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Financial Reporting Council
Review of the Effectiveness of the Combined Code (March 2009)

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Issues for Comment

Which parts of the Code have worked well? Do any of them need further reinforcement?

1. The answer to this question depends on what is meant by ‘worked well’. If it is meant, is a particular provision workable, are the mechanisms prescribed such that companies can comply with them, then most of the Code ‘works well’. If the issue is whether the provisions work well in ensuring effective boards, the position is more questionable, as discussed below.

2. Where the Code has worked well is to establish best practice on board structure and composition. The result is near universal convergence for UK listed companies on a relatively uniform board structure (chair, executive directors, non-executives, company secretary), composition (balance, independent non-executives, usually separate posts chair and chief executive) and operating procedures (nomination, remuneration and audit committees, use of induction procedures, evaluation, review, professional development etc). All of this is undoubtedly useful, but there is an element of ‘motherhood and apple-pie’ to it, a certain naivety, which strikes an odd note now. Essentially the Code says boards should be properly appointed, should be balanced, should meet, should provide leadership, should have dialogue with shareholders etc. Nearly 20 years have passed since the Cadbury Committee reported in 1992 and the structures reflected in the Code are now so established that one wonders whether it is really necessary any more to state them in this way or at this length. It could be argued that the Code’s work on board structure and composition is done and these practices are now so embedded that it would suffice to have a much briefer statement on these issues[1]. On the

[1] See, for example, the OECD Principles of Corporate Governance, Principle VI, The Responsibilities of the Board, which take up a page and a half.

other hand, as discussed below, other aspects of the Code or, more accurately perhaps, other aspects of corporate governance need further development which may be suitable for development within the Code.

Have any parts of the Code inadvertently reduced the effectiveness of the board?

3. *Procedure and process over business leadership* The overall focus of the Code is on form and procedure (how many non-executives; how to appoint them; how many committees; who should sit on them, etc) and the degree of detail on each aspect results in a concentration on processes which detracts from the core obligation of the board which is set out in the Code A.1 (supporting principle, para 1 [2]), namely to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. Code A.1 does refer to the success of the company, but the point is not reflected thereafter. The result is a focus on the processes of corporate governance while losing sight of the need to focus on the success of the company and crucially on shareholder value. Shareholders may also rely too much on checking on compliance with these processes which distracts them from focusing on broader management issues – are these directors doing a good job?

4. *Individual roles rather than collective responsibility* The focus on committees may have undermined to some extent the collective and collegiate role of the board and encouraged individual directors to concentrate on those committee functions rather than their need also to act to promote the success of the company. It is interesting that criticisms of non-executives in respect to the current economic difficulties seem to be relatively muted and they have maintained a near-silence on matters as if anxious to distance themselves from the failure of the executive leadership in many cases. Granted it is in their self-interest to do so (until the dust settles) but equally it suggests a sense of distance from the leadership of the company and, crucially, from responsibility.

[2] It would be helpful at some point to review the numbering of the Code which is not designed for easy referencing. Straightforward sequential numbering would be more user-friendly. Likewise the name of the code (‘Combined’?). It makes sense in the context of the history of its development, but not otherwise. Might it not simply be called the UK Code of Corporate Governance ?

Is the ‘comply or explain’ mechanism operating effectively and, if not, how might its operation be improved? Views are invited on the usefulness of company disclosures and the quantity and quality of engagement by investors.

5. ‘Comply or explain’ is an acceptable mechanism for the type of Code which has evolved. In the context of a ‘motherhood and apple pie’ Code with a focus on processes and procedures, an approach based on explanatory statements and descriptions is perfectly adequate.

The composition and effectiveness of the board as a whole

6. *Composition* As noted, the composition of the board is now somewhat uniform and relatively uncontentious (independent chair, executive directors, independent non-executives, balance of executives and non-executives) but issues remain concerning independence.

7. Independence is needed in order primarily that independent directors are in a position to monitor and resolve the conflicts of interest which affect executive directors in control of assets belonging to others, but also to bring a degree of objective oversight to the management of the business and the development of strategy etc. Hence the need for the independent non-executives to adopt a role of ‘relentless questioning,’ (Myners, Governance of Life Mutuals, 2004).

8. The theory of independence is laudable, but there are practical concerns. First, it is for the board to determine whether it considers someone independent in character and judgment and crucially the board can consider someone independent for these purposes though they fall within the extensive list of connections set out in Code A.3.1. These connections (business links, family links, links to controlling shareholders etc) are the very opposite of independence and even those truly independent when appointed may remain on the board for so long that any initial independence evaporates. To these factors of connection and longevity must be added the issue of remuneration. The level of non-executive remuneration is now such that even if independent on appointment, that independence must be compromised by the natural desire to retain what is a lucrative appointment. Even more so when, as is common, the appointment is one of a portfolio of appointments. In that case there is the additional desire not to do anything as a director of Company A (for example, by being too challenging of the executives) which might

jeopardise the position in Company A *and* the positions held in other companies). Consider further that the pool from which appointments are drawn is quite small with the result that independent directors are drawn from the same mind-set and business background as the executives and so are less likely to challenge them. Arguably then the independent directors are not actually that independent and if independence is desirable (and attainable) then the Code is too lax in A.3.1 in the leeway that it allows on this issue.

9. More fundamentally, it may be that this emphasis on independence (even if the substantive quality of that independence is debatable) is misplaced in that it may have the effect of diminishing the independent directors' sense of collective responsibility for the leadership of the company. 'Independence' may be translated in practice into distance and disengagement from the company as opposed to independence of mind in the collective leadership of the company. Further, it is arguable that the Code (with its focus on relationship independence) does not capture that essential 'relentless questioning' quality of character which is so important.

10. *Effectiveness* There is plenty of evidence to suggest boards have been ineffective, not always and not especially in any particular sector, but there is a recurring picture of board failures in a variety of ways. Most obviously, boards have failed to prevent excessive remuneration and bonuses (not just in the financial sector) so failing to control the most readily identifiable conflict of interest which faces directors and managers. They have failed to prevent excessive risk-taking whether in the case of unwise lending or borrowing or disastrous takeovers and acquisitions at sky-high prices. They have failed at the basic level of protecting the company's assets, business and shareholder value (through undue reliance on bank credit, lack of diversification, failure to move with changing consumer demands, etc).

11. Against that backdrop and in the context of the Code, the effectiveness of the board must be measured against the requirements of Code A.1 and Supporting Principles. To start with, para 1 of the Supporting Principles to A.1 seems to set the bar too low ('board to provide entrepreneurial leadership, set strategic aims, review management performance, set values and standards'). This approach is consistent with this type of 'motherhood and apple pie' code when what is really required is that it should convey a far greater sense of directors' *duties*. They have a legal duty to promote the success of the company for the benefit of the members as a whole and

a legal duty to exercise care, skill and diligence in their leadership of the company. Para 3 (A.1, SP) takes a similar tone towards the non-executive directors (they should 'constructively challenge,' 'help develop', 'scrutinise' etc) which gives little sense of their positive legal duties to the company. In so far as positive obligations are identified in para 3, for example, that non-executives should satisfy themselves on the integrity of financial information, that financial controls are robust and defensible and establishing that they are responsible for directors' remuneration, the effect may be corral them into discrete areas of activity which again erodes their sense of collective responsibility for the leadership of the company.

The respective roles of the chairman, the executive leadership of the company and the non-executive directors

12. *Chairman* Main failing has been in respect of the obligation set out in Code A.2 Supporting Principle that the chairman 'should ensure effective communication with shareholders'. That issue of engagement with shareholders is discussed further below.

13. *Non-executive directors* As discussed above, the focus on independence and on committee' roles may have detracted from the need for the collective board including non-executives to exercise care and skill and promote the success of the company. From a practical point of view, given the level of commitment now required from non-executives (both in terms of their broad responsibilities and specific committee responsibilities), it may be that some limits or more specific guidelines are needed on the number of directorships which may be held at any one time.

14. The position of senior independent director should be re-considered (A.3.3) as it does not seem to have evolved into a role of any great significance, serving it seems merely to enhance the cv of the person holding the 'title'. It could be abolished, save in the case of companies with a combined post of chairman and CEO.

The board’s role in relation to risk management

15. Throughout the evolution of the Combined Code, much of discussion of ‘risk’ issues has focused on accounting errors, management frauds and misappropriation of assets and audit failure. There has been a necessary emphasis therefore on ensuring that the accounts are properly prepared and give a true and fair view and that the audit is conducted correctly and the Code starts in C.1.from that narrow financial reporting perspective. The Turnbull Guidance, on the other hand, addresses clearly the broader issues of risk management (see para 19). However, the Code merely footnotes a cross-reference to Turnbull in C.2 which goes on to emphasis ‘safeguarding shareholders’ investment and the company’s assets’ which may suggest safeguarding from misappropriation and fraud rather than broader obligations with regard to the management of risk. Given the crucial importance of the Turnbull Guidance, it is questionable whether it makes sense for the Guidance to be contained in another document. For example, the last paragraph of the Preface to Turnbull emphasises the board’s responsibility for risk management in the widest sense, but that strong position is not really reflected in C.2. The emphasis in Turnbull on board responsibility and judgment (paras 15-16, 24-27) surely needs the higher visibility of statement in the Code.

16. The Code might also be seen as contributing to the perception that risk management is a matter for the audit committee, given that C.3.2 requires the audit committee to review the company’s internal control and risk management systems unless expressly reserved to the board (which arguably C.2.1 does, so there may be some lack of clarity here, addressed to some extent by Turnbull, para 25). A broader issue is whether the audit committee is equipped to undertake the range of functions set out in C.3.2. It may be worth considering whether the audit committee should concentrate on the financial reporting/audit issues and whether a separate risk committee be created. A separate committee raises, of course, the same issue noted above with respect to the other committees, namely that it contributes in some way to a diluting of collective responsibility. It may be that the lesson of recent events is that risk management should be formally and expressly reserved to the board so ensuring the engagement of all directors on this issue.

The role of the remuneration committee

17. This committee is clearly of limited effectiveness. Its core role is to manage the conflicts of interest surrounding directors' remuneration and to align directors' and shareholders' interests but generally these committees have failed to impose effective controls on directors' remuneration, pensions, options and bonuses. It cannot be said that the committee lacks the necessary information on which to act (the relevant regulations require extensive disclosure) so its ineffectiveness lies elsewhere - in its inability or unwillingness to control terms, to impose restraints, to set realistic performance targets, even to hold people to targets. Generally the committee fails to exercise or appreciate the trustee aspect of directors' duties, i.e. their responsibilities as trustees of the company's money. The reasons for these failures include an element of 'capture' (the non-executives on the committee do not wish to fall out with their executive colleagues) and self-interest (higher executive pay has a ratchet effect on non-executive pay).

18. Whatever the reasons, the failures are so comprehensive over such a period of time that another approach is now required. Disclosure requirements and an independent committee have not worked. The next step must be that shareholders must take much greater responsibility and involvement in this issue and an advisory vote alone is no longer sufficient. That is not to say that there should be Government interference in private bargaining, but that the shareholders must now have a full vote on approving individual directors' pay packages which need to be re-worked in a way which ensures they are actually transparent rather than nominally so. At the moment there is a great deal of information on remuneration, but because the packages contain so many discrete elements, it is difficult to appreciate the overall cost to the company – witness the apparent difficulty in RBS of determining the nature and extent of Sir Fred Goodwin's pension entitlement. A different issue might be whether companies should provide pensions when the annual remuneration is such that the individual is in a position clearly to make their own pension arrangements.

19. All of this raises broader issues than are relevant to this consultation, but the point here is that the current methods of dealing with remuneration via non-executive directors and a remuneration committee are no longer sufficient. The issue should originate from that committee but the shareholders must decide (and not merely advise) on the matter. It is

possible to devise a scheme requiring approval which does not inhibit recruitment. For example, major shareholders could be consulted initially on an appropriate remuneration framework in a particular company (in practice a relatively uniform framework already exists across companies but work is needed to redraw/tighten that framework to align it with shareholder demands/expectations) with consultation necessary on an individual's package only if it falls outside that framework. A vote against an individual package could trigger a three or six month period when the company would have to re-negotiate with that director. Of course, such a scheme would only work if the shareholders are willing to engage on this issue, but there are signs that shareholder patience with remuneration committees has been exhausted.

The content and effectiveness of Section 2 of the Code, which is addressed to institutional shareholders and encourages them to enter into a dialogue with companies based on a mutual understanding of objectives and make considered use of their votes.

20. Overall, the Code is quite weak on shareholder engagement, both in Section 1, D 'Relations with Shareholders' and in Section 2, 'Institutional Shareholders'. In part it is the job of the chairman to ensure 'effective communication' with the shareholders (A.2 SP) and to maintain 'sufficient contact' with major shareholders (D.1 SP). On occasion, it is for the SID to be 'available to shareholders' (A.3.3) and he should meet with the major shareholders (D.1.1). Equally all the directors, as appropriate, should maintain 'sufficient contact' (D.1 SP). Section 2 addressed to institutional shareholders is, if anything, even weaker, save for the endorsement of the ISC Statement of Principles (E.1.SP), but otherwise the Code reverts to 'motherhood and apple pie' mode with gentle exhortations to enter into a dialogue, to attend AGMs, and to vote.

21. Much of the blame for a failure to build on this aspect of the Code lies with the shareholders – if they do not press for engagement, boards will be content to keep them at arms' length. One of the salutary lessons of the current crisis is that shareholder passivity (whether of retail or institutional shareholders) has had its day and new mechanisms must be devised to allow for greater shareholder engagement and indeed control of boards. As discussed earlier, much of the Code is of the 'motherhood and apple pie' variety and little further need be done with it in terms of

refinement or redrafting, but it may make sense to take the two key issues – risk management and shareholder engagement and look to devise new guidance in those distinct areas, whether within this Code (perhaps by incorporating Turnbull) or as stand alone Codes. The issue of shareholder engagement is one which requires a great deal of work to devise workable and effective schemes but considerable groundwork has already been done in other contexts (such as through the Institutional Shareholders Committee and the various Myners' reviews of voting impediments etc). Now would be a good time to draw these strands together into a more coherent framework (whether within the Code or as a separate Code) rather than leaving shareholder engagement to evolve randomly and erratically through individual initiatives.

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