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Chris Hodge
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Dear Mr Hodge,

RESPONSE TO FRC REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE

Thank you for the opportunity to respond to the Financial Reporting Council's Review of the Effectiveness of the Combined Code. I welcome the FRC's expressed commitment to preserving the UK's market-based model of corporate governance in the face of the challenges posed by current economic conditions.

It is particularly encouraging that the Review's remit is focussed on enhancing the effectiveness of the current "comply or explain" method of Code enforcement. In media and political debate over recent months, "soft" methods of financial regulation have been widely criticised as a contributing factor behind corporate crises in the UK banking sector. However, it would appear that the perceived governance lapses in firms such as RBS and HBOS stemmed not so much from a lack of robust governance regulation, as rather a failure on the part of both boards and institutional investors to internalise the Code's existing supervisory and risk management norms on a functional basis. As a means of motivating necessary cultural and attitudinal developments by boards and shareholders in these areas, "comply or explain" has a significant role to play over the coming years. It is therefore imperative that the FRC remains resistant to any calls for the scrapping or formalisation of the Code's characteristic enforcement method.

At the same time, I believe that there are some ways in which the effectiveness of "comply or explain" could be enhanced so as to engender more reflective and responsible governance practices and dialogue in the UK. Two specific suggestions are as follows:

(1) Relative grading of potentially conflicting Code norms

The new Preamble to the Code introduced following the most recent 2007 Review is undoubtedly a constructive addition, insofar as it cautions against excessively rigid methods of compliance-monitoring and also re-emphasises the Code's motivating goal of facilitating effective entrepreneurial leadership. This should go at least some way towards improving the quality and commonality of dialogue between boards and investors in cases of strategic non-compliance, so as to hopefully avert high-profile governance "fallouts" such as that which surrounded Sir Stuart Rose's promotion to the Executive Chair of Marks and Spencer plc in 2008.

I am nevertheless somewhat sceptical as to how effective this change will prove on its own, without a more thorough alteration of the relative weighting of the Code's intrinsic Principles. Indeed, it is notably also stated in the revised Preamble to the 2008 edition of the Code that, where a board chooses not to comply with any of the Code's provisions, they "should aim to illustrate how [the company's] actual practices are consistent with the principle to which the particular provision relates *and* contribute to good governance". The use of the word "and" (as opposed to "or") here is significant in that it suggests boards should not attempt to justify an alternative governance practice (eg a combined Executive Chairman appointment) by reference to any determinant of "good governance" other than the relevant Code Principle itself (eg Principle A.2). If followed literally by boards and their governance advisors, this particular statement would therefore appear to contradict (and hence undermine) the FRC's expressed objective in revising the Preamble to the Code, which is to encourage a less rigid and more dynamic approach by boards and investors towards their respective tasks of compiling and evaluating companies' annual governance statements.

Of course, it remains open to boards to attempt to justify non-compliance with any Code provision via reasoned reference to a term of the Preface itself. For example, a temporary Executive/Deputy Chairman leadership structure is arguably a means of securing "efficient, effective and entrepreneurial management", and this in itself is therefore a potentially acceptable justification for adopting such an unorthodox arrangement. However, an explanation phrased in these terms, regardless of its genuineness or quality, will be a highly risky strategy for boards, given the absence of any express guidance in the Code as to the relative weighting to be afforded to the Preface vis-à-vis the Code's intrinsic Principles and Provisions.

It is therefore submitted that there is a need for the FRC to give serious thought to the feasibility of implementing a more fundamental alteration of the Combined Code along the above lines as an outcome of the present Review. In particular, the FRC should consider the feasibility of establishing a unifying "Macro-Principle" of the Code, which might provide an objective basis upon which both boards and investors can evaluate and grade different Code norms in the event that a proposed governance policy appears to put one or more Main Principles into conflict with one another. This could be achieved by elevating the normative status in the Code of Principle A.1 (board leadership) relative to

Principles A.2 and A.3 (division of leadership responsibilities, and board independence and balance). By reforming the lexical order of these three key Principles in this way, the FRC will vest boards with greater freedom to produce a comprehensive economic case for temporarily deviating from a standard board governance structure.

Rather than merely adding a further unwanted layer of prescription to the Code, such a reform will in fact provide a much-needed common criterion around which to structure productive dialogue between boards and investors as to innovative strategies for application of the Code's various Principles and Provisions. In this way, it promises to reduce the risk of costly misunderstandings occurring between both sides, which often have the effect of encouraging "blanket" compliance by boards with the Code's provisions aimed at pre-empting potential public dispute and/or shareholder reprisal.

(2) Code Recommendation for Integration of Corporate Governance Statement into "Core" Business Review

The FSA's recent simplification of the corporate governance disclosure requirement, by providing expressly that the "appliance" aspect of the statement need only reference how the company has applied the Main Principles set out in Section 1 of the Combined Code, should be welcomed. This will give boards greater freedom to explain how their governance arrangements achieve the general outcomes expected by the Principles, unencumbered (at least in the first part of the statement) by the need to link the company's policies in respect of each Principle to the more detailed Code Provisions underlying that general norm. This is a constructive, albeit incomplete, move in the direction of enhancing the characteristic flexibility of the Code's application.

It is further suggested that, as a means of encouraging boards to view governance issues as more of a mainstream and positive dimension of the company's core strategy-formulating process, boards should be encouraged by the Code to report on their record of conformance with governance norms within the "core" business review section of the company's annual report. Specifically, this could be achieved by incorporating a variant provision to section 417(5)(a) of the Companies Act 2006 within the Code, which could provide that (suggested additions in italics):

> "In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include the main trends and factors likely to affect the future development, performance and position of the company's business, *together with any deviations from generally-accepted corporate governance norms that the directors consider, in good faith, to be justified as an effective response to those trends and factors having regard to their continuing duty to promote the success of the company under section 172 of the Companies Act 2006.*"

This new disclosure obligation could be introduced alongside the current "comply or explain" obligation in Listing Rule 9.8.6(5)-(6), although unlike the Listing Rule obligation it will not be a mandatory requirement but rather a constituent Code norm that is itself enforceable on a “comply or explain” basis.

The fact that boards would be required for the first time to integrate an explanation of their corporate governance appliance policy into the directors’ narrative account of business development and performance is apt to give rise to increased preparation costs. Nevertheless, it is expected that such costs would be outweighed by the corresponding economic benefits ensuing from the board’s increased responsibility for directly documenting and rationalising its approach towards appliance of the Code’s norms in light of the company’s current developments and challenges. This may in turn improve directors’ dual ability: first, to identify inappropriate or cost-ineffective governance safeguards; and, secondly, to provide a convincing explanation for non-compliance set within the direct context of the recent narrative history of the company’s business.

Conclusion

I should urge by way of conclusion that however the FRC chooses to proceed following this Review, it must strongly resist the temptation to respond in a knee-jerk manner to the recent turmoil in international financial markets by proposing either increased prescriptiveness of the Code’s substantive provisions, or else further formalisation of the method for its enforcement. As the experience of the controversial Sarbanes-Oxley legislation in the US has illustrated, there are no guarantees that such a step will be conducive in the long run either to a more attractive investment environment or to more accountable or responsible corporate management.

In my opinion, a truly dynamic and company-specific system of compliance monitoring, far from undermining managerial accountability, will provide boards with a greater incentive to take their company’s annual corporate governance statement seriously, instead of viewing it as a mere bureaucratic inconvenience bearing little relevance to the company’s “real” business affairs. Recent events in the corporate and financial world would suggest, moreover, that such an attitudinal development is sorely needed within many British boardrooms at present.

I hope that my comments are useful. Please do not hesitate to contact me if you wish to discuss any of the above matters in greater detail.

Yours sincerely,

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