UK CORPORATE GOVERNANCE CODE: WILL IT EVER BE ENOUGH?

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Introduction

Corporate governance is particularly essential to large international firms involving a great number of stakeholders. This check and balance system is a must-have to ensure that a company acts in the best interest of its shareholders and stakeholders. Over the years, there have been endless attempts to improve the answerability of companies particularly to avoid sudden unforeseeable downfalls. As history has shown, when a new committee is summoned to review codes on corporate governance, it is always when there is a business failure of a huge multi-national corporation. It has been the ultimate goal of the Financial Reporting Council (hereinafter referred to as 'FRC') to produce a fool-proof governance system. Is this possible? Or is the present system a near-perfect one and sufficient to avoid another major downfall of yet another multi-national?

The Development of Corporate Governance: The Cadbury Report (1992)

The Cadbury Report was the first attempt to formalize and codify a code of practice for corporate governance. In December 1992, the Cadbury Committee was set up by the FRC, the London Stock Exchange (hereinafter referred to as 'LSE') and the accounting profession to discuss the "Financial Aspect of Corporate Governance" in response to the sinking confidence in financial reporting and auditing practices of

companies.[1] Instead of making it actionable in law, the report recommended a Code of Best Practice, promoting the voluntary approach of compilation.

The LSE then made the compliance of the Code a prerequisite condition for companies to be continually listed. Companies had to state in their annual report whether they had complied with the Code and state reasons for non-compliance.[2] Here it was first recognised that the involvement of non-executive directors (hereinafter referred to as 'NEDs') was essential in matters regarding remuneration, audit and nomination of certain positions in the company. It also emphasised the separation of the chairman and CEO of a company to promote the independent nature of the board.[3]

Since the finding of the 'comply and explain' rule by Sir Adrian Cadbury, it has not only been applicable in the UK itself but it has also been adopted by many other countries.

The Development of Corporate Governance: The Greenbury Report (1995)

This report was initiated due to alarming concerns of the behaviour of senior executives who were awarded unjustified sums of benefits and salaries. Attention was given particularly to bosses of newly privatised utility companies by the Thatcher government during that period.[4] Remuneration practices were non-transparent and it was almost impossible to determine the exact amount of salary

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1 Michael Blowfield and Alan Murray, *Corporate Responsibility: A Critical Introduction* (OUP 2008) 216.
2 Richard Smerdon, *A Practical Guide to Corporate Governance* (3rd edn, Sweet & Maxwell 2007) 3.
3 Stephen Griffin, *Company Law - Fundamental Principles* (4th edn, Pearson 2006) 365.
4 Smerdon (n 2) 4.

received due to the different forms used. There were huge annual bonuses, pensions, discounted share options and even compensation payments for departing directors.[5]

As a result, the Greenbury Committee was convened to address public concern on this issue focusing particularly on the remuneration of directors. Issues like accountability, responsibility, full disclosure of accounts, alignment of director and shareholder interest, and improvement of company's performance were brought for discussion. Again, it was suggested that the solution to improve transparency of directors' remuneration was to involve NEDs in the remuneration committee.

After the Greenbury Report, all companies had to include in their annual report a detailed disclosure of the directors' remuneration, including valuation of stock options given and also a detailed description on pension contributions.[6] Apart from that, it also added onto the proposals contained in the Cadbury report. The 'comply and explain' rule remained. On 31 December 1995, the LSE made the compliance of the Code a condition for the listing of companies.

The Development of Corporate Governance: The Hampel Report (1998)

For the Hampel Report, the additional topic was the involvement of shareholders and auditors in corporate governance. In the report, Sir Ronnie Hampel said that, 'good governance ensures that stakeholders with relevant interest in the company are fully taken into account.'[7] There were recommendations that there should be increased communication between investors and the company.

Apart from that, there were suggestions that shareholders should use their voting power to influence company policies whenever possible.[8]

[5] Griffin (n 3) 366.
[6] Blowfield (n 1) 217.
[7] The Hampel Report (1998) 17.
[8] Blowfield (n 1) 217.

The Hampel Committee also identified a problem with the current approach. The practice was that if the boxes of the codes are ticked, the company was regarded to have complied with the codes of corporate governance. But in reality, some big companies with influential CEOs that ticked all these boxes and convinced investors of their governance skills were, in fact, not in good condition. Hence, the Hampel Committee shifted its view slightly from that of the Cadbury and Greenbury report and suggested that companies should be required to explain, alongside the tick made, as to how they applied the principles and codes. The Hampel Report issued a total of 18 Principles underpinned by 42 Provisions.

The Combined Code (1998)

This time, the LSE aimed to consolidate the three previous codes published "The Combined Code", which contained 14 principles of good corporate governance supplemented by provision in the second half of the report, was published on 25 June 1998. It has principles regarding good practices related to the board of directors, controls in directors' remuneration, relationships with shareholders and accountability of the company's audit – combining all codes from all three reports.

The Turnbull Report (1999)

The Turnbull Report was published by the Institute of Chartered Accountants of England and Wales in regards to a Principle D.2 set out in the Combined Code. In relation to Principle D.2, the report requires the board of directors to maintain a sound system of internal control to safeguard the company's assets.

In addition to that, the report also requires all internal accounting controls to be reviewed annually by the company's auditing team. This includes review on the company's financial, operational and compliance control apart from its risk

management. The report formulated what was called the Turnbull Guidance on Internal Control and it forms part of the annexure to the Combined Code.[9]

The US Influence

Although the UK and the US have different approaches towards the subject of corporate governance, the UK reforms on corporate governance have been strongly influenced by the major downfalls and corporate scandals of many US companies.[10] These downfalls and corporate scandals have made the UK realise the importance of improving corporate governance methods to avoid such unfortunate situations and to be solid in the retention of global confidence in the UK markets to local and international investors.

One such scandal was the famous downfall of a huge American corporation, Enron. This case acted as alarm-bells ringing, signalling to leaders not only in the UK but across the globe the importance of good corporate governance within corporations. This scandal ignited the Higgs Review which led to the huge revamp of corporate governance rules through the Revised Combined Code on Corporate Governance.

In just a short timeline of 16 years, Enron transformed from an obscure gas pipeline company to the world's largest energy trading company,[11] standing as America's seventh largest company employing a total of 21,000 staff globally. Unfortunately, the firm's success evolved around an elaborate and shocking scam.[12] Enron used various methods to convince global investors; these included

[9] Geoffrey Morse, *Charlesworth & Morse Company Law* (16th edn, Sweet & Maxwell 1999) 347.

[10] Griffin (n 3) 370.

[11] 'Enron: The Fall from Grace/ The World's Biggest Fraud' <http://www.efham.net/Uploads/EfhamElborsa/ Enron.pdf> accessed 29 December 2010.

[12] 'Enron Scandal At-a-Glance' *BBC* (London, 22 August 2002) <http://news.bbc.co.uk/2/hi/business/1780075. stm> accessed 29 December 2010.

sophisticated accounting techniques to maintain share prices and setting up independent partnerships for the sole purpose of generating further investments. In fact, ventures reported from partnerships formed were not even up and running or at least even intended to be so.[13] After Enron's demise, the question asked by everyone was: how could such practices remain hidden for such a long time?

This was a clear situation where directors of the company were too powerful for any disclosure of their self-enrichment schemes. Apart from that, the structured financial transactions were so complex that even partial disclosure of it would not reveal anything to lay investors.[14] As Enron's scams began to spill over, it became an alarming issue how the ineffectiveness of the system of corporate governance could affect the whole sustainability of the company. It is also interesting to note that Enron's accounts and audits were managed by one of the world's top five leading accounting firms, Arthur Anderson.[15] The problem probably arose partly because they also acted as financial consultants for the firm, hence the conflict of interest that caused them to lose their independence.[16] On top of that, the behaviour of senior executives, bank analysts and rating agencies were all highly questioned by investors around the world.[17]

The Different Approaches

After the wakeup call from Enron, both the UK and the US revamped their system of corporate governance whereby the US passed the *Sarbanes-Oxley Act 2002* (hereinafter referred to as '*SOA 2002*') whilst the UK still kept theirs as a non-legally binding code.[18] This is not surprising since the UK has throughout the years stood firm on its grounds of believing in flexibility when approaching the issue of

[13] ibid.

[14] Enron: The Fall from Grace (n 11).

[15] ibid 11.

[16] Griffin (n 3) 369.

[17] Enron: The Fall from Grace (n 11).

[18] Smerdon (n 2) 9.

governing a corporation. They believe that companies should have the flexibility in determining their style of risk management since everyone has different views and behaviours.

Even though both approaches were different, the *SOA 2002* and the Revised Code were very similar in essence, both ultimately have the same goal – to make corporate transactions more transparent and make procedures regarding corporate disclosures more reliable and accurate.

The Higgs Report (2002/2003)

Derek Higgs was elected the leader of a new committee to produce a report for the preparation of a revised code of practice. In his letter to the Chancellor of the Exchequer, Higgs mentioned that the brittleness and rigidity of legislation cannot dictate behaviour or foster trust when it comes to governing a corporation. [19] Therefore the 'comply or explain' rule was continually supported.

Suggestions from the Higgs Report were regarded highly and taken into account in the publishing of the new Revised Code of Corporate Governance by the FRC. The theme this time was on "the review of the role and effectiveness of non-executive directors". Clearly the spotlight in this report was on the importance of involvement of NEDs. According to Higgs, the ultimate way of making corporate processes transparent was having an independent body that functioned in scrutinising the actions of managers of corporations from time to time. This was a role to be held by NEDs, who were free from the day to day management of the company and, most importantly, were free from any pressure given by higher managing authorities in a particular corporation. Higgs recommended that a company should elect a senior independent director and the elected director should

[19] Derek Higgs, 'Review of the Role and Effectiveness of Non-Executives' (The Stationary Office, 2003) <http://webarchive.nationalarchives.gov.uk/tna/+/http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf/> accessed 7 January 2011.

conduct what is called an 'independent test' while recruiting potential NEDs, not neglecting the fact that they should have the required skills and expertise to act.[20]

Higgs primarily identified the importance of the composition of the board of directors. A significant recommendation was that NEDs should make up at least half of the board of directors in order to make significant impact on company policies. This is in line with the new listing requirements of countries like the US, France and China.[21] In making this recommendation, Higgs was however fully aware that it may take a very long period of time for certain companies to adjust to this.[22] In conclusion, what is seen here is a real shift of influence and control from the shoulders of the executives to the non-executives. Additionally, Higgs suggested that NEDs should also sit in committees in a company especially the committees in relation to financial accountability like audit and remuneration committees.

Apart from the role of NEDs, Higgs also recommended that more transparency is key. In achieving this, Higgs extended the amount of information to be included in the company's annual report. This included the number of meetings held by the committees and the board and the attendance of each director. This is to make sure that a meeting is attended and results are achieved by a balanced amount of executives and NEDs, although the board may already be equal in number. Apart from that, the nomination board also should be answerable to shareholders on questions regarding the eligibility of NEDs. Higgs recommended also that there should be annual reviews on the performance of NEDs and that the method used to achieve the review must be included in the annual report.

[20] ibid.

[21] Griffin (n 3) 371.

[22] Freshfield Brukhaus Deringer, 'New UK Corporate Governance Code in Force from 29 June 2010' (2010) <http://www.freshfields.com/publications/pdfs/2010/May10/28244.pdf> accessed 7 January 2011.

Higgs promoted a closer relationship between shareholders and NEDs. In his review, it was mentioned that many interviews revealed that investors are often distant and disengaged from the non-executives of the company.[23] He urged that a more active role be played by NEDs and the chairman when communicating with investors regularly especially during AGMs. Apart from that, he also encouraged input from investors to NEDs about their views and concerns.

The Revised Combined Code (2003)

Following the Higgs and Turnbull Report, the FRC issued a revised combined code which was heavily based on the recommendation of both reports.

The UK Corporate Governance Code (2010)

In 2010, the FRC issued the latest revised code on corporate governance in the UK. This code applies to all companies with a Premium Listing of Equity Shares in the UK for financial years beginning on or after 29 June 2010.[24] The Code retained the 'comply and explain' framework and continued to give discretion to each company in determining methods of corporate governance. The core value - flexibility - give companies the alternative route of justifying any non-compliance if they feel that existing practices or other means are more capable of bringing about good governance. However, companies first have to review every provision carefully and give it careful and thorough consideration before departing from any practice of provision.[25]

The Code listed down five main principles accompanied by various supporting principles and core provisions on how to carry out the principles given.

[23] Higgs (n 19).
[24] Financial Reporting Council, 'The UK Corporate Governance Code' (June 2006) 1.
[25] Financial Reporting Council, 'The Combined Code on Corporate Governance' (July 2003) <http://www. fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf>accessed 7 January 2011.

The resulting changes were far more in number when compared to previous codes of practices of companies and it also highlighted the behaviours and commitment of leaders in bringing out corporate governance.[26]

The first principle sets out the importance of good leadership. In ensuring good leadership, the Code recognises the combined effort of different leaders of the company – the collective role of the board, the chairman, and the NEDs. Moreover, it recognises that no sole person in a company should have unfettered powers of discretion as seen in the fall of Enron. Hence, the Code provided that companies should expressly lay down the division of responsibilities of both chairman and chief executive and that these two roles should not be held by the same individual. The Code also requires the appointment of a senior independent NED to act as a medium between the chairman, other NEDs and most importantly shareholders. Overall, increased responsibility has been put on the shoulders of the board, particularly the responsibility of reporting agendas to shareholders. Compared to the previous Code, many supporting principles have been upgraded to main principles including the need for NEDs to constructively challenge and assist in the development of proposals on strategies.[27]

The second principle centres on the effectiveness of the board. This new principle encourages boardroom diversity by requiring an appropriate balance of skills, experience, independence, knowledge and even gender of members of the board in order for duties and responsibilities to be carried out effectively.[28] The Code, like the previous one, recommended a balance in the composition of the board of executives and NEDs. An additional criterion was laid down regarding the commitment of directors in that more time should be allocated in carrying out

[26] 'The Revised UK Corporate Governance Code – Attacking the Fungus of Boiler-Plate' (2010) <www.ry.com/files/teaser/14505/Boilerplate.pdf> accessed 7 January 2011.
[27] Freshfield (n 22).
[28] Ronan O'Sullivan and Ross McNaughten, 'New UK Corporate Governance Code' (2010) <http://www.paulhastings.com/assets/publications/1615.pdf> accessed 6 January 2011.

responsibilities given.[29] Apart from that, a hotly debated change was the requirement of annual re-election of all directors for FTSE 350 companies by their shareholders.[30] For other companies, directors should be subject to election by their shareholders at the first AGM after appointment and thereafter re-elections should be carried out at intervals especially for those who have held their positions for more than nine years.[31]

The third main principle is the board's accountability. The biggest change here is the requirement to disclose the business model of the company which is the strategy and basis of the company in preserving value in the long run.[32] It was seen as a need by the FRC to bridge the gap between the reporting process and shareholders; hence, this disclosure was required to be added in the annual report together with the existing business review,[33] presented in a balanced and understandable way.[34] Besides that, there is a new main principle here where the board now has the responsibility to determine the nature and extent of risk the company is willing to take.[35] Additionally, there is also an extended responsibility of maintaining a sound risk management system, apart from the maintenance of internal control systems required by the previous Code.[36] This is done by conducting reviews of the effectiveness of the systems from time to time, at least annually.[37]

[29] FRC (n 24) 14 [B.3].
[30] Clifford Chance, 'Publication of the New Corporate Governance Code' (2010) <http://www.cliffordchance.com/publicationviews/publications/2010/06/publication_of_ thenewukcorporategovernanc.html> accessed 7 January 2011.
[31] FRC (n 24) 17 [B.7.1].
[32] Freshfield (n 22).
[33] Companies Act 2006, s 417.
[34] FRC (n 24) 18 [C.1].
[35] ibid 19 [C.1].
[36] Freshfield (n 22).
[37] FRC (n 24) 19 [C.2.1].

On top of that, in line with the principle of accountability, the board now has the duty to report to shareholders the main features of internal control and risk management systems as a part of the financial reporting process. In previous Codes, there was no mention of the need to have a risk management system.[38] Here again, better accountability is tied in with the involvement of shareholders. The code also requires that reporting processes be transparent, especially those related to audit reports.[39] In ensuring this, the code suggests that the audit committee should comprise of at least two independent NEDs.[40] To further increase accountability, it is suggested that the committee should have regular reviews of the internal financial controls and audit functions.[41]

The fourth principle is related to the directors' remuneration. The Code encourages a well proportioned remuneration, just enough to attract, retain and motivate the directors.[42] The principle here is that the pay should mirror the commitment, performance and responsibility of a particular role.[43] There is a new provision stating that the aim of performance-related remuneration should be aligned to ensure the long term success of the company.[44] In order to ensure independence, the code has been amended to clarify that remuneration of NEDs should not include share options and any performance-related incentives.[45] Again here, transparency is mentioned in formulating remuneration packages.

Lastly, Section E of the Code concerns relations with shareholders. The emphasis again here is better communication between shareholders and directors of the company. To achieve this, the Code states that there should be constant dialogue

[38] O'Sullivan (n 28).
[39] FRC (n 24) 19 [C.3].
[40] ibid 19 [C.3.1].
[41] ibid 20 [C.3.2].
[42] ibid 22 [D.1].
[43] ibid) 22 [D.1.3].
[44] O'Sullivan (n 28).
[45] FRC (n 24) 22,23 [D.1.3].

between them in order to ensure that both views are known to each other.[46] The Code further extends this communication to include the involvement of NEDs, taking into account recommendations from the Higgs Review. Moreover, directors are required to report to shareholders about steps taken to ensure that shareholders' views are forwarded to NEDs.[47] This, again, has had the effect of increasing accountability as it keeps the management on their toes in order to answer questions put forward by shareholders during dialogue sessions.

Apart from dialogues, AGMs are also a way to communicate with shareholders. Alongside voting sessions, AGMs must also act as an active forum for Q&A sessions between shareholders and audit, remuneration and nomination committees.[48] Overall, the Code has encouraged the participation of shareholders in influencing the survival or prosperity of the company.

The Impact of the Developments on UK Company Law

Although much of corporate governance goes beyond the legal framework, there are still certain basic elements which the UK has decided to statutorily codify. Unlike other codes of practice which lay down the specific processes of achieving good corporate governance, English Company Law deals only with the individual and collective responsibility of directors instead of the board as a whole.[49] Apart from judicial precedents, English company law is mainly statute-based. Its main source is the *Companies Act 2006* (hereinafter referred to as '*CA 2006*') which came into effect in 2009. In this Act, the legislators set out for the first time the principal duties owed by directors to their companies. The Act also requires the board to

[46] ibid 25 [E.1].
[47] ibid 25 [E.1.2].
[48] ibid 26 [E.2.4].
[49] 'Corporate Governance in the UK' <http://www.iod.com/Home/Business-Information-and-advice/Being-a-Director/MainWebSite/Resources/Document/factsheet_corp_gov_uk_1006.pdf> accessed 10 January 2011.

balance the need to promote the long term success of the company and the benefit of the shareholders, a similar provision as that of the codes of practice.

In promoting the element of accountability, the *CA 2006* made it a statutory requirement for companies to include a 'business review' in the annual report.[50] This review is to include the aims and goals of the company and the extent and progress of achieving those aims. However, the downside to it is that, due to its binding nature, it may be burdensome to some smaller companies.

Due to the developments of corporate governance practices, the UK saw the need to attach legal sanctions for certain failures to maintain good corporate governance. One such example is implemented by the *Insolvency Act 1986*. This Act lays down general duties of directors where non-compliance would give rise to civil claims. For instance, the duty not to defraud the company,[51] and not to be negligent in accruing further debts if the company is undergoing insolvent liquidation.[52] Apart from that, *Section 463* of the *CA 2006* also makes it liable for anyone to include negligent or misleading statements in the company's annual report.

At times, certain situations require a force of law in order to be carried out. For example, a beneficial owner of shares does not have any right to vote at shareholders' meetings or even compel the company to send them an annual report before this situation was reversed by the *CA 2006*.

Conclusion

Undoubtedly, the UK Corporate Governance Code has set a high watermark for future reviews to come. However, although there is constant reviewing of the codes

[50] Companies Act 2006, s 417.
[51] Insolvency Act 1986, s 213.
[52] Insolvency Act 1986, s 214.

on corporate governance practice, it all goes back to the attitude and moral standing of the NEDs.[33] Even if they were to form a large part of the company's board of directors, the board would not be transparent if they do not expose the company's wrong doings or fraudulent practices in exchange for the benefits they receive from the company's business. Apart from that, it also depends on whether shareholders and investors are able to use the powers they have responsibly and maintain appropriate pressure on the board to ensure that the company's risk management is constantly robust and defensible.[34]

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[33] Derek French, Christopher L Ryan, *Mayson, French & Ryan on Company Law* (25th edn, OUP 2008) 413.

[34] Bob Tricker and Chris Mallin 'UK Corporate Governance Code' (28 May 2010) <http://corporategovernanceoup.wordpress.com/2010/05/29/uk-corporate-governance-code/> accessed 10 January 2011.