was formed in August 2002 with a mandate to “develop and deliver an industry-wide... framework for corporate governance which could provide a practical guide for listed companies, their investors, the wider market and the Australian Community.”¹

Chaired by the ASX, the ASX Corporate Governance Council has brought together 21 diverse business, investment and shareholder groups to develop the “if not, why not?” principles-based reporting framework that applies to listed companies. This reporting framework is embodied in the ASX Corporate Governance Council *Principles and Recommendations* (The ASX CGC Principles).²

1 ASX Corporate Governance Council, *Principles and Recommendations* (First Ed – March 2003), p2.
2 See < <http://www.asx.com.au/governance/corporate-governance.htm> >

It is important to understand that the first edition of the ASX CGC Principles that were released in March 2003 were formulated at the time when corporate governance collapses and failures like Enron, Worldcom and, in Australia, the insurance giant HIH, were still very fresh in the minds of investors, policymakers and the community at large.

The establishment of the ASX CGC Principles and a flexible reporting framework was viewed as an opportunity to lift governance standards without the need for a prescriptive regulatory regime such as that adopted under Sarbanes Oxley in the United States³. The implicit threat from the Australian Government at the time was that black letter law change would be imposed unless issuers and stakeholders developed and implemented a set of principles themselves.

The “If not, why not?” reporting model of the ASX Principles was created by reference to the UK Corporate Governance Code (formerly the Combined Code) that provided for a “comply or explain” approach emanating from recommendations of the Higgs Report. One major difference in the Australian context is that the ASX Principles have been created and agreed on by the 21 stakeholder groups that make up the ASX Corporate Governance Council, rather than being created by an authority equivalent to the UK’s Financial Reporting Council.

The fact that a wide diversity of organisations came together to supplement regulatory requirements and introduce an “If not, why not?” regime has been seen as setting a positive tone in the Australian business community. Institutional investors, such as those represented by ACSI, have used the principles as a point of engagement on issues like director independence and risk management.

³ See Eric Mayne, Launch of the Revised Corporate Governance Council Principles, ASX Sydney (2 Aug 2007).

Summary of the ASX Principles

The ASX CGC Principles provide recommendations for listed companies to apply on a broad range of issues. Where particular recommendations are considered inappropriate to a company's circumstances, a company is able not to adopt recommendations. However this is 'tempered' by a requirement to explain why not⁴. The recommendations of the ASX CGC Principles are underpinned by 8 core principles:

- Principle 1 - Lay solid foundations for management and oversight
- Principle 2 - Structure the board to add value
- Principle 3 - Promote ethical and responsible decision-making
- Principle 4 - Safeguard integrity in financial reporting
- Principle 5 - Make timely and balanced disclosure
- Principle 6 - Respect the rights of shareholders
- Principle 7 - Recognise and manage risk
- Principle 8 - Remunerate fairly and responsibly

Each principle has a number of recommendations against which companies must report. Guidance and commentary is provided on each principle and recommendation. These recommendations have been updated periodically since the ASX CGC Principles were established in 2003. For example, a significant update occurred in 2010 which introduced a requirement for companies to:

“Establish a policy concerning diversity and disclose the policy or a summary of that policy. The policy should include requirements for the board to establish measurable objectives for achieving gender diversity and for the board to assess annually both the objectives and progress in achieving them.”⁵

⁴ ASX Corporate Governance Council, Principles and Recommendations (Second Ed – June 2010), page 5.

⁵ Ibid, page 34.

The ASX CGC Principles define diversity as including “gender, age, ethnicity and cultural background.”⁶ The introduction of this recommendation has seen a marked increase in reporting on board and organisational diversity among Australia’s largest listed companies over the past 18 months.

The establishment of the Principles has also coincided with broader changes to the underlying rules of governance achieved through the *Corporations Act* changes and the ASX Listing Rules. For instance, reforms to the *Corporation Act* introduced in 2005, have required Australian listed companies to submit their remuneration reports for a non-binding shareholder vote at annual general meetings. A binding vote on executive termination pay has also been introduced by legislators.

Votes on these resolutions have now formed a major element in the proxy voting activity by institutional investors in Australia. Australia has seen an increasing level of proxy voting activity from institutional investors over this period, and a high level of engagement between investors and company boards on a range of governance issues. One clear strength of “If not, why not?” reporting is that it has provided a mechanism for companies to augment ‘hard law’ reporting requirements with practical governance disclosures which emphasise the need for a narrative on key governance issues.

Why superannuation trustees are interested in ‘If not, why not?’ reporting standards

ACSI has been a participant on the ASX Corporate Governance Council since it was formed in 2002. ACSI assists its member superannuation funds to manage environmental, social and corporate governance (ESG) investment risk. As representatives of long term investors in listed Australian companies, ACSI is focussed on promoting high standards of corporate governance in the Australian market.

⁶ Ibid.

Participation on the ASX Corporate Governance Council has been an important part of ACSI's work for close to a decade. In ACSI's view, the ASX CGC Principles reflect an accepted 'middle ground' view which is agreed by the Council as a whole rather than minority interests of particular issuers or investor groups. The principles have been important in setting a benchmark of 'good governance' norms and providing practical guidance.

Conclusion

Australia now has almost a decade of "if not, why not" reporting. From ACSI's perspective, these standards have provided a critical supplement to legal reporting requirements. The approach of the ASX Corporate Governance Council has been to develop a set of practical principles which promote a strong framework of corporate governance. Rather than an over-reliance on prescriptive legislative requirements, Australian investors have been well served by a system of principles-based "if not, why not" reporting underpinned by appropriate 'hard law' requirements. The establishment of "if not, why not" reporting has been one of several factors which have led to a high level of engagement between company boards and institutional investors in the Australian market.

Gerard Noonan

President, Australian Council of Superannuation Investors

Commercial freedom, sound governance



Regulating corporate governance – the systems by which companies are directed and controlled – involves an inevitable conflict between the need to ensure high standards and public accountability on the one hand and, on the other, the need to allow companies sufficient commercial freedom and flexibility to succeed.

Although we routinely use the terms ‘corporations’ and ‘big business’ as if they describe an homogenous group of identikit organisations, real companies are of course enormously diverse, operating in a multitude of different markets and geographies, and subject to continual and increasingly rapid change. They are also, lest we forget, governed by people – with all their strengths and weaknesses and infinite variety. It is therefore folly to imagine that good corporate governance can simply be reduced to a rule book.

Even if it were possible, I believe that prescribing rigid rules and then requiring strict adherence could actually be counter-productive and harm good governance – for one thing, the business environment changes so rapidly that the rules would be out of date before the ink dried. More fundamentally, regulating behaviour in this way can, perversely, encourage companies to merely comply with the letter of the rules rather than making ethical judgements that aim to meet their spirit. David Jackman of the Ethics Foundation articulated this risk very well in a recent article for *The Independent* (22 July 2012) when he wrote “... but in fact we insulate companies from making difficult choices: regulations tell firms what to do and so there is no need for them to think for themselves. This is a kind of laundering of conscience; if it’s legal, it must be alright.”

None of which is to argue for no regulation of corporate governance. Companies do not exist in isolation from society, and their actions – good and bad – have wider societal consequences, in addition to their direct effect on customers, employees, pensioners etc. It is therefore entirely right

that regulation should aim for high standards of corporate governance and public accountability and, at a bare minimum, seek to avoid the worst cases of corporate governance failure.

Sir Adrian Cadbury and his committee began their work in 1992 in the wake of a series of high profile company failures, including Maxwell Communications, BCCI and Polly Peck. These corporate governance failures had led to understandable public anger and a clamour for tough regulation to rein in what many perceived as business acting recklessly and with impunity.

Cadbury was therefore acutely aware of the need to reconcile those conflicting aims of commercial freedom, flexibility and success for companies with the need for proper public protection. Indeed, he noted in the preface to the report that “The country’s economy depends on the drive and efficiency of its companies.” And, therefore “[Boards] must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability.”

“Comply or explain” was the elegant solution proposed by Sir Adrian and his committee and, among the many wise recommendations contained in their report, this precept is, for me, the most valuable contribution to the regulation of corporate governance.

It seems to me that if we want companies to think and behave morally and form judgements based upon what they believe is right, rather than simply being compliant, then we must allow that there will be times when they decide that strict compliance is not appropriate. “Comply or explain” enables this type of flexibility but, crucially, retains the discipline of public accountability through the requirement to disclose and explain non-compliance.

There has, over the years, been some criticism that explanations for non-compliance are often inadequate. No doubt too many explanations have

been somewhat glib and boiler-plate; of the “we consider this to be in the best interests of the company and its shareholders” variety. But this is a failure of the application of “comply or explain”, not the principle itself. It is for shareholders, and others, to judge the merit of an explanation and to hold companies to account where it is considered inadequate. Pressure on shareholders to actively exercise this stewardship role continues to increase, and this can only reinforce the positive effect of “comply or explain”.

It is very hard for outsiders to judge the quality of corporate governance in companies. By its nature, good governance tends to go unnoticed whereas bad governance, usually associated with a high profile scandal, is there for all to see. Such high profile governance failures are then rather unfairly interpreted as a proxy for the general quality of corporate governance.

In my experience, there can be no question that corporate governance has improved immeasurably since the publication of Sir Adrian Cadbury’s report in 1992. The recommendations have been widely adopted and are regarded, quite naturally, as standard practice in most companies. Moreover, by adopting a principles based approach and avoiding the need for statutory regulation, Cadbury enabled and laid the foundations for the subsequent revisions that have kept the code relevant. Boards are better run and make better decisions as a result. Above all, the “comply or explain” principle has encouraged and enabled this improvement in corporate governance without compromising the flexibility and commercial freedom necessary for companies to succeed.

For all these improvements however, we find ourselves, twenty years on from Cadbury, in depressingly familiar circumstances – a new string of corporate governance failures, public anger and fresh calls for tougher regulation. The public mood is currently more inclined toward “comply or else!” than “comply or explain”. We must acknowledge that the anger is justified, and recognise with due humility that the task of ensuring good corporate governance can never be “finished”.

But we should resist any attempt to move from “comply or explain” to simply “comply”. This precept is the best, and perhaps only, means of marrying commercial freedom with sound governance and is the best hope we have for encouraging companies to do the right thing, for the right reasons. It is the Cadbury Committee’s most valuable legacy.

Sir John Parker

Chairman, Anglo-American plc

A work in progress



In its initial stages the UK Corporate Governance Code, which implemented the main recommendations of Sir Adrian Cadbury's pioneering report on corporate governance, could claim some outstanding successes. Indeed, it played a central part in professionalising the British boardroom.

Key recommendations such as splitting the role of chairman and chief executive, bringing significant independent representation onto the board and establishing board committees may have been best practice at the time, but they were nonetheless controversial. Thanks to the flexibility of the "comply or explain" formula, which relied on market discipline rather than law or hard regulation to raise standards, resistance from business failed to turn into effective opposition. What was once controversial very quickly morphed into widely accepted practice.

This pattern was repeated over time with other governance issues. In 1995 the Greenbury Report elaborated the original Cadbury recommendations on executive remuneration. The Hampel committee in 1998 took forward the agenda on shareholder voting. Internal control and risk were highlighted by the Turnbull report in 1999 and so forth. Today, following further reports by Lord Myners and Sir David Walker, a code that was originally heavily oriented towards board composition and behaviour is now complemented with a stewardship agenda that addresses the role of shareholders in holding management to account.

Compliance tends to diminish with the size of the corporation. Yet on the big issues such as the chairman-chief executive split, or strong independent representation on the audit committee, compliance is high across the board. The existence of the Code has also been a force for the encouragement of dialogue between institutional shareholders and boards since the quality of the explanations for non-compliance is an obvious focus for such exchanges. Here UK practice is in striking contrast to the US, where there is no governance code and much less dialogue between institutions and boards.

That is not to say that the Code has been uniformly successful. The biggest area of failure concerns the workings of the remuneration committee and the recommendations of Greenbury on boardroom pay. The mere fact of disclosure has brought about a ratchet in chief executives' remuneration. The non-executive directors who people the remuneration committee do not like to feel that their chief executive is in anything other than upper quartile material. They have an understandable wish to encourage and support the executive team. For their part, chief executives are not uniformly motivated by money. Yet they have an understandable concern with relative pay, feeling slighted if their reward is less than they think is justified by comparison with their peer group. The sheer complexity and the flawed metrics of so many incentive schemes cannot be blamed on the Code. But there is no question that boardroom pay remains the great uncracked problem of corporate governance in the English-speaking countries.

Also problematic has been the quality of the explanations for non-compliance. This is variable; and where it is poor, it is not clear that institutional investors and the media have been bringing adequate pressure to bear to secure improvements. This is particularly true, to take just one obvious case in point, of board appraisal, which has yet to bed down fully. Chairmen are often reluctant to go on a regular basis to outside independent firms to do the job. Yet this is not an issue on which many institutions have been actively campaigning.

A critic would also be entitled to say that despite the evolution of the Code over 20 years there are still examples of governance failure in central areas that the Code seeks to address. The current problems of the insurer Aviva, for example, boil down to that longstanding problem, unarrested decline. This raises yet again questions about the role of the board and shareholders in a dispersed ownership system. The board weaknesses exposed by the LIBOR scandal at Barclays fit that old governance chestnut, the overbearing chief executive. To a degree the problems of BP in the Gulf of Mexico and Texas City reflect the same syndrome during the long tenure of Lord Browne as chief executive.

That said, part of what was wrong at BP related to flawed incentive structures within the company. And it could be argued that the Code has too little to say about governance below board level. Yet that also raises questions about the limitations of what a code can be expected to achieve. Many recent corporate governance scandals or failures have been about qualitative issues. No code could ensure leadership qualities in the boardroom. So, too, with integrity. Perhaps the biggest failure in corporate governance apart from remuneration concerns the widespread decline of ethical standards in banking. Boards have simply failed to recognise that pay and incentive arrangements were encouraging behaviour that was at odds with the claimed values of the organisation. Hence the seemingly endless succession of mis-selling scandals and rogue trading losses.

These issues of integrity also apply to the area of audit, which is vital to the sound workings of the corporate sector and of capitalism more generally. One of the less happy developments of the past thirty years has been the commercialisation of the audit profession and the heavy focus on maximising revenues rather than fulfilling the public service remit. It takes more than a few code recommendations on conflicts of interest to overturn that culture, just as it is difficult for a code to address cultural issues in companies.

To highlight the limitations of governance codes is not to minimise their importance. The fact that so many countries around the world have followed the original Cadbury “comply or explain” approach is a reminder of the lesser appeal of the alternatives. In the case of the UK, the Code remains a work in progress. Governance would undoubtedly have been less effective without it. Yet because success in preventing governance failure is inherently unmeasurable, its positive achievements cannot be fully known.

John Plender

Columnist, Financial Times

The power of example



The idea of a code of best practice on corporate governance has proven to be a remarkable export. The report entitled *The Financial Aspects of Corporate Governance* may have been intended for a British audience, but the approach has since been adopted or adapted in more than 70 countries worldwide. The slim volume, with its unprepossessing title and modestly priced two page code of best practice for Boards has been a catalyst for extraordinary and continuing change in corporate governance across developed and emerging markets. The Cadbury Code's approach

has been taken up at national level across Europe, Asia, Latin America, the Caribbean, Africa and the Middle East. The audience and purpose have evolved to reflect local needs, but the core approach has proven resilient.

The approach of the Cadbury Code has also been reflected in guidelines and principles issued by inter-governmental groups such as the Organisation for Economic Co-operation and Development and the World Bank Group. Even CalPERS, in the United States, a market marked by the absence of a national code, calls upon countries to develop codes of practice in order to raise standards of corporate governance.

The international dissemination of the UK's code of practice came through several channels. Sir Adrian Cadbury travelled widely to present and debate the code of best practice internationally. The combination of principles, with practical intent, resonated across markets. Also, there was also an appeal in what appeared to be a resolution of a long standing tension between the competing views on whether corporate governance addresses public concerns or private interest. The code's answer is that both matter.

Likewise, there was an appreciation internationally that the Cadbury Code understood the connection between principles and performance.

This was not an exercise in hand-wringing after disaster, or pious advice from the worthy.

“The country’s economy depends on the drive and efficiency of its companies. Thus, the effectiveness with which their boards discharge their responsibilities determines Britain’s competitive position”

The development of principles, designed to have practical effect, understanding that the goal is harnessing private interest to the public good, is a hallmark of the Cadbury Code. This approach has been shown to have broad international appeal. Much attention has been focused upon the innovation and flexibility allowed by the “comply or explain” approach, but these other features should not be underestimated when considering the broad international appeal of the code.

The thinking represented in the code of best practice was further elaborated through international dialogue at the OECD with the Business Sector Advisory Group (BSAG), of which Sir Adrian became an active member. This group was chaired by Ira Millstein, who had been working in the United States on guidelines for corporations and investors on governance, notably at General Motors and through the Columbia Institutional Investor project.

The two worked intensely with a small team of business leaders from France, Japan and Germany, and their task was to consider if amidst the variety of law, custom and practice, there were common principles of corporate governance which could be espoused across OECD member states.

The prize was to improve competitiveness and access to capital. That shared objective, once it was realized, provided the foundation for common principles. The BSAG concluded that the principles of corporate governance, regardless of national law and custom, could be distilled as being those of transparency, accountability, responsibility and fairness. Regardless of origin, or difference, economies needed capital and these principles would be needed to promote investor confidence. The principles

were also viewed as having an impact upon competitiveness. These twin goals – access to capital and competitiveness – gave the project a compelling international agenda.

The stage was set for the development of the OECD Principles of Corporate Governance, an international policy document, which encapsulated much of the earlier thinking, but broadened the range of actors in corporate governance from directors, shareholders and auditors to include stakeholders, such as employees, who play important roles in the governance structures of many OECD member countries. The trade union delegation to the OECD played a key role in negotiating this provision which allowed the Principles to frame both single and two tier board structures, and a wide range of corporate purpose among member countries.

The work expanded further as the OECD Principles formed the basis of a partnership with the World Bank Group, which realized the potential of these guidelines to address its development agenda, through the potential for tackling poverty through improving access to capital.

There was also a recognition that rapid privatization and liberalization had exposed developing countries to volatile capital flows and the potential for unrestrained corporate influence. James Wolfensohn, then President of the World Bank, pithily remarked that “the governance of companies is now as important to the world economy as the government of countries”. Globalisation and privatization put governance into a central role in the development agenda.

The OECD Principles were in due course incorporated by the Financial Stability Forum as core standards directed at strengthening the international financial architecture in the wake of the Asia financial crisis. The OECD Principles also became a central plank of joint work with the World Bank and IFC, which resulted in the formation of the Global Corporate Governance Forum. Both Cadbury and Millstein contributed to

the work through a private sector advisory group, and later collaboration via private sector networks such as the International Corporate Governance Network.

The partnership of the World Bank and OECD provided a powerful alliance of international agencies to sponsor the core principles of transparency, accountability, fairness and responsibility through regional Roundtables to engage local investors, companies, regulators and trade unions in reform proposals on corporate governance through development of 'white papers' which set out recommendations, within the framework of the Principles.

Work at country level to develop national codes of best practice, became a core area of work for both the Forum and other development agencies such as the Center for International Private Enterprise, sponsored by the US government. Work to develop governance standards in those markets led to some dramatic examples of improving access to capital. The Brazilian Novo Mercado, designed to bring new corporate governance standards as a foundation for attracting new capital, grew dramatically over the period providing a powerful demonstration of the appeal corporate governance could have for investors.

In other countries the Cadbury formula was been remixed and invigorated in surprising ways to address new issues, but also new corporate forms, and new sources of enforcement. The original audience for the Cadbury Code was listed companies, with encouragement to institutional investors to ensure companies raised standards. The role of the regulator was to ensure disclosure which would facilitate this. However, this arrangement of roles is rare internationally. There are few markets where listed companies are dominant economically. Likewise, providers of capital are more often banks, families or government, not institutional investors. This presents new dynamics, which national codes have addressed with some energy and innovation.

The code of best practice in Switzerland is directed to companies controlled by families and interlocking group structures. Content addresses protection

of minority shareholders, the conduct of annual meetings and capital structures. The code states that corporate governance should be a guiding principle in this setting. The approach reflects the original Cadbury Code thinking, but tailored to different circumstances.

“Corporate governance encompasses the full range of principles directed towards shareholders’ interest seeking a good balance between direction and control and transparency at the top company level while maintaining decision making capacity and efficiency.”

The code acknowledges that foreign investors have criticisms of Swiss practice, and view the advice as a step towards explaining local practice and encouraging improvement.

The code of best practice on corporate governance developed in Bangladesh is directed at their own economically significant actors: state owned enterprises, non-governmental organisations and banks. Summing up, the code states its broad, long term goals quite differently from the Swiss code.

“In short, corporate governance can be a catalyst for change, for higher economic growth, for a more efficient use of resources, for a private sector that is accountable to investors and society, for a reduction in corruption, and for a healthy inflow of funds from domestic and foreign investors.”

The approach taken by both countries echoes the thinking of the first edition of the Cadbury Code, twenty years ago.

“The way forward is through clear definitions of responsibility and an acceptance by all involved that the highest standards of efficiency and integrity are expected of them. Expectations of corporate behaviour are continually rising and a corresponding response is looked for from shareholders, directors and auditors. The machinery is in place. What is needed is the will to improve its effectiveness.”

The code of practice has clearly become an important part of that machinery. That is a worthy legacy for the committee's work, and one which continues to grow.

Anne Simpson

*Senior Portfolio Manager, Investments, Director of Global Governance
CalPERS*

A cumulative impact



“Comply or explain” was forged in the fires of the furnace created by a series of corporate scandals. The genius of the Cadbury Committee was to use the heat generated to put some iron in the backbone of the UK’s system of corporate governance, while maintaining its flexibility to allow a diversity of governance arrangements rather than manufacturing a steely straitjacket of regulations. Twenty years is an appropriate time to take a close look at how the “comply or explain” principle has fared and is made even more apposite by the recent global financial

crisis, which has fired up the regulatory furnaces once again. This short essay takes the perspective of a long-term investor, who is actively involved in the heat and hurly burly of corporate engagement, the foundry that produces the practical application of “comply and explain” in the execution of our stewardship responsibilities.

From the perspective of a long term investor there are several yardsticks that “comply or explain” can be measured against:-

- 1) Its adoption rate
- 2) Its original aim of promoting corporate diversity
- 3) The nature and quality of the explanation it produces and its correlation with long run return
- 4) The impact on engagement and resolution when explanations are inadequate or poor

If adoption were the sole criteria, “comply or explain” can be seen to be a massive success. It has not only survived a number of reviews over the last two decades but also forms the central plank of a number of national codes outside the UK such as Germany as well as a number of international initiatives. It most recently has come under intense sceptical scrutiny in Europe and as a principle has survived with its integrity intact.

On the diversity point it is interesting to note that MacNeil and Li found that “Our survey of FTSE 100 serial non-compliers suggests that there is in fact a strong link between share price performance and investors’ tolerance of non-compliance with the Combined Code”¹. To the extent that non-compliance with the Code is correlated with share price out-performance this provides possible evidence that the Code does facilitate the promotion of diversity of governance arrangements. However, positive correlation or association tells us little about cause and effect. The conditions for the non-compliance of governance arrangements to be driving return are quite onerous. It would require the explanation for non-compliance to be directly connected to the business model and strategy of the business and for that to be driving the superior return and for shareholders to recognise and support the non-compliance.

This is a hard test and evidence from the last twenty years is pretty sparse. Potential examples of this working in practice are the executive chairman at Carnival, and the tendency to source the chairman at HSBC from the executive team because of the global and complex nature of their business. A weaker version of the test is that businesses and their boards are given the benefit of the doubt on non-compliance as long as they are delivering superior returns so that “comply or explain” becomes for practical purposes comply or perform. If this is the dominant explanation behind continued diversity as measured by non-compliance then the jury is out on its sustainability. However, if comply or perform is simply an intermediate step to a period of intense engagement by shareholders when performance falters that then results in either compliance with the Code and improvement in performance or a clearer articulation of the particulars of the business model and corporate strategy, then “comply or explain” will be seen to have real bite.

EMI was a business with an executive chairman that did not perform well. The financial crisis and the role of shareholders in bringing banks to account suggests a smattering of comply or perform in the run up to 2008.

¹ I. MacNeil & Xiao Li 2005 Comply or Explain: Market Discipline and Non-Compliance with the combined code.

The recent shareholder spring may suggest we are starting to move towards a mature version where quality of the explanations for non-compliance need to map with strategy and the drivers of long return rather than a simple statement at the AGM.

Given all the dislocations suffered over the last couple of years it is still far too early to come to a definitive conclusion. What is clear is that, twenty years on, the “comply or explain” principle remains as relevant as it ever was and arguably is even more important if a compelling narrative is to be built around the need for a corporate led economic recovery. If the animal spirits are to revive and foster a return to sustainable growth, government, regulator and most important of all public confidence in the corporate sector and the risks it will need to take in deploying investment from society’s savings will have to be very high. In a very real sense it will be the next ten to twenty years that will determine whether “comply or explain” is fit for purpose as the principle that helps mitigate the myriad of principal-agent conflicts in the long chain that connects savings and investments in a modern economy.

Stewardship and governance are long term concepts and should be measured across many economic or business cycles rather than any particular cycle no matter how deep or vicious. The impact of good governance is cumulative and is felt in the very long run. The debate about how to mitigate the principal-agent problem at the heart of capitalism has been with us for over four hundred years and during that time governance arrangements have undergone significant change, sometimes through revolution, but more often than not through evolution. The “comply or explain” principle has survived, just, a pretty tough test as the banks, a key link in the savings-investment chain have been found wanting as have their governance arrangements and any explanation for non-compliance with the Code.

So the acid test will be the behaviours of all involved, investors who need to be forthright about ensuring that explanations for non-compliance tie in with the execution of the individual corporate strategy and the delivery of return.

Regulators need to ensure that code remains dynamic and connected to corporate reality. “Comply or explain” has served us well and its up to all those involved to use the flexibility it gives to good effect or we will lose both it and the potential for diversity it brings, something long term-investors would not like to contemplate.

Keith Skeoch

Chief Executive, Standard Life Investments

Forging a link to performance



The UK Corporate Governance Code (formerly the Combined Code) incorporating the “comply or explain” model of establishing good standards of corporate governance is widely claimed to have achieved much since its introduction in 1992. However I would question the degree of progress that has been achieved in substance as opposed to form and suggest that real challenges remain if it is to succeed in driving sustainable business success to the benefit of

all stakeholders. The latter objective, if accepted, requires movement from both shareholders but crucially also company management.

I believe that “comply or explain” has helped to establish better standards of governance arrangements and to provide shareholders with benchmarks against which to judge arrangement within companies. It has also provided a means for shareholders to press for improvements through their regular engagement with management. I fully accept that such a model works better than a strict regulatory approach in terms of improving standards over time, but where I differ is in whether the model is working well enough.

Firstly I question whether we should tighten the elements within the UK Corporate Governance Code over which “comply or explain” applies. There are many areas of the code where the vast majority of shareholders believe that there should be little or no discretion, so I would query why it should persist. The movement of a CEO to Chairman is widely believed to be a retrograde step as is the combination of Chairman and CEO and therefore I’m unsure why they are still seen as a reasonable arrangement. The first should be in genuinely exceptional circumstances only. Possibly most investors did believe there would always be hard cases but that the clear code benchmark was justified. However, even with the current Code formulation there are clearly too many companies that believe that they are special. The second is a clear breach of the Main Principle that “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."

There is rightly now a focus upon the 'explanations' part of "comply or explain" to ensure that the 'perfunctory' approach is eliminated and that instead they are convincing, time limited and address the risks of non-compliance. In essence shouldn't we be moving away from elements of the Code being seen as optional and instead being seen as the de facto standard that should be attained? Of course this requires that investors themselves accept the Code as the right standard that needs to be more strictly adhered to. In the context of shareholders providing an additional check on management and providing accountability whilst seeking out competitive returns for their clients, my sense is that they should be less willing to accept deviations from the Code. In essence, if the Code is really the standard bearer of what constitutes good behaviour then shareholders need to implement it with fewer exceptions than exist today.

However this then takes me on to the related point that shareholders need to express greater judgements, not simply over whether the Code is being adhered to but also the quality of that adherence. For instance, while a company may comply with the Code in relation to executive pay, as shareholders we need to express greater judgement over how well the company is complying. It needs to be acknowledged that the Code itself has comparatively little to say on remuneration issues and that ABI (Association of British Insurers) guidelines have always played a key role in establishing best practice but these themselves very much embody the same comply or explain approach. As an example, are the performance criteria genuinely consistent with the corporate strategy and are they aligned with driving sustainable business success? Hence I think that shareholders not only need to be shortening the list of items which allow for departures from best practice, but they should also be managing the quality of compliance much more rigorously. Hence we need to focus not

upon mere compliance but also driving beyond that standard to ensure that the companies in which we invest are operating as best they can given the circumstances in which they find themselves.

Lastly, I'd suggest that while the "comply or explain" principle has helped to make the UK Corporate Governance Code an important mechanism for improving governance, we need to decide if it is sufficiently encouraging the creation of sustainable business success. Is "comply or explain" sufficiently driving the right behaviours within companies which are consistent with longer term success? While clearly much effort needs to be directed at how compliance with the Code is being managed by shareholders, through both their engagement but also their voting decisions, we should also reflect upon whether the script we are using itself is correctly focused upon the right behaviours and metrics. Hence, we need to ensure that compliance does not descend into a game in which management achieves a certain standard, shareholders agreeing that the standard has been reached, but that this does not necessarily result in strongly performing businesses. We need to continually assess the substance of the arrangements agreed between management and shareholders and not just the form if we are to seek to achieve better performing companies.

Overall therefore, while I fully recognise the benefits of the "comply or explain" system and fundamentally believe that it has achieved to date much improvement in governance standards, we still need further work to ensure that institutions are making the Code operate as well as it can and that companies themselves see the benefit of complying. In addition, we should continue to challenge ourselves as to whether we are focused upon the right things consistent with longer term business success when asking companies to comply.

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