

Averting the overprescription of UK corporate governance norms

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ABSTRACT

This paper examines the continuing practical relevance of the 'comply or explain' doctrine underlying the UK's Combined Code on Corporate Governance. In particular, it assesses whether the progressive growth in detail and rigidity of some of the Code's key principles and provisions over recent years has undermined the characteristic flexibility of this self-regulatory, market-enforced body of norms. The analysis concentrates primarily on Principle A.2 of the Code, which regulates the division of leadership responsibilities (DoLR) between the company's chairman and chief executive officer (CEO). The application of this Prin-

iple is illustrated with reference to the recent case of the British retailer Marks & Spencer plc (M&S), the decision of which to promote its current CEO, Sir Stuart Rose, to the dual office of executive chairman effective from 2008 onwards was met with widespread investor hostility. It is submitted that the M&S fallout highlights the potential for intractable 'clashes' to occur between equally ranking Code Principles, and that such clashes are a source of costly and potentially divisive confusion for investors and boards alike. The paper highlights the need to identify a unifying macro-Principle of the Code as an objective yardstick for settling conflict between Code norms. It also assesses recent reforms to the Code and UK Listing Rules implemented, respectively, by the Financial Reporting Council (FRC) and Financial Services Authority (FSA), which were aimed at enhancing the Code's flexibility and mitigating the recent tendency towards 'overprescription' of its key governance principles. It will be concluded that, while these reforms represent a moderate step in the right direction towards combating the compliance difficulties faced by investors and boards, a more fundamental reconfiguration of the Code's structure is ultimately called for.

Keywords: UK corporate governance; Combined Code; flexibility; board leadership; investor relations; regulatory structure



INTRODUCTION

In a recent document produced by the UK Financial Reporting Council (FRC) as part of the ‘City of London — City of Learning’ initiative, it was recounted that the City of London *‘has a history of encouraging free trade and good corporate governance, based on the application of simple principles to the individual and distinct circumstances of each entity’*.¹ By strongly resisting the governmental temptation to control for every conceivable contingency, while relying on capital market participants themselves to formulate and police the ‘rules of the game’ in their collective self-interest, the UK is widely regarded to offer an effective, yet relatively costless, framework of quasi-legal controls in respect of crucial business and financial issues.

One of the linchpins of this celebrated ‘London approach’ to regulation is the Combined Code on Corporate Governance, which has underpinned the UK’s characteristic self-regulatory system of corporate governance since its inception (in an earlier form) at the beginning of the 1990s. In contrast to the formal, extensive and detailed catalogue of governance rules imposed on US-listed companies under the Sarbanes–Oxley Act of 2002, the UK has succeeded in preserving a set of corporate governance norms that are not legally binding in form, relatively broad-based in substance and readily comprehensible by boards without the need for extensive professional assistance.

Arguably, the most crucial factor underlying the Combined Code’s comparative advantage in the above regards is the doctrine of ‘comply or explain’, by virtue of which UK-listed companies are exempted from the need to adopt a prescriptive ‘one size fits all’ model of internal organisational control. In spite of the generally positive reception that this concept has received within both the investor

and directorial communities in the UK over the past decade and a half, however, some serious doubts remain as to whether the central promise of the ‘comply or explain’ principle — namely, its purported capacity to ensure an efficient balance between (a) ensuring governance best practice and (b) nurturing managerial flexibility and diversity — is being effectively achieved in practice. This issue will be the main focus of the paper.

A SHORT HISTORY OF THE ‘COMPLY OR EXPLAIN’ DOCTRINE

The principle of ‘comply or explain’ was pioneered by the Cadbury Committee in its landmark 1992 *Report on the Financial Aspects of Corporate Governance*.² As the basis for its inaugural Code of Best Practice on governance, the Cadbury Report proposed a system of voluntary compliance by corporate boards with certain recommended norms of ‘best practice’, backed up by a mandatory disclosure requirement that would be contained in the Listing Rules of the London Stock Exchange.

All listed companies registered in the UK were accordingly urged to comply with the Code’s initial 19 provisions covering the four overarching (and overlapping) issues of the board of directors, non-executive directors, executive directors, and reporting and controls. In respect of each relevant company, the board was required to make a statement about the firm’s compliance with the Code as part of its annual directors’ report and, in the event of non-compliance with any one or more provisions, to provide supporting reasons. Meanwhile, institutional shareholders and/or their professional advisers were encouraged to use their ownership influence to pressurise companies towards compliance with the Code’s provisions.

This novel ‘soft’ approach was justified on the basis that a mandatory and legalistic set of standards would be likely to encourage a perfunctory form of compliance by companies with the ‘minimum standard’, whereby boards and their legal advisers would aim to satisfy the strict letter of the law while nevertheless negating the Committee’s key policy goals.³ The Committee was also very keen to enable a degree of ‘flexibility in implementation’ of the Code.⁴ Accordingly, the Cadbury Report recommended that ‘[t]he Code [should] be followed by individuals and companies in the light of their own specific circumstances . . . and in interpreting it they should give preference to substance over form’.⁵

When Cadbury’s recommendations underwent their first comprehensive review in 1998, the over-riding concern of Sir Ronnie Hampel’s review committee was ‘the need to restrict the regulatory burden on companies, and to substitute principles for detail wherever possible’.⁶ This necessitated a reconfiguration of the balance that had hitherto been achieved between the dual criteria of compliance and flexibility, with Hampel recommending an increased emphasis on the latter goal and a correspondingly reduced focus by boards on ensuring ‘blind’ compliance with the Code, absent proper regard for the peculiar circumstances of the relevant company. As the Committee explained:

Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. There is a need for broad principles. All concerned should then apply these flexibly and with common sense to the varying circumstances of individual companies.⁷

To this end, the Hampel Committee recommended a significant change in the

process whereby companies report to shareholders and the public on their record of compliance (or otherwise) with the Code’s Provisions, together with a complementary alteration to the Code’s underlying structure, both of which were subsequently adopted within the first Combined Code on Corporate Governance in 2000.⁸

On the basis of Hampel’s suggestions, the Code was divided into two different, but adjoining, levels of prescription, comprising 17 relatively open-ended Principles, supplemented by a larger number of more detailed explanatory Provisions. Companies were subsequently required by Listing Rules to produce a two-part corporate governance statement in their annual reports and accounts, explaining, firstly, in broad and narrative terms, how they *apply* the higher-level Principles of the Code, detailing the particular governance policies that the board has adopted in order to implement those Principles within the specific and current circumstances of the company’s business,⁹ and secondly, whether the company *complies* with all of the more specific lower-level Provisions of the Code, together with supporting reasons in the event of non-compliance with any one or more of those Provisions.¹⁰

In the more recent editions of the Code that followed the publication of the Higgs and Smith reports in 2003, the compliance task has been further complicated with the insertion of a third layer of norms into the Code’s basic regulatory structure.¹¹ As a result, boards are today faced with a three-pronged structure of high-level Main Principles, mid-level Supporting Principles and low-level Provisions. Curiously, the Code contains no express guidance on the precise interaction between these three levels of norm, besides simply reiterating the continuing Listing requirement for

companies to explain how they apply the first category of norms, together with their record of compliance or otherwise with the final category. The rather open-textured wording of the Supporting Principles, however, would suggest that they are of purely illustrative value in relation to each of the Code's Main Principles.

Since its inception in Sir Adrian Cadbury's landmark recommendations 16 years ago, the 'comply or explain' doctrine has been exported from the UK to provide a basis for numerous other countries' corporate governance systems, including those of Australia, Canada, Mexico, the Netherlands, Singapore, and, to a very limited extent, even the USA.¹² More recently, the concept has been adopted as a basis for fledgling programmes of self-regulation by financial industry bodies both in the UK and beyond, including the Walker Committee's influential *Guidelines on Disclosure and Transparency in the UK Private Equity Sector*, and also the newly established Hedge Fund Working Group's report on standards of best practice for hedge funds.

Overall, then, it suffices to say that the Cadbury Committee's brainchild of 'comply or explain' has come a long way within its relatively short existence.

THE DIVISION OF LEADERSHIP RESPONSIBILITIES (DOLR) AND THE PROBLEM OF 'OVERPRESCRIPTION'

One of the most common criticisms levelled at the Combined Code over recent years is the charge that it has become too detailed and prescriptive in form. In particular, there is a view that the 2003 revisions to the Code suggested by the Higgs Committee on the role and responsibilities of non-executive directors (NEDs)¹³ represented an unjustified 'knee

jerk' reaction to some well-publicised supervisory failures in US and continental European firms. This arguably had the effect of increasing the prescriptiveness and rigidity of the Code at the expense of its characteristic flexibility. One critic, for example, has argued that Higgs '*introduced so many requirements that it is simply legislation by the back door*',¹⁴ while others have described recent developments in UK corporate governance in terms of a process of 'regulatory creep', whereby improvements in governance occasioned by codes encourages people to broaden their scope and also increase their level of detail.¹⁵

A notable example of this process of 'regulatory creep' in action can be observed in relation to the controversial Code Provision on the separation of the respective offices of the company's chairman and CEO. The Cadbury Committee, in 1992, recommended that '*the chairman's role ... should in principle be separate from that of the chief executive*'.¹⁶ To this end, Cadbury's Code of Best Practice provided that '[t]here should be a clearly accepted division of responsibilities at the head of the company, which will ensure that no one individual has unfettered powers of decision'.¹⁷ The Code further provided that, in those cases '[w]here the chairman is also the chief executive, it is essential there should be a strong and independent element on the board, with a recognised senior member'.¹⁸ Cadbury stopped short of laying down any definite requirement as to separation of the chairman and CEO positions, however, leaving the decision ultimately up to boards themselves in the light of the company's specific circumstances and strategic challenges.

In a similar vein, the Hampel Committee in 1998 opined that, '*other things being equal, the roles of chairman and chief executive officer are better kept separate*', although the Committee acknowledged that '*a number of companies have combined the two roles [of chairman and CEO]*

successfully, either permanently or for a time'.¹⁹ While the ensuing 2000 version of the Combined Code emphasised that '*the running of the board*' and '*the running of the company's business*' were the '*two key tasks at the top of every public company*',²⁰ the Code stopped short of recommending that these functions should, as a rule, each be performed by separate officers. In fact, the only seemingly absolute expectations of boards in this regard established in the 2000 Code were that they:

- (a) *publicly justify* any decision to combine the chairman and CEO positions in one person; and
- (b) ensure that they contain a robust independent non-executive element, in particular by appointing a special senior NED to act as the focal point for NEDs' concerns in respect of the combined chairman/CEO office and its consequences for the board.²¹

In spite of the somewhat ambivalent tone of Cadbury and Hampel's recommendations on the issue of the chairman/CEO split, the committees' basic affirmative view on the matter nevertheless quickly became recognised as a highly influential tenet of British corporate governance best practice. From a study of 250 randomly selected UK-listed companies conducted between 1998 and 1993, Franks, Mayer and Renneboog discovered that the chairman/CEO roles were combined in 32 per cent of firms.²² But a further study by Conyon and Mallin found that, just two years after Cadbury's initial recommendations (in 1994), this figure had been reduced to 14.2 per cent.²³ Moreover, later data presented by MacNeil and Li showed that, in 2004, only 8 per cent of FTSE All Share companies (excluding investment trusts) were recorded as combining the two offices.²⁴

The general success of these early

recommendations in engendering near-universal separation of the chairman/CEO functions on listed company boards did not, however, discourage the Higgs Committee from asserting a notably more resolute line on the matter in the 2003 version of the Code, the relevant part of which has subsequently been adopted full-scale in the 2006 and (current) 2008 versions.²⁵ Main Principle A.2 of the current Code, which deals with the issue of the chairman and CEO, represents a progression from its post-Hampel predecessor in so far as it now demands 'a clear division' between the dual responsibilities of board and executive leadership, as opposed to Hampel's softer requirement that any lack of such division be supported merely by a reasoned justification plus effective 'back-up' arrangements. Supporting Principle A.2, meanwhile, affirms this basic position by offering a brief description of the chairman's specialist responsibilities in the former of those regards.

The most definite assertion of the 'division of leadership responsibilities' (DoLR) doctrine, however, is Code Provision A.2.1, which states in no uncertain terms that '*[t]he roles of chairman and chief executive should not be exercised by the same individual*', and that '*[t]he division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board*'. Code Provision A.2.2 firmly establishes, moreover, that '*[a] chief executive should not go on to be chairman of the same company*'. The only slight degree of leeway for boards on this issue is provided by the latter of those Provisions, which stipulates that:

If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set

out its reasons to shareholders at the time of appointment and in the next annual report.

THE MARKS & SPENCER 'FALLOUT'

The Higgs Committee's decision in 2003 to place the DoLR doctrine on a firmer prescriptive footing within the Code is understandable, given that its review was commissioned in the imminent wake of the Enron and WorldCom catastrophes in the USA, when considerations of managerial accountability and NEDs' supervisory capabilities were cast starkly into the public and political eye. Nevertheless, the specific degree of weight that should be afforded to the DoLR doctrine, relative to other Code norms and also to any extraordinary firm-specific circumstances, has become a live issue of public debate following the recent investor furore surrounding the promotion of Marks & Spencer plc (M&S) CEO Sir Stuart Rose to the dual position of the company's executive chairman.

M&S first publicly announced its decision in this regard on 10th March, 2008, after which the company's then-chairman, Lord Burns, compiled a ten-page letter to the company's major institutional shareholders outlining the board's reasons for adopting this unusual governance policy.²⁶ In his letter, Lord Burns explained that, because no single member of the M&S board at that time had been with the company prior to the high-profile boardroom 'clearout' carried out in 2004, both the nomination committee and general board were of the opinion that there was no viable internal candidate currently equipped to take over the CEO position and that it was therefore '*felt important to be able to create an environment in which internal candidates could develop over a defined period of time*'. Lord Burns further explained that, while the possibility of the

company recruiting an external candidate for the office had also been considered, the board's conclusion was that during the present tumultuous trading environment this '*was likely to be a damaging and unwelcome distraction at precisely the time that the business needed clear leadership to sustain its recovery and transformation*'.

At the same time, aware that this course of action entailed deviation from Principle A.2 of the Combined Code, Lord Burns set out a list of 'balancing controls', which he claimed would '*mitigate the governance concerns that [a joint chairman-CEO] structure might otherwise engender*', including (*inter alia*):

- (a) promoting the company's then-present senior NED, Sir David Michels, to the position of non-executive deputy chairman, in which capacity:

He will chair the Nomination Committee, provide leadership for the Independent Directors, be responsible for monitoring Board Effectiveness and lead on Corporate Governance issues;

- (b) creating a new senior executive position of group finance and operations director (to be filled by then-present executive director Ian Dyson) in order to reallocate a significant number of the executive chairman's previous day-to-day CEO responsibilities, thereby enabling Sir Stuart Rose '*to concentrate on the strategic growth areas of the business*';
- (c) rendering Sir Stuart Rose's three-year tenure as executive chairman conditional upon annual shareholder reappointment by way of a resolution to be passed at each subsequent annual general meeting (AGM) of the company; and

(d) ensuring that the proposed new arrangement was only a '*transitional governance structure leading to appointment of a new Chairman and Chief Executive by Summer 2011*'.

Although a small number of M&S' institutional shareholders, such as Invesco Perpetual and Standard Life, publicly supported the board's unorthodox policy in this regard,²⁷ the overall air of investor opinion in the press was one of hostility. In some instances, this negative reaction was understandable, such as Legal & General's claim to have been given only one hour's notice of the company's decision prior to its official public announcement, despite Combined Code Provision A.2 clearly requiring that the board consult the company's major shareholders in advance of any definite decision to amalgamate the CEO and chairman positions.²⁸

In other instances, however, the basis for investors' antagonism with M&S' board was not so clearly comprehensible and, arguably, suggested a fundamental misunderstanding from some quarters of the precise normative status of the Code. For example, Peter Chambers, chief executive of Legal & General Investment Management, was recorded in *The Times* newspaper as saying:

We believe we have a moral responsibility to uphold corporate ethics in the UK and believe bellwether companies share this responsibility. We don't believe M&S should be explaining why they are not complying. They should be complying.²⁹

In a similar tone, Schroder's head of UK equities Richard Buxton reportedly accused the company of setting 'an appalling example'³⁰ on corporate governance by promoting its CEO in this way,

despite M&S' board having undertaken to provide a detailed written account to shareholders of its reasons for adopting this unorthodox policy.

A CLASH OF CODE PRINCIPLES

While the basic proprietary entitlement of shareholders to form their own conclusions in respect of controversial governance matters should ultimately be respected, there is the risk that an overly conservative approach by investors towards policing compliance with the Code might pressurise boards to forego potentially value-adding 'alternative' governance structures in favour of an inappropriate 'one size fits all' model.³¹ Indeed, the Preface to the 2006 edition of the Combined Code³² emphasises that:

Whilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not automatically be treated as breaches.

Rather, '*institutional shareholders should carefully consider explanations given for departure from the Code and make reasoned judgements in each case*'.³³

Even on the assumption, however, that shareholders *are* prepared to evaluate carefully a company's explanation for deviating from any Code provision and make reasoned judgements thereon,³⁴ there remains doubt as to the precise 'high-level' considerations that should guide shareholders' deliberations in this regard. In the M&S case, for example, Lord Burns amplified in his letter to shareholders that '*the Board has taken what it believes is the best decision for shareholders, cogniscent of its prime objective to ensure the Company's ongoing commercial success*'.³⁵

This point is expanded on by M&S' board in its annual Corporate Governance Statement for 2008, in which it explains in further detail how the new management structure will be conducive to stable and effective leadership for the ultimate benefit of the company and its shareholders.³⁶ The difficulty, however, is that while the board is correct to recognise that promoting the long-term success of the company for the benefit of its shareholders is the board's overriding positive legal duty as directors,³⁷ the criterion of 'corporate success' is not actually reflected at any point in the relevant Code Principle (A.2) pertaining to the specific issue of division of leadership responsibilities.

The only reference in the Code to the 'corporate success' criterion appears in Principle A.1, which deals with the separate (albeit not unrelated) issue of board leadership. Main Principle A.1 states that '[e]very company should be headed by an effective board, which is collectively responsible for the success of the company'. Supporting Principle A.1, meanwhile, expands on this by explaining that the board's overall role 'is to provide entrepreneurial leadership of the company'. In explaining how it had applied this Principle in the context of its proposed restructuring plan, M&S' board stated that '[t]he new structure will ensure continuity of leadership, strengthen the Board and streamline the organisation', thereby 'focus[ing] everyone on business performance during a period of significant trading uncertainty' while also 'address[ing] investor concerns over succession'.³⁸

In contrast to Principle A.1's dynamic 'leadership' doctrine and its annex to the projected commercial benefit of the company, however, Principle A.2 is markedly more 'static' in form. Under Main Principle A.2, the division of leadership responsibilities at the top of the

company is clearly established as a worthy 'end' of the Code in its own right, regardless of any wider strategic factors that may justify temporarily sacrificing separate board *vis-à-vis* business leadership in favour of achieving concentrated entrepreneurial direction of the firm. In other words, rather than being merely a procedural means towards the ultimate substantive end of ensuring effective board leadership and resultant corporate success, the DoLR doctrine is established by the Code as an independent policy goal of British corporate governance in *itself*. It is therefore questionable to what extent the M&S board's reasoned reference to '*the Company's ongoing commercial success*' provided a truly valid justification for eliding separation of its chairman and CEO functions, because, according to the strict logic of the Code, this ultimately entailed the board deploying one independent policy goal of the Code (effective leadership) to defend its non-fulfilment of another, *equally highly ranking* goal (division of leadership responsibilities).

In justifying non-compliance with Code Provision A.2.1 in its annual Corporate Governance Statement, meanwhile, M&S' board cited the proposed 'back-up' arrangement detailed in Lord Burns' earlier letter, most notably including the creation of a new non-executive deputy chairmanship position to provide an effective 'check' on the executive chairman's power.³⁹ It is questionable, however, whether, even in this respect, the board referenced a criterion of relevance to Principle A.2's DoLR doctrine, because, strictly speaking, the deputy chairman constitutes a senior independent director and therefore falls to be covered under the rubric of the separate Code Principle A.3 on the issue of board balance and independence. Main Principle A.3 provides that:

The board should include a balance of executive and non-executive directors (and in particular non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.

To this end, Code Provision A.3.3 requires the board to nominate one of the independent NEDs to act as a senior independent director, echoing the previous requirements in this regard that followed the Cadbury and Hampel reports.⁴⁰

In view of the fact that M&S' creation of the deputy chairmanship position was achieved by promoting the company's existing senior independent director (Sir David Michels) to this functionally more senior position, while retaining (and, moreover, strengthening) his status as the premier non-executive member of the board (outside the chairman), it would appear that, for the purposes of the Code, he should continue to be formally treated as the company's de facto senior NED. Consequently, the strengthening of Sir David Michels' boardroom influence under the reorganisation should be treated primarily as a factor relevant to the achievement of boardroom balance and independence for the purposes of Principle A.3.

On the other hand, this criterion is formally *of no direct relevance* to the attainment of an effective division of leadership responsibilities for the purposes of Principle A.2, given that the role of deputy chairman is not a leadership position in the strict sense of the term.

Therefore, even though the issue of board balance and independence is by no means far removed from that of DoLR, we once again witness a collision of equal-raking Code Principles. In this case, the achievement of a balance of executive and non-executive influence on the

board (as required by Principle A.3) is effectively cited as a 'defence' to the 'charge' of failing to comply with Principle A.2's DoLR norm. Further, because M&S's board felt the need to explain Sir David Michels' appointment at three separate points in its annual corporate governance statement in view of the perceived relevance of this criterion to each of the Code's first three Principles (A.1-A.3),⁴¹ there resulted an inevitable degree of repetition of material that arguably diminished the intended narrative flow of the document.

THE NEED FOR A 'MACRO PRINCIPLE' IN THE CODE

Although the recent approval by M&S' shareholders of the above reorganisation plans at the company's 2008 AGM has put an end to this issue for the time being,⁴² the above points are by no means only of academic interest. On the contrary, they highlight continuing problems with the drafting of the Code and, in particular, its arguably excessive level of prescription in the above respects. As the M&S case succinctly illustrates, this is a source of uncertainty not only for boards themselves in compiling effective and relevant explanations for non-compliance with any Code provision(s), but also for investors and their corporate governance advisers. The latter group are increasingly faced with the need to make difficult and uncertain judgements on the basis of necessarily limited information, equipped with a collection of confusing and, at times, contradictory yardsticks in the Code as to what constitutes a 'good' governance structure.

It is submitted that, in this context, there is a need for the UK's corporate governance regulatory body, the Financial Reporting Council (FRC), to establish a unifying 'macro principle' of the Com-

bined Code, which might provide an objective basis upon which both boards and investors can evaluate and 'grade' conflicting Code norms in the event that a proposed governance policy puts one or more Main Principles into conflict with one another. 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 a lessening of 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.⁴³

Interestingly, the FRC has very recently implemented a moderate change to the Code along the above lines as a product of its 2007 Review of Code's operation.⁴⁴ This was in response to concerns voiced by investor groups as to the general level of detail in the Code today, and the consequent bureaucratic burden that the compliance process has come to entail for investors and boards alike.⁴⁵ In particular, the FRC acknowledged, in its Review, a number of requests from respondents for it to '*emphasise that the primary objective of the Code is to support the board in providing entrepreneurial leadership of the company*'.⁴⁶ The latest 2008 edition of the Code accordingly contains a revised and more detailed Preamble, which begins by amplifying the following two key considerations:

Good corporate governance should contribute to better company performance by helping a board discharge

its duties in the best interests of shareholders ...

Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term.⁴⁷

The new Preamble further makes clear that '[t]he Code is not a rigid set of rules', but rather is '*a guide to the components of good board practice distilled from consultation and widespread experience over many years*'.⁴⁸ It is therefore '*recognised that non-compliance may be justified in particular circumstances if good governance can be achieved by other means*'.⁴⁹

THE SIMPLIFICATION OF CORPORATE GOVERNANCE STATEMENTS UNDER FSA LISTING RULE REFORM

In its recent Review, the FRC acknowledged further comments from some respondents as to the arguably excessive reporting demands entailed by the dual 'appliance' and 'compliance' dimensions of the corporate governance statement. In particular, submissions were received to the effect that:

the requirement in the Listing Rules for boards to state how they have applied the Code's principles (as well as how they have complied or explained with its provisions) was adding unnecessarily to the 'boilerplate' disclosures because it 'is often interpreted as a requirement to explain how all 60+ elements of the Main and Supporting principles are applied'.⁵⁰

It was observed that, partly as a result of this, many companies were copying the same material in their corporate

governance statements on a year-on-year basis with little regard to whether the discussion therein referenced factors of relevance to the company's current situation.⁵¹

In so far as the corporate governance reporting obligation stems not from any provision of the Code itself, but rather from the Listing Rules of the London Stock Exchange, it falls outside of the FRC's jurisdiction and instead within the remit of the Financial Services Authority (FSA) as the UK's Listing Authority. The FSA has, however, recently taken it upon itself to tackle this issue within the purview of its implementation of EU Directive 2006/46/EC on company reporting. In essence, the Directive inserts a new Article 46a into the existing EU Fourth Company Law Directive, requiring all companies the securities of which are admitted to trading on a regulated market in the EU to (*inter alia*) publish an annual corporate governance statement similar in key respects to that which listed UK companies are currently expected to produce by virtue of Listing Rule 9.8.6 (5)–(6).⁵²

Because, in relation to listed UK companies at least, the new European rule effectively 'gold plates' the existing domestic requirement for a company to publish an explanatory statement in respect of its compliance (or otherwise) with the Combined Code, the FSA has provided that a British company that complies with its current listing obligation in this regard will be treated as *immediately satisfying* the corresponding EU requirement.⁵³ But the EU-wide 'comply or explain' rule is, from a substantive perspective at least, not as wide as that of its UK counterpart in so far as the European rule requires only that a company discloses:

(a) the particular corporate governance code to which it is subject;

(b) the extent to which it complies with the provisions of that code; and
(c) any reasons for non-compliance with those provisions.

Unlike the UK requirement, however, the EU rule does not demand the publication of a further narrative 'appliance' statement detailing the company's policy in relation to application of the relevant code's provisions as a whole.

Accordingly the FSA, in formulating its policy for implementation of the Directive's requirement in respect of the corporate governance statement, expressly considered removing the much-criticised 'appliance' aspect of the domestic governance disclosure rule. This was for the dual purpose of bringing the UK regime into line with the basic standard applicable across the Community as a whole, while at the same time responding to the aforementioned concerns raised by respondents to the recent FRC Review about the tendency for 'boiler-plating' of companies' appliance statements.⁵⁴

The FSA's final view on the matter was that it should retain the dual appliance and compliance components to the disclosure obligation, but that Listing Rule 9.8.6(5) should be slightly altered so as to provide 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, as opposed to the Provisions of this part in general, as was the previously understood position under the Rule.⁵⁵ Listing Rule 9.8.6(5) has since been altered accordingly.⁵⁶

EVALUATING THE FRC AND FSA'S RESPECTIVE RESPONSES TO THE PROBLEM OF OVERPRESCRIPTION

The aforementioned preliminary statements contained in the revised Preface to

the 2008 edition of the Code⁵⁷ together represent an undoubtedly constructive addition, and should go at least some way towards improving the quality and commonality of dialogue between boards and investors in cases of strategic non-compliance. There is nevertheless some cause for scepticism as to how effective this change will prove on its own, absent any more thoroughgoing alteration of the relative weighting of the Code's intrinsic Principles.

The FRC notably also points out, in its revised Preamble to the 2008 edition of the Code, that if a board chooses not to comply with any of the Code's particular Provisions, it *'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'*.⁵⁸ 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 the DoLR doctrine in Principle A.2). If followed literally by boards and their governance advisers, this particular statement would therefore appear to contradict (and hence undermine) the general policy impetus of the new Preamble, 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, M&S' temporary executive/deputy chairman leadership structure is arguably a means of securing *'efficient, effective and entrepreneurial manage-*

ment',⁵⁹ and this *in itself* is therefore a potentially acceptable justification for adopting such an orthodox arrangement. But 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.

Likewise, the FSA's recent simplification of the 'appliance' aspect of the annual corporate governance statement under Listing Rule 9.8.6(5)⁶⁰ will not resolve the aforementioned difficulty of 'grading' conflicting Principles in the event of clash. It will undoubtedly, however, give boards greater discursive 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. As such, it should be welcomed as a constructive, albeit incomplete, move in the direction of enhancing the characteristic flexibility of the Code's application, which should, in turn, help to mitigate the recent tendency towards the overprescription of its key governance Principles.

CONCLUSION

Of course, only time will tell whether the FRC and FSA's moderate reforms have the intended effect of giving boards greater confidence to opt for reasoned non-compliance in cases in which they can present a convincing strategic argument to shareholders for doing so. In the opinion of the author, this outcome is unlikely for the reasons explained above.

In any event, it befalls the FRC to give serious thought to the feasibility of implementing a more fundamental alteration of the Code along these lines during its next planned Review process in 2010.

In particular, the FRC should consider elevating the grading of Principle A.1 (board leadership) relative to Principles A.2 and A.3 (DoLR, 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 discursive freedom to produce a comprehensive economic case for temporarily deviating from a standard leadership structure. Far from undermining managerial accountability, this will provide boards with a greater incentive to take their company's annual governance statement seriously, instead of viewing it as a mere bureaucratic inconvenience bearing little relevance to the company's 'real' business affairs.

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- (2) Cadbury Committee (1992) *Report of the Committee on the Financial Aspects of Corporate Governance*, December ('the Cadbury Report').
- (3) *Ibid*, para. 1.10.
- (4) *Ibid*.
- (5) *Ibid*, para. 3.10.
- (6) Hempel Committee (1998) *Committee on Corporate Governance (Final Report)*, January, ('the Hempel Report'), para. 1.6.
- (7) *Ibid*, para. 1.11.
- (8) FRC (2000) *The Combined Code: Principles of Best Practice and Code of Best Practice*, May.
- (9) Although the Preamble to the most recent (2008) edition of the Code confirms existing common board practice by providing that, where a company is fully compliant with the Code's Provisions, it need only report the fact of full compliance in its annual corporate governance statement (para. 4). See *infra*, n 11.
- (10) This dual disclosure requirement is today laid down by Listing Rule 9.8.6 (5)–(6), which is contained in the official Handbook of the UK Listing Authority, the Financial Services Authority.
- (11) The most recent edition of the Combined Code was published by the UK Financial Reporting Council (FRC) in June 2008. It can be downloaded from the FRC's website at: www.frc.co.uk/corporate/combinedcode.cfm. The two preceding editions were published in 2003 and 2006 respectively.
- (12) Coombes, P. and Wong, S. (2004) 'Why codes of governance work', 2 *The McKinsey Quarterly*, 48, 51.
- (13) Higgs Committee (2003) *The Higgs Report: Review of the Role and Effectiveness of Non-Executive Directors*, January.
- (14) Arthur Piper (internal auditor), cited in Arcot, S. R. and Bruno, V. G. (2006) *In Letter but not in Spirit: An Analysis of Corporate Governance in the UK*, Working Paper, London School of Economics, p. 35 (fn. 9).
- (15) Coombes & Wong, *supra*, n. 11, 52.
- (16) Cadbury, *supra*, n. 2, para. 4.9.
- (17) *Ibid*, para. 1.2.
- (18) *Ibid*.
- (19) Hampel, *supra*, n. 6, para. 3.17.
- (20) Combined Code (2000), *supra*, n. 8, Principle A.2.
- (21) *Ibid*, Code Provision A.2.1. The Hampel Report, in fact, went further than this and recommended that a senior NED should be identified in a company's annual report in any event, both for those companies that split the

- chairman/CEO positions and those that did not: see Hampel, *supra*, n. 6, para. 4.5.
- (22) Franks, J., Mayer, C. and Renneboog, L. (1998) 'Who disciplines bad management?', cited in Mayer, C. (2000) 'Corporate governance in the UK' in *Corporate Governance and the Reform of Company Law*, Hume Papers on Public Policy, 8(1), 1–9, at 5.
- (23) Conyon, M. and Mallin, C. (1997) 'A review of compliance with Cadbury', 2 *Journal of General Management* 24, cited in Mayer, *Ibid.*
- (24) MacNeil, I. and Li, X. (2006) 'Comply or explain': market discipline and non-compliance with the Combined Code', 14 *Corporate Governance* 486, 489, drawn from data collected by PIRC in its *Corporate Governance Annual Review 2004*.
- (25) See *supra*, n. 11.
- (26) See M&S (2008) *Letter to Shareholders re Management Changes*, 3rd April, available online at <http://corporate.marksandspencer.com>.
- (27) Invesco Perpetual's head of equities Neil Woodford claimed that '[i]t is entirely appropriate for the M&S board to have taken the decision they have reached with regard to Stuart Rose', in that '[i]t is especially important to create an executive structure that maintains Stuart's leadership of the business but that also enables him to bring on successor talent such that at the appropriate time he can step down': *Drapers Record* (2008) 'M&S makes concession to appease shareholders', 3rd April.
- (28) Although the board afterwards justified this deviation from proper Code procedure in its annual Corporate Governance Statement for 2008 on grounds of the risk of potential press leaks resulting from such private consultations. The statement is available online at http://corporate.marksandspencer.com/documents/specific/investors/governance/governance_statement.pdf.
- (29) *The Times* (2008) 'Investor outcry smothers hope of pay rise for Rose in dual role at M&S', 31st March.
- (30) *The Times* (2008) 'M&S says it had to raise Rose to executive chairman role', 4th April.
- (31) Arcot and Bruno have recently put forth a convincing academic argument to the effect that '[c]ompanies, which have carefully thought about the application of the Code to their specific circumstances, are more likely to provide better explanations of their choice and are thus likely to be well-governed, which is reflected in their performance' (at 4). Based on a wide data sample of UK-listed companies between 1998 and 2004, the authors found that firms departing from the Code for genuine and valid reasons attained significantly better operating performance not only relative to those that failed to comply for an invalid, or no reason, but also in comparison to the fully compliant companies in the sample. See Arcot, S. R. and Bruno, V.G. (2007) *One Size Does Not Fit All, After All: Evidence from Corporate Governance*, Working Paper, London School of Economics, esp. pp. 18–19.
- (32) This was the relevant edition of the Code in operation for most of the period of the M&S affair.
- (33) This important statement is almost wholly reproduced in the revised Preface to the current 2008 edition of the Code, on which see *infra*, nn. 47–9 and accompanying text.
- (34) This assumption is, admittedly, somewhat tenuous. A recent academic study highlighted the fact that, while there was a marked and continual increase in the percentage of companies complying fully with the relevant Code provisions (from 10 per cent in 1998–99 to 56 per cent in 2003–04), and the vast majority (70 per cent) of non-compliances were supported by some kind of explanation, there were nonetheless significant problems with the quality of explanations provided for non-compliance. In particular, the study

- highlighted the widespread use of perfunctory and unimaginative explanations for non-compliance, which failed adequately to reference the specific circumstances of the company. See Arcot and Bruno (2006), *supra*, n. 14.
- (35) *Letter to Shareholders*, *supra*, n. 26.
- (36) *Supra*, n. 28.
- (37) By virtue of their statutory duty of loyalty under s. 172 of the Companies Act 2006.
- (38) M&S Corporate Governance Statement 2008, *supra*, n. 28.
- (39) See *supra*, n. 28.
- (40) On which, see *supra*, nn. 18 and 21 (and accompanying text).
- (41) See *supra*, n. 28.
- (42) On the other hand, the fact that 22 per cent of M&S' voting shareholder base either abstained from voting on, or else actively opposed, the resolution to appoint Sir Stuart Rose to the office of executive chairman demonstrates the continuing high level of investor hostility in relation to this issue. See *Financial Times* (2008) 'M&S shareholders give Sir Stuart dressing down in promotion vote', 10th July.
- (43) Indeed, one notable factor conducive to a 'tick box' mentality in regard to Code compliance by investors and companies is the potential for differing estimations by these two groups of the likely costs of compliance with any particular Code provision. As MacNeil and Li explain: 'A high cost of compliance may well create an expectation within a company that investors would regard non-compliance as justified, but there remains the risk that the company's assessment of this issue would not be the same as investors, not least because assessment of the cost of compliance is largely subjective.' See MacNeil & Li, *supra*, n. 24, 487.
- (44) For the initial review agenda, see FRC (2007) *Review of the Impact of the Combined Code*, April. For a summary of the ensuing responses to the Review, see FRC (2007) *2007 Review of the Combined Code: Summary of Responses to Consultation*, November. Both documents are available online at www.frc.co.uk/corporate/combined_code.cfm.
- (45) As the Institute of Directors opined in its response to the Review, for example: 'Many directors ... consider that a disproportionate amount of their effort is directed towards compliance and conformance, rather than the strategic direction of the company'. See *Summary of Responses*, *Ibid*, 3.
- (46) *Ibid*.
- (47) See *supra*, n. 11, Preamble, para. 1.
- (48) *Ibid*, para. 2.
- (49) *Ibid* (emphasis added).
- (50) *Summary of Responses*, *supra*, n. 44, 16, citing a quote from the corporate governance lobby group QCA.
- (51) *Ibid*, 15.
- (52) On this, see Department of Trade and Industry (now Department for Business, Enterprise and Regulatory Reform) (2005) *Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company: A Consultative Document*, March, 21–3.
- (53) This is by virtue of the new Rule 7.2.4G of the FSA's Disclosure Rules and Transparency Rules (DTR), which expressly provides: 'A listed company which complies with LR 9.8.6R(6) (the comply or explain rule in relation to the Combined Code) will satisfy the requirements of DTR 7.2.2R and 7.2.3R [ie the obligation to include a comply or explain statement in its annual corporate governance statement as required by the EU Fourth Company Law Directive].'
- (54) See BERB (2007) *Implementation of Directive 2006/46/EC on Company Reporting: Amending Accounting Directives — Government Response*, July, para. 3.9.
- (55) See FSA (2008) *Implementation of the 8th Company Law Directive: Feedback on CPO7/24 and Final Rules*, June, paras 2.12–2.13.
- (56) Listing Rule 9.8.6(5) now states that:

‘In the case of a listed company incorporated in the United Kingdom ... its annual financial report [must contain] a statement of how the listed company has applied the Main Principles set out in section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied.’ In the previous (pre-2008) version of the Rule, the emphasised term ‘Main Principles’ read merely ‘Principles’,

which was deemed to give an insufficiently clear indication of in relation to what specific level(s) of the Code’s norms a company’s board was required to explain its appliance strategy.

(57) See *supra*, nn. 47–9 and accompanying text.

(58) *Supra*, n. 11, para. 5 (emphasis added).

(59) *Supra*, n. 47.

(60) See *supra*, nn. 55–6.