Response to

2009 Review of the Combined Code ("CC")

Introduction

You have asked for comments on the way in which the CC is working and on how it might be improved. I wish to respond as a company secretary and in-house solicitor for over 30 years in quoted and private companies and other corporate entities.

I am responding also as a private investor (direct and indirect), a pension saver, a bank customer, an over-burdened taxpayer and, in a general sense, as a "stakeholder" in "UK plc".

Background

In the 11 years since the CC was first introduced there have been many examples – too numerous to mention – of businesses failing due to poor corporate governance. This has, of course, been most recently highlighted by the virtual collapse of the world's banking industry where it is patently obvious that corporate governance and risk management has failed to a disastrous degree.

These disciplines – corporate governance and risk management – are often discussed as if they were abstract concepts whereas, of course, their operation is no better or worse than those individuals who perform and manage these functions. In the UK and in the quoted company sector, the CC places responsibility for these activities firmly and squarely on the directors of the companies concerned and that is why a review of the CC must begin with individual directors themselves.

My starting point, therefore, in responding to your request for comments on the operation of the CC, is that the corporate governance structures currently operated in the UK are deeply conflicted – they are riddled with conflicts of interest. Some examples are:-

- Non-Executive Directors ("NEDs") are appointed by and their remuneration is authorised by Executive Directors ("Execs").

- Execs are appointed by (Nominations Committee) and their remuneration authorised by (Remuneration Committee) by NEDs.

- An individual director's performance (or appraisal) is reviewed by other directors.

- A company's auditors are, to all intents and purposes, appointed by and, in effect, their fees proposed (and, therefore, authorised), by directors.

- Credit rating agencies are appointed by and their remuneration authorised by senior management and/or boards of directors of the companies being rated.

- Benefit consultancies (advising boards on remuneration, incentive and bonus schemes, pension plans, etc) are appointed by a company's board (again, the directors appoint and authorise the fees of the consultants who are advising the directors on what the directors themselves should be paid).

- Institutional directors (where they seek to influence a company's board, (if at all) will often be represented by individuals who are themselves NEDs and who may not wish to apply as robust an approach to the directors of investee companies as might otherwise be expected.

It is absolutely obvious now, particularly as a result of the recent catastrophic management of businesses in the financial services sector, that the current model of corporate governance is not working properly. This is due largely, in my view, to these inherent conflicts of interest.

The CC and other governance mechanisms must, therefore, be changed urgently to reduce these conflicts and improve existing poor management.

The proposals below reflect this main current area of failure, namely financial services. However, it is my view that many of these proposals – all of which are aimed at improving and strengthening the senior management in any business entity – should certainly apply to all quoted and large private companies. I do not agree with Peter Boyle (FRC CEO - Mansion House: 25.2.09) when he urges caution in extending the scope of a strengthened and expanded CC to the non-financial sector. This review of the CC is a great opportunity to strengthen and so improve corporate governance in the UK's business sector.

Indeed, many private businesses (especially those of a reasonable size) use the CC as a model for part, if not all, all their corporate governance requirements. The CC has an influence, therefore, way beyond LSE quoted companies.

With reference to Section 12 of your Call for Evidence, we have the following proposals:-

Composition and Effectiveness of the Board as a whole

I agree with the existing 50/50 split between Execs and NEDs. But, NEDs must urgently become more robust and, therefore, more effective than at present. Specifically:

- All NEDs should, within the next 5 years, gain appropriate professional qualifications specifically for the role of a company director for this role, e.g. the Institute of Directors Chartered Director qualification. It is not sufficient that an NED should be merely a qualified accountant or a solicitor, for example.

- The initial appointment and remuneration of all NEDs should not be determined by the Execs, but directly by an independent appointments body, which would be responsible for ensuring that NEDs were fully qualified and for proposing suitable candidates to companies requiring NED vacancies to be filled. This should greatly reduce the 'old boy network' approach to NED appointments, rather than appointment on merit, which still exists in many companies. Such 'independent' appointments would then be ratified by shareholders, as now, at the following agm.

- All quoted and large private companies should be subject to a formal, annual, independent performance appraisal of the Board and its committees and of individual directors. It is, we believe, largely useless for this task to be carried out, as now, internally by the company itself. This practice is another blatant conflict of interest and provides no real protection to investors, customers or staff of the company concerned. The individual or entity carrying out the appraisal should be properly qualified in this regard and be appointed to each relevant company by an independent regulator (eg the FRC or FSA).

- Such annual appraisals could be conducted in accordance with parameters and standards set by the FRC (or FSA).

- All NEDs in a company should be required to meet independently of the executives at least quarterly to review and record any concerns they may have about the performance of any or all of the Execs and to decide what action should be taken, and when, to address any such issues. These meetings should be attended by the independent appraisor and minuted by him or her.

The appraisor should be required to refer in the company's annual report when any such matters have arisen and have not been adequately addressed during or after the year in question.

<u>Roles of Chairman, Executive Leadership and NEDs</u>

The cosy and conflicted relationship endorsed by the CC between the Chairman, Execs and NEDs of a company has clearly led to some disastrous corporate results since the CC was introduced. As a result, mechanisms are needed that will reduce these close links between directors of a company, without leading to conflict, as far as possible. I propose, therefore, that:

- The Chairman of all quoted companies should be appointed by the shareholders, not the board.

- The Chairman of the FTSE 100 companies should not also be the chairman of another such company (the recent decision to allow this was wrong). These are huge businesses and it is unfair to shareholders for a chairman's time and attention to be divided between two such larger entities.

- All independent and non-executive directors should be under an *obligation* to exercise a robust challenge to management excesses, decisions and dominance and to maintain a more detailed knowledge than many of them have currently of the company's business, structure, results, trends and future strategy and staffing policies, attitude and morale.

Board's Role on Risk Management

Again, it is patently clear that the CC requirements on audit committees to review risk management frameworks and to ensure that adequate financial systems of control are in place have almost totally failed over the past 18 months (e.g. Northern Rock, RBS, Lloyds Banking Group, Chaucer, Woolworths, to name but a few). To reduce this area of failure, I propose:

- NEDs' training (see above) should include a substantial element of risk management concentrating, particularly, in recognising early signs of weaknesses in the business and external threats.

- NEDs should be *required* to challenge Execs whenever they identify such weaknesses or threats and should expect urgent and comprehensive explanations as to how and when these problems will be addressed.

- All quoted and large private companies should be *required* to have a risk committee (many already do) and these should have as members at least two NEDs who are also members of the Audit Committee. This is so that the Audit Committee can better undertake its oversight role in ensuring that an adequate risk management framework and systems of financial control are in place.

- Where there is a serious risk management problem that the Execs are failing (or refusing) to address, the NEDs should be *obliged* to raise the issue with an independent body, e.g. the FRC or FSA, which may then take action to have the problems remedied.

<u>Role of the Remuneration Committee ("Remco")</u>

I believe that a remuneration committee, as currently constituted under the CC, represents only a foundation on which to build a less conflicted remuneration structure for the future. It must be possible to devise a system where conflicts of interest are reduced, where there is greater transparency and where members of the same "elite" group are not authorising each other's remuneration. I suggest, therefore, that:

- The Chairman should be appointed initially by, and his or her remuneration authorised by, the shareholders in general meeting (or by post or electronic ballot).

- The Remco should be *prohibited by law* or, at the very least, by a revised CC, from rewarding failure and it should be empowered to retrieve excessive salary payments, bonuses, options and other perquisites where it is clear that substantial individual failure has occurred.

- All Execs' contracts should be *required by law* to allow for dismissal without compensation for incompetence. Directors should, of course, benefit from all usual employment law protections, but where they have patently failed, they should be subject to summary, uncompensated, dismissal (and not be entitled to £700,000 per annum pensions, for example). The FRC could produce a set of standard service contract clauses to cover these points.

- The system of external annual reviews of NEDs' performance and annual shareholder approval of the directors' remuneration report (which should no longer be merely an advisory vote) should reduce the current practice of taking the easy route when relinquishing or dismissing an under-performing Exec.

<u>Quality of Support and Information Available to the Board and it's Committees</u>

Years of experience have shown that much time is wasted at formal board meetings. Too often those present are asked to "run through" reports that have already been circulated to board members (and which they should have read before the meeting), thus repeating information already disseminated. Loose chairmanship of meetings leads to rambling discussions often deviating from the point at issue. Further, I estimate that, say, 80% of board meetings are generally concerned with history, rather than being concerned with current and, particularly, future threats and opportunities. I propose, therefore, that:

- There should be compulsory training and testing (perhaps via the new annual appraisal system for board chairman in how to manage meetings.

- Businesses should be encouraged to reduce the volume of detailed financial reporting so often produced at board meetings. Greater use should be made of exception reporting, traffic lights, KPIs and forecasting.

- NEDs should be obliged, within 6 months of their initial appointment to a board, to learn about the business in some detail and this could involve a reasonable period of working within the business to whose board they have been appointed. For example, how many of Woolworths' NEDs actually worked on the shop floor? Additionally, NEDs should be required to meet a selection of staff at all levels within their business, there being no substitute for face-to-face meetings and the knowledge gained from the "shop floor". Again, this requirement should be monitored through the annual appraisal system.

- Boards and, especially, committees should be encouraged to use the services and experience of relevant employees of the business itself and, where appropriate, external experts (and not only, as is often the case currently, when a particular problem arises).

- Board and committee members, whether Execs or NEDs, should be required to undergo regular training and to accrue a prescribed amount of continuous training in relation to their role as directors. Compliance with this requirement could be monitored by an external entity, e.g. the FRC or the FSA, or by the annual appraisal system.

Section 2 of the CC – Institutional Shareholders

There can be no doubt that institutional shareholders have failed to use their potential influence in connection with corporate governance – at the very least since the CC was introduced. This has resulted in such devastating consequences as those that have hit the financial services sector in the last 18 months. As described elsewhere, institutional shareholders are "the City's absentee landlords".

I have worked for companies where such shareholders are conspicuous only by their absence and, as a direct or indirect investor, my interests have certainly not been actively represented or supported by these institutions. I propose that:

- Institutional Shareholders should be under an *obligation* to maintain frequent contact with investee companies and to take action (by proposing resolutions at AGMs, calling EGMs if necessary, communicating with NEDs on a regular basis, rejecting directors' remuneration reports (the votes on which should no longer be merely advisory) when it is clear that excesses (e.g. bad management decisions, unjustifiably high pay awards, inappropriate corporate transactions) occur or are proposed.

- Institutional investors should operate a common set of guidelines (issued under the auspices of the ABI or FRC, perhaps) which state specifically what governance role institutional shareholders should play and the remuneration and employment conditions for directors which they should enforce in their investee companies.

- These guidelines should require institutional shareholders to work together to achieve these goals.

- Institutional shareholders should prepare an annual report for inclusion in the Company's annual accounts setting out what action they have taken on such

- matters, thus imposing on them a degree of accountability of which, at present, they have none.

Comply or Explain

This approach to corporate governance has some benefits, e.g. reasonable flexibility, and it should continue, provided it operates within the more rigorous governance regime set out above. Many elements of these proposals should, however, be compulsory so that "comply or explain" will become much less of an opportunity than at present for a company to wriggle out of complying with many of the reasonable CC governance guidelines.

The Future

I realise that these proposals will increase the level of governance and scrutiny that boards will face (though this will be a relatively minimal amount for financial services companies which are already highly, if ineffectively, regulated).

This will incur additional cost, but this will not be great when compared with, for example, the colossal loss of shareholder value and reduction in net assets over the past 18 months of many, many poorly governed businesses.

Conclusion

By adopting these significant amendments to the CC and, in some cases, introducing legislative changes, we believe that much will have been achieved in meeting Sir Christopher Hogg's "basic principles of good governance, namely: accountability, transparency, objectivity and putting the company's long-term interests ahead of all other considerations".*

Philip Osman

Lawtax Limited
Tel 01892 515883 (mobile 07774 890014)
Email: paosman@gmail.com

* ICSA Corporate Governance Conference: 18.3.09