

GENERAL

The Financial Reporting Council's current review of the Combined Code is seen as a laudable attempt to remain on the front foot in setting the corporate governance agenda. To head off unhelpful pressure for a rules-based system of governance, it is critically important to keep the Code under constant review and improvement.

The principle of comply or explain is seen to be working well and has, on the whole, stood the test of the downturn.

It is therefore no surprise that we had a positive response from everyone we approached for views.

Spencer Stuart spoke to approximately 20 chairmen of FTSE 250 companies; some at a breakfast workshop, others in individual conversations. In addition, we spoke to a number of institutional investor representatives and senior observers in finance and politics.

Their responses were generally to the point, though one or two people attributed wider powers to the FRC than it actually has. This can only be a sign of high expectations.

The consensus is that there is no case for a radical overhaul of the Combined Code. Nearly five years of use has at the same time exposed some areas that could be improved. These need to be fixed.

Respondents' remarks are summarised under the same headings used in your request for submission. We have made it clear where we have added our own comments to those of our respondents.

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ISSUES FOR COMMENT

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

The Code has been successful to date. Few compliant companies have failed and people generally feel that, with its early teething problems out of the way, the Code reinforces good management practice. The chairmen whose views we have taken are unanimously of the view that an increase in legislation would be retrograde for governance in the UK.

The unitary board structure (A1) with separation of chairman and CEO roles (A2) should be preserved at all costs, they said.

Our respondents noted a number of unhelpful comments by officials and commentators. They see no case for employee representation on boards. That would only dilute the board's focus and expertise. Equally, employing full-time non-executive directors would be a mistake; such a move would interfere with the division of responsibilities between the board and the executive (A2) and create ambiguity over director independence. These points should be uncontroversial.

It should be recognised that governance failure is just as likely to result from matters that cannot be codified (such as competency, boardroom behaviour, relationships and culture) as it is from weak processes. Most instances of governance failure would not have been prevented by a rules-based system. The intangible aspects of leadership, culture and board dynamics play a vital part in board effectiveness, in addition to ensuring that boards are fit for purpose, reinforcing the importance of rigorous recruitment and evaluation procedures (A6).

The enhanced role of senior independent director (A3.3) generally works well. Clarification would be helpful on two points: first, whether the SID can remain independent if appointed as the deputy chairman; and second, how the SID should be remunerated (B1.3), bearing in mind that the SID does not really come into his own until a crisis occurs, for all the backroom work he may undertake to prevent crises early. Is it appropriate to have wartime versus peacetime pay? During 'peacetime', the primary function of the SID is to review the chairman's performance (A1.3) annually and to monitor the relationship between the chairman and CEO. These are crucial, sensitive and difficult tasks. The capabilities required not should be underestimated.

Since board evaluations (A6) have become a regular part of the board calendar, their value has been widely recognised. However, there is inconsistency in how evaluations are conducted and in their ability to bring to the surface important issues. The Code might demand that more detail about the process and outcome of board evaluations be published (A6.1) in annual reports and recommend that external evaluations take place at least once every three years.

Informal meetings of non-execs, led by the senior independent director, were widely supported as a vital part of evaluating the chairman's performance (A1.3, A6.1).

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

While the objective of refreshing the board is a good one, it is nevertheless counter-productive for boards to lose long-serving independent directors who are more than capable of outstanding contributions. The challenges of recession have highlighted the value of an experienced independent director. Few current executives were in a position of responsibility the last time markets faced anything like their current trials – and so they need support from old hands all the more.

Some of our respondents believe that six years' service is too short a period for independent non-executives to find themselves "subject to particularly rigorous review" (A7.2). This wording inappropriately invites shareholder suspicion that non-executives cannot sustain independence after six years. The Code requires the board to state reasons for retaining the services of a non-executive director beyond the nine-year mark; as a result, almost all non-executives step down after nine years for fear of shareholder opposition (A3.1, A7.2). This frequently deprives boards of much-needed experience. For this reason, there may be scope for some flexibility on tenure in the Code's supporting principles.

Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?

Because of a perceived lack of diversity, efforts to increase the representation of women and ethnic minorities on boards of UK-listed companies should be encouraged, but probably not by the FRC.

We agree with the principle that appointments should be made on merit and against objective criteria, and we do not think that any form of quota system will result in better balanced boards. The Code should address the question of diversity broadly in terms of background, skills and international experience, and the balance of skills on the board (A4.2), rather than confining itself to gender or ethnicity. The key point is that boards should continually examine whether they are fit for purpose (A6.1, A7.2), because in so doing they will have to address the issue of diversity.

Nomination committees should probably ask to see a more diverse slate of candidates, though it is probably inappropriate for the Code to do more than encourage the general principle of diversity. Revealingly, the word diversity appears nowhere in the Code, the nearest wording being that boards should "maintain an appropriate balance of skills and experience within the company and on the board".

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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.

The principle is widely supported and seen as a competitive strength of UK governance. At the same time, it is the view of some chairmen that 'comply or explain' is not working as well as it should because shareholders tend to treat the Code's recommendations as binding and are not interested in explanations. This situation would be less likely if the Code required companies to provide more detailed explanations (Preamble, 5, 9, E2). There is scope for the Code to provide more guidance on what constitutes an acceptable explanation.

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CONTENT OF THE CODE

The composition and effectiveness of the board as a whole.

Every chairman should continually ask: is my board fit for purpose, with the right balance of skills? The Code could require companies to explain why their board is fit for purpose on an annual basis, or perhaps articulate the succession planning process laid out in A4.

We share our respondents' scepticism about the value of formal qualifications for non-executive directors. We believe that the general level of assimilation and training programmes (A5, A51, Schedule B, 2, (ii)) for directors could be improved.

Some respondents suggested that if companies were to provide a secretariat for non-executives, this would enhance the effectiveness of the board. Such a service, however, would clearly be too onerous for smaller companies to provide.

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

Culture has a greater impact on a board's effectiveness than rules. The chairman determines the boardroom culture and is therefore largely responsible for the effectiveness (or otherwise) of the board. Much depends on the chairman's ability to harness the knowledge, experience and judgment of non-executives and to oversee their constructive criticism. Although these skills are difficult to codify, the Code's definition of the chairman's role (A2) is seen by many as light. Some further elucidation of best practice would be valued.

While the Code is clear about the division of responsibilities and the avoidance of "unfettered powers of decision" (A2), further emphasis on the role of the senior independent director in monitoring the chairman/CEO axis would be valuable. Several respondents commented on the difficulties independent directors face when seeking to challenge a matter on which the chairman and CEO jointly agree.

The board's role in relation to risk management.

There is significant variation in the way boards approach risk management. The Code charges the audit committee with responsibility (C2) for supervising internal controls in the absence of a risk committee, but offers no guidance on best practice in risk management. The whole board should be involved in the *identification* of risk and concentrate on a limited number of risk factors; it should be the responsibility of a committee to *monitor* risk controls and ensure they are exercised properly.

Audit tends to be backward-looking, whereas risk is forward-looking. Our respondents believe there is a case for more financially complex companies to set up a separate committee whose sole function is to identify and monitor risk. This is a matter for individual boards to decide. Clearly, audit and/or risk committees should be especially alert to changes in risk profile, though again it is hard to see how the Code can make provision for that. Strategic risk analysis is as much a matter of creative thinking as

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science. A proper annual board evaluation would seek throw light on the quality of board-level risk management.

More clarity of thought is needed about what comprises risk. It is important to recognise that one cannot regulate risk management, since risk is a precondition of profit. However, the biggest risks are by definition invisible and often contingent upon the quality of the relationship between the chairman and CEO.

We think that it would be wise for the Code to clarify that the chairman of the audit committee does not necessarily need to have recent and relevant financial experience. Although C3.1 makes it clear that only one member of the committee needs to have this particular expertise, many companies default to insisting that the financial expert should be the chairman. In many instances, it may even be better for the financial expert to be someone other than the chairman, to help the committee make decisions guided by broad, commercially oriented thinking.

The role of the remuneration committee.

We believe that remuneration committees need to retain flexibility over executive pay (B2) and that transparency needs to be maintained at a high quality, to defuse any shareholder pressures to dilute remuneration committees' powers of discretion.

Consideration should be given to whether remuneration consultants (B2.1) need to be subjected to a governance code, as is being considered with the audit profession. A review of remuneration consultancy firms' governance may be helpful, some respondents have suggested. We are open-minded on this and feel that perhaps a discussion with the profession may suffice.

Some respondents suggested that if the remuneration committee undertakes some consultation with institutional shareholders in advance of remuneration being set, this should be declared in the annual report.

It would be useful for the Code to provide guidance on whether it is a good thing for non-executive directors to be paid largely or in part in shares, to be held for a significant period (Schedule A1). The Code is seen as rather brief and non-committal on direct equity payments for non-executives, although it is clearly and uncontroversially against share options.

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The quality of support and information available to the board and its committees.

Auditors should be encouraged to limit the technical language used in their reports and to express opinions in plain English. Perhaps this is best left to the audit committee when considering the reappointment of external auditors (C3.6).

The dialogue with institutional shareholders.

More critical engagement from institutional shareholders (E1) is needed, but it is clear that many lack resources to pay sufficient attention to individual investee companies. There is also a disconnect between institutions' compliance departments and fund managers.

This disconnect is counter-productive and a constant source of frustration to boards seeking a more constructive relationship with institutional shareholders. This is beyond the formal remit of the Code, but it is, all the same, interesting to note that several respondents called for ways for compliance officers and fund managers to work more closely together. It is a matter, clearly, on which the FRC has informal influence.

A number of people commented on how the increasing heterogeneity of the shareholder base makes engagement more complex for major institutions. Although traditional institutional funds remain the core of major shareholder registers, their share is contracting.

Some respondents controversially suggested that institutional shareholders should play a key role in ensuring that boards have the right people in place. However, we can see no advantage in undoing the power of the nomination committee.

Additional comment

There was much support for Sir David Walker's review of Corporate Governance of the UK Banking Industry. Special provisions are clearly needed for banks, so long as they are compatible with the Combined Code. Respondents assumed that the cooperation between the FRC and Walker reviews is close.

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