



A corporate governance debate on the theme of “Compliance or Crisis” was recently held before an invited audience of business and investment leaders at The Plaisterers’ Hall. Our chairman, Ken Olisa, invited contributions from a distinguished panel before opening the debate to the audience. We are grateful to the panel: Sir Rob Margetts, CBE (Chairman of Legal & General Group), Sir Christopher Hogg (Chairman of the Financial Reporting Council) and Martin Dickson (Deputy Editor of the Financial Times).

This paper aims to capture the flavour of the debate and the many points raised by our panel and from the floor.

The key themes

- Increasing involvement of activist investors is creating new governance challenges for company boards. It highlights the need to sustain regular dialogue with mainstream investors to make sure their concerns are fully understood. Building strong relationships during relatively good times makes it easier to sustain effective dialogue with investors should a crisis arise.
- The “comply or explain” approach is one of the strengths of the UK’s Combined Code on Corporate Governance, but there is room for improvement in its practical application. Board members need to talk through any areas of non-compliance thoroughly – and be prepared to explain their reasons to investors clearly. Investors too could do more to support the effective working of the “comply or explain” mechanism, not least by ensuring internal consistency between the views of fund managers and compliance officers.
- The principles and provisions of the Combined Code are generally accepted by UK companies, and seen as supporting capital markets that are respected round the world. However, complacency must be avoided. The Financial Reporting Council (FRC) has an important role in reviewing the Code’s effectiveness.

The impact of activist investors

Companies now face an environment where **activist investors, potentially from overseas and with short-term agendas, can attract media headlines**. Some may seek to use the “governance cloak” as a means to challenge a company. Deciding how to respond can be hard, particularly when the precise holding of the activist fund (taking into account contracts for difference) may be unknown. This will remain the case unless regulators tighten up disclosure requirements.

The involvement of activist investors could potentially create **a perceived conflict of interest** for company boards. Activists will tend to be concerned with particular short-term issues, whereas the majority of investors have longer-term concerns.

How can company boards deal most effectively with activist investors? Trying to **hold a dialogue with them behind closed doors** and out of the glare of publicity is recommended. The board should also remember the importance of sticking firmly to its stated strategy.

Though it can create pressure for companies, activism is not necessarily a bad thing. Boards can find it stimulating to be challenged. It should also be remembered that **activists can have little impact unless they take the mainstream investors with them**. Thus understanding the concerns and priorities of this mainstream group is essential. While this has always been important, the emergence of activist funds only makes it more so. Boards need to build strong relationships with their investors; **chairmen should be using up “shoe leather”** to get out and about listening to views. If boards



establish routine dialogue with investors in the good times, it becomes easier to sustain that dialogue effectively when times are tough.

Even when boards do put in this effort, the involvement of third parties may also be needed. **What investors tell chairmen may not always be what they are really thinking.**

Comply and explain in practice

The **“comply or explain” approach is one of the strengths** of the Combined Code. However, although the dialogue that takes place between companies and investors is better than in the past, further improvement could be made in terms of how “comply or explain” works in practice.

Where boards do decide to stray from the Code’s precise provisions, they need to **discuss the issues fully** among themselves so that they can then explain their reasons effectively to investors.

However, both companies and investors may have some faults that prevent the most fruitful dialogue on compliance matters. On the company side, board members have occasionally shown themselves not to fully understand the Code’s provisions. **The “comply or explain” principle can “bring out the wimp”** in executive directors, who may sometimes think non-compliance a better option but fail to pursue the matter in the face of non-executive anxiety. **Some boards think they can be non-compliant without having to explain themselves** in any meaningful way. Others expect that as long as they give an explanation, investors will just roll over and accept it.

Investors could also do more to make comply or explain work effectively. Do they always focus on the most important governance issues? Some still have **different opinions in-house on compliance issues** – fund managers may take one view and compliance officers another. Smaller funds and proxy holders can be prone to a **box-ticking approach** to checking compliance. Some funds managers seem less worried about compliance as long as a company is doing well.

Both companies and investors could do better. The FRC also has an important role to play, acting as **an impartial referee** to ensure that the “comply or explain” principle works effectively.

Attitudes towards the Combined Code

The Combined Code is generally accepted in the UK, particularly by the largest companies. That said, **some of the precise provisions may have critics** and public company directors may cast an envious eye at counterparts in private – and particularly private equity-backed – companies who enjoy a lighter compliance burden.

Nevertheless the general principles are widely supported. **UK companies listed on AIM increasingly choose to comply with the Code**, even though not required to do so. The FRC’s recent review of the Code did not identify any major areas for reform.

The UK’s governance environment is respected round the world. In the US, for example, regulators appear concerned that their capital markets are losing competitiveness. **But the UK can’t be complacent.** Good companies listed elsewhere (for example, in the US, Germany and France) still perform well.



Other points made

During the wide-ranging discussion, a number of interesting points were made on other issues.

- Executive remuneration is a growing corporate governance issue. This is partly because of the relatively **short-term incentives given to management** – often annual. A three year timeframe would be a maximum. This is despite the fact that boards are supposed to be focused on the long-term success of the company. Taking significant shareholdings is seen as an important way to align senior personnel with the long-term interests of the business.

Another concern is that **directors' remuneration will continue to rise beyond levels that seem reasonable externally**. Rising pay may be an unintended result of the Greenbury report, which introduced greater remuneration disclosure. The ability to make comparisons with peers creates inflationary pressure. There is a strong feeling that **executive pay must be linked with performance**. However, shareholders who try to counter the largest pay packets may be taking up a challenge akin to trying to stop the tide.

- The value of crisis should not be forgotten. Good corporate governance should not be equated with risk avoidance. It is about taking appropriate risks to create value. **UK companies must not stop taking risks**. Unless they risk crisis, they will not be able to make the returns that investors such as pension funds need.
- If a crisis erupts, the precise circumstances determine whether it is the chairman or the CEO who receives the journalist's first call. Nevertheless, the **chairman needs to be visible**. The CEO runs the company, but the chairman runs the board.
- There should be no tension between shareholders' interests and those of society. If boards manage companies with **a view to sustainability** and the creation of long-term value, then they must address all relevant issues. These include the safety of employees and the company's environmental footprint.

Cautious optimism

Companies and investors enjoy a healthier dialogue than in the past, supported by the principles of the Combined Code. There are new challenges being created by the emergence of activist funds, but these can be met – particularly if boards continue to build strong relationships with mainstream investors, talk to them often, keep focused on their long-term strategy and clearly link their own remuneration with performance.
