SUBMISSION TO THE FINANCIAL REPORTING COUNCIL'S REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE

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I. INTRODUCTION

This submission is made from the perspective of one who has observed boards and CEOs, both first-hand and at a distance, over many years, and been involved in corporate governance, directly and indirectly, since before the publication of the Cadbury Report, to which I also made a submission on behalf of the Hay Group, as well as on an individual basis to the various later Reports (Greenbury, Hampel and Higgs).

What follows is divided into two main sections – Major Issues, and Specific Comments on the current text of the Combined Code. It will be illustrated periodically with quotations from my book 'Who Will Guard the Guardians? Corporate Governance in the Millenium' (Management Books 2000 Ltd., 1999), much of which I believe to be still relevant today. I have not addressed directly all the questions posed in the Call for Evidence, but focused mainly on those issues which I regard as especially important.

II. MAJOR ISSUES

1. The overall structure of the Combined Code, encompassing principles together with more detailed provisions, with the resulting flexibility of application enshrined in the concept of 'comply or explain', I believe to be soundly based and appropriate: its general philosophy and approach have been widely emulated around the world – with the unfortunate exception of the United States. The focus on complying with the spirit of good corporate governance rather than specific rules is its key achievement, because the latter can always, given sufficient ingenuity, be circumvented, whereas breaches of the former are usually evident to all.

2. It is not easy to be sure to what extent the sudden and severe worldwide recession has been caused by systemic failures of corporate governance, and to what extent by the failures of management and boards in the financial services sector and elsewhere, but clearly the checks and balances which are supposed to constrain spectacularly bad decision-making did not work as they should have done, and all three must be judged culpable in varying degrees. Improvements in the system can certainly be made, and in what follows I propose some of these; but the most egregious failures, apart of course from those of management, must have been those of the watchdogs of the system – boards and specifically non-executive directors (NEDs). There has been much debate in recent years over whether the aim and result of good corporate governance is to improve corporate performance or to avert corporate disaster, and I firmly believe that recent events conclusively settle the question: it may be a necessary condition of the former, but it is clearly a sufficient condition of the latter. Institutional shareholders must also undoubtedly share some of the blame.

3. Questions have been raised about the level of disclosure of information in Annual Reports: this is an important but not a critical issue, since those who take the crucial external decisions, including institutional shareholders, have access to much more and more focused information if they require it (incidentally, this makes nonsense of the statement in Note 20 that "Nothing in these principles or provisions should be taken to override the general requirements of law to treat shareholders equally in access to information"), since private (individual) shareholders do not enjoy such access outside the AGM, which has its own deficiencies (see below). Furthermore, much of the disclosure, specifically on corporate governance provisions, remuneration and the background and experience of directors, is essentially boilerplate, sometimes intended to obfuscate (and to protect the board) as much as to inform. This is especially true of banks, and even more so in the documentation provided at the time of rights issues, a particularly striking example being that of the recent rights issue by Vernalis.

4. The Code states (B.1) that “A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance”. Leaving aside the fact that the word “significant” has often been interpreted in practice to mean “overwhelming”, especially in banks, there is a serious and seldom-remarked problem in attaching the rewards of executive directors (EDs), and in particular the CEO, to corporate as opposed to individual performance: the statement that the total remuneration package “ should be designed to align their interests with those of shareholders” (B.1.1), while admirable in intention, inevitably opens the door to manipulation and abuse, especially when Total Shareholder Return (TSR) is, as suggested in Schedule A.4, used as the criterion of corporate performance. There is clearly a causal link between individual and corporate performance, but it is often not direct or obvious, and may be long delayed. Alignment of the type desired could much more effectively be achieved by the payment of bonuses, whether annual or long-term, in restricted shares (not, for obvious reasons, options, which constitute a one-way bet), which may only vest after a considerable lapse of time, perhaps even in some cases after the ED has left or retired. A case in point: Richard Fuld’s substantial holding of shares in Lehman Brothers became worthless at its bankruptcy, which some would consider to be poetic justice. Switching the focus to individual rather than corporate performance would entail much greater attention to operational results, admittedly not always publicly available, and to the many non-quantitative results for which a CEO should be held accountable (e.g. developing and implementing a sound strategy, developing an effective organization and management team, identifying and implementing new products, services and markets, and effectively communicating company policies and achievements both internally and externally, etc., etc.). The catch is of course that these results have to be assessed rather than measured – but surely this is what the Remuneration Committee is supposed to do. If it can be trusted to do its job competently and with integrity (and admittedly this trust is in short supply nowadays), the problem of rewarding performance should be greatly reduced. It follows that, to the extent possible, institutions and other outsiders should look to these kinds of leading indicators rather than relying on simplistic judgements based on reported financial results and TSR. To be fair, the better practitioners already do this, but it is much harder work, and requires digging below the surface, and a much greater understanding of the dynamics of managing a business than many analysts (and journalists) possess. It would also be most helpful for the Remuneration Committee to comment in the Annual Report on the CEO’s performance against these criteria.

5. A coda to the above is that most institutional shareholders (with the very rare exceptions of activists like Hermes, Governance for Owners, Knight Vinke and the former UK Active Value Fund) lack the resources to focus on key leading performance indicators of the majority of companies in their portfolios. As a result, rather than carrying out their own research, they often rely to an unhealthy degree on the judgements of the various ‘proxy advisors’ or voting services, such as ISS, Glass Lewis, Manifest, PIRC, ABI and RREV (the NAPF spin-off). These undoubtedly attempt to do a thorough job of investigation, but are sometimes accused of relying overmuch on what is frequently stigmatized as ‘box-ticking’, i.e. whether the company does or does not meet a multitude of highly specific criteria, such as the length of service of NEDs.

6. It is of course not only institutional shareholders who are concerned about the governance of companies in which they own shares. A remarkable omission from the Code is any mention of private shareholders, who still own a substantial percentage of the shares of major companies. Their interests are supposedly represented by the UK Shareholders’ Association, which however does not generally play an activist role, but confines itself mainly to lobbying activities, policy submissions, and issuing guidelines to its members on various issues, e.g. on participation at AGMs. This is a striking contrast with the situation in France and Germany, where ADAM (Association pour la Defense des Actionnaires Minoritaires) and DSW (Deutsche Schutzvereinigung fur Wertpapierbesitz) have for many years undertaken a number of high-profile campaigns, often successful, against companies that they judged to be neglecting the rights of private shareholders. There is a similar organization in Sweden. “It is a mystery why activism in the interest of individual shareholders should have manifested itself in these countries, none of them by Anglo-Saxon standards thought of as particularly shareholder-friendly” (Williams, op. cit.), and why it has not done so in the UK or the US, but perhaps Anglo-Saxon individualism is the reason for the latter. That said, there are two important ways in which the Code could I believe be significantly strengthened to assist the exercise of their rights by private shareholders, who are at present virtually disenfranchised. The first would be to insist that all private shareholders, whether they hold their shares via nominee accounts or not, should be entitled to receive Annual Reports and other company communications as of right, without having to request them, as is often the case at present. Many invest through an ISA, into which PEPs have recently been merged, for the tax benefits, and do not normally receive any company communications,

which is outrageous. The second, and more potent, way in which the Code could be strengthened would be for it to require that private shareholders be given the opportunity to vote separately for an NED to represent their interests; this would probably not necessitate a change in the law, as I once thought it would, since the application of the 'comply or explain' principle would oblige companies to give convincing reasons for non-compliance. This would I think be difficult, in terms both of logic and of public relations, for them to do. They would naturally be extremely reluctant to comply, but would surely have eventually to yield. "All manner of entrenched interests will of course object strongly to such a proposal, on the grounds that all directors must represent the interests of all shareholders, and that for an NED to be elected by a specific group of shareholders would breach that principle. To this I reply that the principle is already frequently breached, i.e. when a company takes a significant minority position in another company and appoints a director to the board. Whilst formally his duties and responsibilities are identical to those of his colleagues, it is straining credulity to believe that he does not pay particular attention to the interests of those who put him there" (Williams, op.cit.). Institutional shareholders in the UK do of course have the right to nominate candidates for election to the board, but scarcely ever exercise it. It is interesting to note that in the US the SEC has just issued a proposal to permit this (the so-called 'proxy access'). It seems very likely that this right, long sought, would be exercised there not infrequently.

7. Last, but far from least, are the issues relating to NEDs, who together with the Chairman must be the ultimate guarantors of the quality of a company's corporate governance. The role is one that it is far from easy to discharge effectively, and I believe that improvements in four areas, which should somehow be incorporated into the Code, are needed to make it less difficult for them to do so. The first is to spell out more clearly its duality. "There are two sides to the NED role – not always easy to reconcile or balance: the first of these is to help direct and guide the company, by providing support to management and to the rest of the board, through bringing valuable experience…..and often a range of relevant contacts as well – it is sometimes referred to as the advisory side to the role, but a better adjective might be 'enabling'; the second is to act as the 'conscience of the board', representing the broad interests of shareholders (and rather vaguely of other stakeholders), and the principles of good governance, i.e. in effect a policing role. It is a commonplace that both of these are of equal importance" (Williams, op.cit.). What is not normally articulated or even recognized is that many whose previous experience has been exclusively managerial, and have grown accustomed to the exercise of power, find the need to exercise influence rather than power to be a difficult transition to make. This point leads us to the second area, the pool from which NEDs are drawn. At present the great majority are serving or retired EDs, and often CEOs, on the unspoken premise that previous membership of a board, and thus familiarity with its practices, are essential requirements. I believe that the latter is indeed essential, but that the former is not, especially if an ED's experience has been exclusively or largely within one company or business sector. It is often said that the pool of potential NEDs is a limited one, which is of course only correct if both of the above criteria are applied. This is a fallacy, because there are in fact many potential sources of NEDs, who would not necessarily have prior ED experience. They "would of course need to have extensive business experience, however acquired, and might be drawn from the ranks of professional advisors and experts, e.g. lawyers, investment bankers, consultants, business academics, and, yes, perhaps even analysts and fund managers. Prospective candidates from these groups would have, provided they were sufficiently senior and experienced, one significant advantage…….that they would almost certainly have had far wider exposure to companies and boards than most directors" (Williams, op.cit.). Any potential conflicts of interest could surely be managed. Such appointments are now rare, and should not be. The third area needing attention is the information needs of NEDs, who are, with certain exceptions, required to rely on information supplied through management channels. Even if all those supplying it are honest and not already committed to a specific position on the issue in question (which is often the case), this information is highly likely to be shaped by management perspectives and preconceptions. Apart from the built-in access to independent advice provided to the Audit and Remuneration Committees, it is rare for NEDs to utilize other sources – and these, be it noted, are generally busy people without the time to do their own research; they may also have grown accustomed to having others do their analytical work for them. There is an obvious solution, which as far as I know only BP, amongst major companies, has adopted – to have a small independent staff unit, responsible solely to them via the Company Secretary, which would provide whatever support they required. This is good practice, and should be strongly recommended, at least for large companies. For smaller companies, external advice could be sought: this is explicitly provided for in the Code (A.5.2), but seldom happens in practice. The fourth area where clear guidance is required can be stated briefly: in today's environment, no NED can satisfactorily fulfil his responsibilities to more than a limited number of companies, especially large and complex ones (it is relevant also to take into account unpaid commitments such as

trusteeships of major charities, universities, etc.). The days when the late Professor Sir Roland Smith could (reputedly) hold down 19 directorships are over.

III. SPECIFIC COMMENTS

I have confined myself here to certain sections of the Code, identified by paragraph number. The topics raised are not those covered above.

Preamble:6. I should welcome here some statement on the extent to which the principles and provisions of the Code could and should be applied to public bodies and mutual organizations, in which a description of corporate governance as weak would be a serious understatement.

A.2. Supporting Principle: It is not clear from this who should be expected to communicate effectively with shareholders.

A.3. Main Principle: I see some merit in Boards having (say) one non-independent NED, e.g. a retired ED of the company, who would be able to provide extensive inside knowledge to his colleagues.
Supporting Principles: Undue reliance is often placed on particular individuals as committee members in investment trusts, which are glossed over in the Code (the AIC Code is much less demanding in this and other respects).

A.3.1. 4th bullet-point: I would add "or personal" after "family", to draw attention to the dangers of cronyism.

A.3.3. There should also be channels for contact with other NEDs than the SID, if only to give them first-hand exposure to shareholders' views.

A.6. The evaluation of board performance should always be carried out with the assistance of an outsider, for obvious reasons; it often is not.

A.7.1. A three-year appointment, terminable only for misconduct, would add to the independence of NEDs; for EDs one year should be sufficient, but for NEDs to be re-elected annually, as some propose, could expose them to undesirable pressures which might compromise it.

B.2.3. It seems to me very undesirable indeed to allow the CEO any part in determining the remuneration of NEDs, and I would prefer to leave this to the Chairman alone, supported by the Company Secretary if necessary.

C.1.1. The language here is odd: the NEDs play no part in preparing the accounts, other than setting the parameters, but they must approve them.

C.3.2. 3rd bullet-point: the internal audit function should never, as sometimes happens, be outsourced, and most certainly not to the same firm which conducts the external audit, but report either directly to the Chairman of the Audit Committee, or indirectly via the Company Secretary.
5th bullet-point: periodic changes of the firm conducting the external audit should be required.

D.2. The basis of the AGM needs to be rethought, as it is virtually the only opportunity for private shareholders to make their views and concerns known. "It is hard to escape the conclusion that most chairmen and chief executives regard AGMs as a tiresome formality, or even charade, which they are obliged to go through once a year, and where their main priorities are to get their resolutions through as quickly and easily as possible, to avoid public relations blunders, and to deal expeditiously with any protests that occur" (Williams, op.cit.). It is also worth giving much stronger encouragement to institutional shareholders to attend (see E.3), which they seldom do at present unless there is a crisis.

Schedule A.2. There should be a much stronger presumption against the use of share option schemes, since they provide a one-way leveraged bet which EDs cannot lose.

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