

THINKING OUTSIDE THE BOX – ELIMINATING THE PERNICIOUSNESS OF BOX-TICKING IN THE NEW CORPORATE GOVERNANCE CODE

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On 16 July 2018, a new corporate governance code was published. As with previous iterations, it applies on a ‘comply-or-explain’ basis, whereby companies are required to either comply with provisions or explain reasons for non-compliance. However, the new code substantially simplified the previous version of the code in an attempt to attenuate the process of ‘box-ticking’. Box-ticking manifests itself in two ways: firstly, by companies complying with the letter rather than the spirit of the provisions, and, second, by companies not utilising the inherent flexibility to implement the optimum firm-specific governance structures by explaining rather than complying. This article will elucidate the history of box-ticking, and the reasons why companies succumb thereto, since Adrian Cadbury pioneered the concept of ‘comply-or-explain’ in 1992, before proposing a new exclusively principles-driven approach to corporate governance which would alleviate box-ticking and fulfill the original aspirations of Cadbury over a quarter of a century ago.

INTRODUCTION

In 1992, the Committee on the Financial aspects of Corporate Governance, chaired by Sir Adrian Cadbury (the Cadbury Committee), published a report promoting the trailblazing concept of ‘comply-or-explain’ in the context of corporate governance compliance.¹ Its successor, the UK Corporate Governance Code (the Code) as published by the Financial Reporting Council (FRC), continues to apply on a comply-or-explain basis. One of the key benefits justifying the comply-or-explain

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¹ Report of the Committee on the Financial Aspects of Corporate Governance (1 December 1992) (Cadbury Report) at 57.

approach to compliance, as opposed to mandatory application, is that it provides flexibility, giving companies the freedom to deviate from the requirements of the Code, if the relevant company deems that the requirement does not optimise the health of the company, so long as it explains to its shareholders the reason for the non-compliance.²

However, notwithstanding the intended benefits of comply-or-explain, the danger persists that companies will engage in a tactic that has been termed ‘box-ticking’. In effect, this entails a company complying with a specific provision in a literal sense without observing the spirit of the principle on which the provision is based. The box-ticking strategy can also manifest itself in boards erring on the side of caution by determining that it is simpler to comply with specific provisions rather than explain to shareholders why it is to the company’s benefit not to comply. This can result in companies not embracing alternative corporate governance structures that could be beneficial to firm performance; eliminating one of the principal advantages of comply-or-explain over mandatory legislation.

On 16 July 2018, the FRC published the final version of a new Corporate Governance Code (the New Code)³ to be effective for accounting periods commencing on or after 1 January 2019. One of the stated aims of the New Code is to emphasise the importance of applying the principles of the Code rather than merely surrendering to strict compliance with the provisions⁴ – essentially, an attempt to reduce the preponderance of box-ticking. The New Code represents the first major revision of the Code in nearly a decade,⁵ with much anticipation that the New Code will simplify the reporting process for listed companies. However, the question remains – will the New Code curb box-ticking?

This article will commence with a description of the attempts to-date to eliminate box-ticking, together with the reasons for usage of the strategy, and the problems inherent therein. It will continue

² As referenced in the Code: ‘It is recognised that an alternative to following a provision may be justified in particular circumstances if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result.’ (‘Comply or Explain’ in the April 2016 version of the Code at 4).

³ FRC: The UK Corporate Governance Code (July 2018).

⁴ FRC consultation dated December 2017, ‘Proposed Revisions to the UK Corporate Governance Code’ at 4.

⁵ In 2010, the ‘Combined Code’ was significantly revised and relabelled as the ‘UK Corporate Governance Code’. Arguably, the last substantive changes were made even longer ago in 2003, with only ‘limited tweaks’ since (*Corporate Governance: Law, Regulation and Theory*, eds. M. Moore and M. Petrin (London: Palgrave (2017)) at 61).

with a critical analysis as to whether and how the New Code could alleviate the preponderance of box-ticking, before concluding, by taking a normative approach to how the New Code could be improved in pursuing that goal and proposing a new principles-driven methodology to the Code and corporate governance, generally, which would be beneficial to listed companies that exist in what is very much now a mature corporate governance environment in the UK.

AVOIDING BOX-TICKING: THE ROAD SO FAR

The Cadbury Committee was established in 1991, focusing mainly on auditing issues, but also corporate governance generally. The committee's report, published in 1992, encompassed a Code of Best Practice setting-out nineteen corporate governance recommendations for listed companies.⁶ The report prioritised 'self-regulation',⁷ rather than the use of mandatory rules, and lobbied the London Stock Exchange to amend its continuing listing obligations to require that any company subject to its rules should publish a statement in its annual report stating whether it complies with the Code of Best Practice and identify and give reasons for any areas of non-compliance.⁸ Thereby, 'comply-or-explain' was born. The advantages and disadvantages of self-regulatory regimes, and 'comply-or-explain' in particular, has been extensively discussed in the literature⁹ and an overview of the full range of such aspects is beyond the scope of this article. However, key amongst the advantages is the maintenance of flexibility for those companies subject to the relevant regime. If the board of a company resolved that a specific provision of the Code of Best Practice was not relevant to the company, or did not entail the soundest structure given the company's individual circumstances, the company could deviate from the strict requirements of that provision, as long as the reasons for such

⁶ n 1 above 58.

⁷ Ibid, para. 3.14 - 'The responsibility for putting the Code into practice lies directly with the boards of directors of listed companies to whom it is addressed.'

⁸ Ibid, para. 3.7.

⁹ For example, *Company Law: Theory, Structure and Operation*, ed. B. Cheffins (Oxford: Clarendon Press (1997)) at chapter 8; K. Sergakis, 'Deconstruction and Reconstruction of the "Comply or Explain" Principle in EU Capital Markets' (2015) 5 Account. Econ. Law 233; and n 5 above 58.

non-compliance were disclosed in its annual report.¹⁰ Additionally, the Code prompted companies to address substance over form;¹¹ as proclaimed by the Cadbury Report, ‘Statutory measures would impose a minimum standard and there would be a greater risk of boards complying with the letter, rather than with the spirit, of their requirements’.¹² It is therefore clear that one of the stated aims of this novel approach was to eliminate box-ticking behaviour.

If it was hoped that the Cadbury Committee’s approach would eradicate box-ticking, it did not have the anticipated effect. In 1998, the Committee on Corporate Governance, chaired by Sir Ronald Hampel (the Hampel Committee), published a report¹³ that reviewed, and proposed amendments to, the Cadbury Report and a separate report on directors’ remuneration by a committee chaired by Sir Richard Greenbury (the Greenbury Committee).¹⁴ The Hampel Report averred that although the Cadbury and Greenbury Committees had intended that their recommendations be implemented in a flexible manner, in practice, companies had treated the codes promulgated by such committees as hard and fast rules.¹⁵ In the words of the Hampel Report: ‘Their shareholders or their advisers would be interested only in whether the letter of the rule had been complied with – yes or no. A “yes” would receive a tick, hence the expression “box ticking” for this approach.’¹⁶ Additionally, the Hampel Report drew the connection between box-ticking and the propensity for companies to comply with form over substance.¹⁷ Against this background, the Hampel Report drew a distinction

¹⁰ Of course, if the reasons for non-disclosure were not persuasive, the company would be subject to the ire of shareholders, and therefore significant pressure to comply; in theory, though, a credible explanation would satisfy shareholders and allow the company to remain in non-compliance.

¹¹ n 1 above at para. 3.10.

¹² Ibid, para.1.10. Also, see: S. Arcot, V. Bruno and A. Faure-Grimaud, ‘Corporate Governance in the UK: Is the Comply or Explain Approach Working?’ (2009) at 2 <<http://ssrn.com/abstract=1532290>> Unless otherwise stated, all URLs were last accessed on 20 November 2018.

¹³ The Final Report of the Committee on Corporate Governance (January 1998) (Hampel Report).

¹⁴ Directors’ Remuneration: Report of a Study Group chaired by Sir Richard Greenbury (17 July 1995) (Greenbury Report).

¹⁵ n 13 above, paras. 1.11 and 1.12.

¹⁶ *ibid*, para. 1.12.

¹⁷ *ibid*, para. 1.14 – ‘There is another problem with box ticking. It can be seized on as an easier option than the diligent pursuit of corporate governance objectives. It would then not be difficult for lazy or unscrupulous directors – or shareholders – to arrange matters so that the letter of every governance rule was complied with but not the substance.’

between guidelines, which engender the question ‘How far are they complied with?’, and principles, which engender the question ‘How are they applied in practice?’.¹⁸ As such, the Hampel Report promoted a set of broad principles, backed-up by more detailed code guidelines. This approach manifested itself in the publication, in May 2000, of a code combining the Cadbury and Greenbury Codes and the findings of the Hampel Committee.¹⁹ The London Stock Exchange amended its listing rules by expanding upon the original simple requirement to confirm compliance or explain reasons for non-compliance, to a bifurcated requirement – a statement in the annual report setting-out (i) how the company has applied the principles, and (ii) whether the company has complied with the combined code and, if not, an explanation for non-compliance.²⁰ By connecting each set of detailed provisions applicable on a ‘comply-or-explain’ basis to a specific overarching principle which the relevant company must apply, it was envisaged that companies, and shareholders, would be less likely to engage in box-ticking, since, firstly, deviations could be justified by adherence to the relevant principle, and, second, there would be greater respect for the spirit of the code by applying the principles.

The next major step change in UK listed company corporate governance arose as a consequence of a review published by Derek Higgs in 2003.²¹ Although Higgs recognised the ills of box-ticking behaviour,²² his proposals drew hostility from boards that viewed a number of the new provisions as being overly prescriptive in nature.²³ Accordingly, in a revised Combined Code, certain of the provisions outlined by Higgs were converted into broader ‘supporting principles’, which sat between the broad main principles and the prescriptive code provisions. Under the first arm of the bifurcated disclosure regime, companies were now instructed to disclose how they had applied both the principles and supporting principles.²⁴ By linking those supporting principles to the main

¹⁸ Ibid, para. 2.1.

¹⁹ The Combined Code: Principles of Good Governance and Code of Best Practice (May 2000) (the Combined Code).

²⁰ Ibid 1.

²¹ Review of the role and effectiveness of non-executive directors by Derek Higgs (January 2003) (Higgs Report).

²² Ibid, para. 1.19.

²³ R. Cranfield, S. Watts, P. Burns and L. Ryland (Allen & Overy), *Practical Law Company* (October 2003) 29, 36.

²⁴ The Combined Code on Corporate Governance (July 2003) at 1 – ‘Preamble’ para. 4.

principles, it was thought that the substance of the additional elements proposed by Higgs could be implemented in a softer manner, to encourage companies to follow the spirit of the code and reducing the potential number of ‘boxes’ to ‘tick’, so to speak.

Ironically, the new structure of principles, supporting principles and provisions arguably exacerbated box-ticking. The FRC took account of responses to its April 2007 consultation,²⁵ where certain respondents identified that the onerous requirement to state how more than sixty elements under the principles and supporting principles had been applied was adding unnecessarily to ‘boilerplate’ disclosures.²⁶ The complaint related to how companies, overburdened by excessive disclosure requirements, were producing generic, non-company-specific narratives as to how they were applying the principles and supporting principles, making it impossible for investors to ascertain whether the relevant companies were adhering to the spirit of the code or utilising the flexibility ingrained within the mechanics of the code. Highlighting the rather mercurial attitude that the FRC has had to the application of the supporting principles, the FRC responded by amending the preamble to a revised version of the Combined Code in June 2008 to state that the first part of the two-part disclosure regime would revert to disclosure of general adherence to the main principles only and not, additionally, to the supporting principles.²⁷ Peculiarly, the supporting principles remained in the Combined Code, and subsequent versions of the Code until the publication of the New Code, even though there was no formal disclosure requirement against them. Therefore, the supporting principles seemingly acted as guidance or served as an interpretative function in applying the main principles.²⁸

Notwithstanding the demotion of supporting principles in relation to disclosure, frustrations with box-ticking persisted. The FRC’s 2009 review highlighted that this was still an issue.²⁹ Partly in an attempt to resolve this problem, the FRC implemented various changes to the Combined Code in 2010, renaming it the UK Corporate Governance Code (the Code), a moniker still used today. The

²⁵ FRC Review of the Impact of the Combined Code (April 2007).

²⁶ FRC 2007 Review of the Combined Code: Summary of Responses to Consultation (November 2007) at 16.

²⁷ The Combined Code on Corporate Governance (June 2008) at 1 – ‘Preamble’ para. 3.

²⁸ M. Moore, “Whispering Sweet Nothings”: The Limitations of Informal Conformance in UK Corporate Governance’ (2009) 9 JCLS 95, 107.

²⁹ The FRC 2009 Review of the Combined Code: Final Report (December 2009) at 33.

FRC drew attention to the tendency for the Combined Code to be treated as a compliance exercise rather than as a means to encourage better behaviour and communication, and for boards to prioritise the detailed provisions over the high-level principles.³⁰ The FRC responded by adding further principles and more closely tying them to relevant provisions. In addition, board chairs were urged to include a personal statement in company annual reports setting-out how the principles relating to leadership and board effectiveness had been applied – the intention was that this would allow companies to further justify to shareholders any deviations from the provisions, thereby, as dramatically expressed therein, ‘attacking the fungus of “boiler-plate”’.³¹

Until the publication of the New Code, only minor corporate governance changes were made to the Code after 2010, mainly to conform it to mandatory audit requirements imposed by EU law, and the structure of the Code remained more or less static. Nevertheless, each year between 2011 and 2016, the FRC’s annual review of corporate governance and stewardship developments included criticisms that either referenced box-ticking specifically, or indirectly through the identification of related aspects.³² Although, since 2011, a majority of FTSE-350 companies have complied with all the provisions of the Code, and a significant majority have complied with all but one or two provisions of the Code (as shown in Figure A), the FRC noted that this may not necessarily equate to good corporate governance, and instead could be an indication of box-ticking.

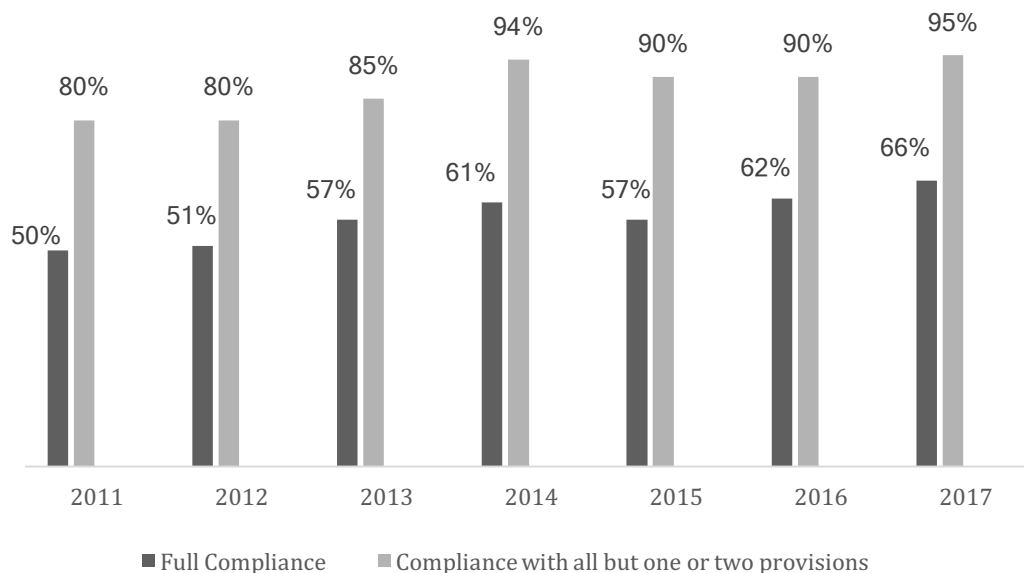
³⁰ *ibid* 6.

³¹ UK Corporate Governance Code (June 2010) at 3.

³² For example, *Developments in Corporate Governance and Stewardship 2014* (January 2015) at 12 (2014 FRC Review) remarked that the inherent flexibility of the Code would be reduced if companies were inclined to comply with provisions without considering what structures were in fact applicable and relevant. *Developments in Corporate Governance and Stewardship 2016* (January 2017) at 7 also observed that companies should be encouraged to provide more constructive reporting in line with the spirit of the Code.

Figure A

Code Compliance - FTSE-350



Sources: Annual Grant Thornton Corporate Governance Reviews 2011-2017, and annual FRC Developments in Corporate Governance and Stewardship 2011-2016.

The Code emerged from humble origins as a tailored, self-contained set of nineteen recommendations, with an aim to improve the corporate governance of listed companies whilst avoiding the scourge of box-ticking symptomatic of mandatory legislation. Many iterations later, the Code developed into a somewhat bloated document of 18 principles and 55 provisions, accompanied by 27 paragraphs of supporting principles that can themselves be divided into several elements. Although ensuing versions of the Code since Cadbury have attempted to palliate the tendency of companies to disregard alternative arrangements and to follow the form of the Code over substance and spirit, twenty-five years later, it appears that companies are still ticking boxes.

WHY DO COMPANIES BOX-TICK?

WHY SHOULD IT BE AVOIDED?

Prior to ascertaining how to reduce the prevalence of box-ticking, it is apposite to establish why companies box-tick, and why box-ticking does not necessarily result in optimum governance structures. As well as depicting the exploits of boards, the literature has often attributed the term ‘box-ticking’ to the actions of shareholders in methodically ticking compliance boxes against specified recommendations when assessing the corporate governance structures of their portfolio companies.³³ If shareholders equate good corporate governance with adherence to prescribed structural norms, it is no surprise that boards also submit to box-ticking in order to avoid admonishment or more drastic sanctions from their shareholders. Coombes and Wong coined the term ‘comply-or-breach’ in describing how shareholders truly treat the ‘comply-or-explain’ regime.³⁴ In effect, shareholders treated the Combined Code as a rigid set of rules,³⁵ exerting significant pressure on boards if they had the audacity to deviate from the code. Shareholders would not accept, or even consider, explanations for non-compliance.³⁶ Over time, this designation of shareholder behaviour became more nuanced, to

³³ P. Coombes and S. Wong, (2004), ‘Why codes of governance work: Corporate-governance codes are definitely effective – within limits’ 2 *The McKinsey Quarterly* 48, 53.

³⁴ Ibid 53. The term ‘comply-or-else’ has also often been used to describe the same phenomena (for example, V. Wilcox and M. Musaali, ‘From “Comply or Explain” to “Comply or Else”’ (2007) <<http://ssrn.com/abstract=1407444>>

³⁵ n 13 above, para 1.12

³⁶ S. Arcot and V. Bruno, ‘In Letter but not in Spirit: An Analysis of Corporate Governance in the UK’ (2005) at 32 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=819784>; Arcot et al (2009) (n 12 above 22); S. Arcot and V. Bruno, ‘One size does not fit all, after all: Evidence from Corporate Governance’ (2007) at 24 <<http://ssrn.com/abstract=887947>>; N. Canker, ‘Transition Economies and Corporate Governance Codes: Can Self-Regulation of Corporate Governance Really Work?’ (2005) 5 *JCLS* 285, 301; Coombes and Wong, (2004) (n 33 above 53); and Sergakis (2015) (n 9 above 264). A much cited example is when Marks and Spencer plc (M&S), in 2008, combined the roles of chairman and CEO, contrary to the June 2006 version of the Combined Code. The CEO of Legal & General Investment Management, a significant shareholder in M&S, infamously stated, ‘We don’t believe M&S should be explaining why they are not complying. They should be complying.’ (N. Paler, ‘AAA-rated Buxton and Fidelity pile pressure on M&S’s Rose’ *CityWire Money* (31 March 2008) <<http://citywire.co.uk/money/aaa-rated-buxton-and-fidelity-pile-pressure-on-mandss-rose/a299805>>.

what some have called ‘comply-or-perform’.³⁷ When portfolio companies were performing well, shareholders would be ambivalent to the corporate governance arrangements of such companies. However, upon a downturn in performance of any such company, to the extent that such company had deviated from code recommendations, shareholders would severely reprimand the relevant board.³⁸ Both the concepts of ‘comply-or-breach’ and ‘comply-or-perform’ incentivise boards to box-tick,³⁹ and ‘comply-or-perform’, in particular, hampers proactive action by shareholders prior to a company becoming distressed, negating one of the aims of the Code.⁴⁰ In order to avoid the rebuke of shareholders, whether from the outset, or after a period of downturn, boards would find it simpler and safer to adhere to all the provisions of the relevant code.

The penchant for shareholders to engage in box-ticking, which, in turn, creates a box-ticking environment within companies, is further nourished through shareholders over-relying on proxy advisors and corporate governance indices. The ability of fund managers to carefully examine the disclosure statements of all companies in their portfolios, and to drill-down into explanations in the event of non-compliance through company engagement, is hampered by significant resource constraints.⁴¹ Proxy advisors or corporate governance advisory firms provide a means by which

³⁷ I. MacNeil and X. Li, “‘Comply or Explain’: market discipline and non-compliance with the Combined Code’ (2006) 14 Corp. Gov. 486, 492 - the term ‘comply-or-perform’ was used in describing how investors used financial performance as a proxy for assessing justifications for non-compliance with the Combined Code.

³⁸ Arcot and Bruno (2005) (n 36 above 33); Arcot et al (2009) (n 12 above 23); and Sergakis (2015) (n 9 above 264).

³⁹ In the relation to ‘comply-or-breach’, see: FRC Review of the 2003 Combined Code: The Findings of the Review (January 2006) at 8.

⁴⁰ In the case of a company downturn caused by poor governance, the application of comply-or-perform would lead to shareholders only pressuring the board to improve governance after the company has seen a downturn of performance, rather than pushing for governance changes prior to, and in avoidance of, such a downturn (Arcot et al (2009) (n 12 above 23)).

⁴¹ M. Schouten, ‘Do Institutional Investors Follow Proxy Advice Blindly?’ (2012) at 28 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1978343&download=yes>. There is also a lack of motivation to expend further resources on monitoring investments, since a shareholder can ‘free-ride’ on the back of the monitoring efforts of other shareholders; the shareholder that is proactive in lobbying for change incurs all the costs, but all the shareholders benefit from the upside to the extent of their interests in the company. This is a situation particularly pertinent where no shareholder has a large enough interest in the company to be incentivised to take the lead, and where shareholders can simply exit through sale of shares.

resource constraints can be overcome by them assessing the corporate governance arrangements of companies and using such assessments to advise their clients on how to vote at general meetings. It seems, though, that proxy advisors themselves take a box-ticking approach to corporate governance, rarely taking into account the individual circumstances of companies, nor fully accepting explanations for non-compliance.⁴² One example, of this approach is the manner in which International Shareholder Services (ISS), one of the most prominent proxy advisors, recommends, as a matter of principle, shareholder objection to the combination of the roles of CEO and chair,⁴³ even though this requirement is merely a provision against which companies should comply-or-explain under the Code. By treating this aspect as a bright-line rule, clearly the proxy advisor is not considering whether a relevant company is able to adhere to the main principle that there is a clear division of responsibilities at the head of the company without separating the roles of CEO and chair. Although evidence of the extent to which shareholders blindly rely upon the advice of proxy advisors is inconclusive,⁴⁴ the FRC has acknowledged that with the extensive diversification of the UK equity markets over the last few decades, smaller institutional investors and non-UK-based investors, with

⁴² See: 2014 FRC Review at 4; Developments in Corporate Governance and Stewardship 2015 (January 2016) at 15 (2015 FRC Review); Moore (2009) (n 28 above 123). The rationale for proxy advisors in taking this approach stems from a degree of resource constraint themselves, aggravated by listed company annual general meetings (AGMs) tending to bunch together around a notional ‘AGM-season’ (2015 FRC Review at 15).

⁴³ ISS International Sustainability Proxy Voting Guidelines 2018 Policy Recommendations (23 January 2018) at 11. On the other hand, Glass Lewis (although it strongly supports the separation of roles) states that it will not automatically recommend votes against the nomination committee chair if an executive also chairs the board so long as there is an incumbent senior independent director (Glass Lewis 2018 Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice (UK) at 6 (Glass Lewis UK 2018)).

⁴⁴ For example, J. Cotter et al, ‘ISS Recommendations and Mutual Fund Voting on Proxy Proposals’ (2010) 55 Vill. L. Rev. 1 - US mutual funds who were clients of ISS consistently voted in accordance with its advice. In contrast: (i) Choi et al, ‘Voting Through Agents: How Mutual Funds Vote on Director Elections’ *New York University Law and Economics Working Papers* (9 January 2011) 1 – suggesting that ISS recommendations were used as inputs into an independently measured evaluation; and (ii) n 41 above - suggesting that investors attribute evaluation resources where there is the potential for a large effect on portfolio value.

less familiarity of UK company governance structures, may be more inclined to rely upon proxy advisors, thereby increasing their influence.⁴⁵

Both shareholders and companies may also be influenced by the machinations of corporate governance rating firms. An industry has grown on the back of rating or, more aptly, marking the corporate governance structures of listed companies.⁴⁶ Such an undertaking, though, is difficult, if not impossible, to accurately roll-out across companies on a general basis. Good corporate governance is very much a nebulous term, and, therefore, such rating firms use visible and discrete measures as a substitute for detailed research into day-to-day governance on a company-by-company basis.⁴⁷ The result is a wish-list of governance requirements, whereby a compliant company receives a positive ‘tick’ and a non-compliant company receives a negative ‘cross’; the very definition of box-ticking.⁴⁸ Such a ‘one-size-fits-all’ approach ignores both the flexibility intended by the Code and the level of an individual company’s adherence to the spirit of the Code. A company not compliant with provisions of the Code could be subject to a low ‘score’ by a rating firm. Such a low score could affect risk assessment, and therefore investment appetite, of shareholders in a particular company. Box-ticking by boards is a reasonable reaction to avoid such impacts.

Another driver toward box-ticking is the sheer volume of governance disclosure. The April 2016 version of the Code required premium-listed companies to set-out how they had applied the 18 main principles, as well as explaining reasons for deviation from any of the 55 provisions, and further

⁴⁵ Developments in Corporate Governance 2012: The Impact and Implementation of the UK Corporate Governance and Stewardship Codes (December 2012) at 26.

⁴⁶ Examples include ISS’s QualityScore and the Institute of Directors Good Governance Index (IoD GGI).

⁴⁷ B. Black et al, ‘Corporate governance indices and construct validity’ (2017) 25 Corp. Govern. Int. Rev. 397, 397.

⁴⁸ Arcot and Bruno (2007) (n 36 above 8); and Moore (2009) (n 28 above 121). An example can be seen in ‘The Institute of Directors 2017 Good Governance Report: The great governance debate continued’ at 16 – the report sets out the key objective factors against which a company’s governance will be scored. The criteria (for example, ‘separate CEO and Chairman?’, and ‘independent chairman?’) do not take into account individual company circumstances nor potential explanations for non-compliance. A low score under the IoD’s GGI can result in adverse press (see, for instance, E. Featherstone, ‘GlaxoSmithKline ranked worst in business group’s list of well run companies’ *Independent* (9 October 2017) <<https://www.independent.co.uk/news/business/news/glaxosmithkline-worst-institute-of-directors-well-run-companies-a7990721.html>>

embodying a number of disclosure requirements,⁴⁹ consideration of the supporting principles and publication of a chair's statement. Outside of the Code, premium-listed companies are required to make substantial further disclosures in their annual reports.⁵⁰ The average length of the annual report for a FTSE-350 company in 2017 was 170 pages,⁵¹ with the front end of the report, being the narrative disclosures excluding the financial statements, amounting to 104 pages on average.⁵² The levels of disclosure required can overwhelm governance teams. In such a scenario, with respect to the Code's provisions, the easiest option is to comply rather than explain any form of non-compliance. Moreover, it can become difficult for boards to see the wood from the trees leading to the burden of disclosure burying thorough consideration of the most appropriate forms of governance structures and ensuring that those structures are consistent with the principles of the Code. Disclosure becomes a compliance exercise rather than an instrument to shine a light on the governance arrangements of a company that could prompt the appropriate degree of self-introspection. Likewise, from the perspective of shareholders, attempting to ascertain the appropriateness of a company's governance structure becomes a Sisyphean task in the face of such voluminous disclosure. For a diversified institutional shareholder with a vast portfolio, through the necessity of practicality, the natural instinct is to use the Code as a check-box list, rather than forensically analysing the disclosures of each investee company. A vicious circle develops with the clutter of disclosure influencing the behaviours of both boards and shareholders, each of which further perpetuates the conduct of the other.

So why should the two types of box-ticking be avoided? The first point to note relates to companies not considering alternative governance arrangements. In and of itself, box-ticking is not insidious if the corporate governance norms with which it forces adherence result in the most expedient governance structures for companies. If that were the case, a good argument could be made

⁴⁹ For example, disclosures as to why non-executives are considered independent, board evaluation outcomes, going concern statement, and descriptions of the work of the committees (for a full list, see: PWC: Continuing obligations for companies listed in the UK (January 2018) at 12).

⁵⁰ Including pursuant to the Listing Rules, the Disclosure Guidance and Transparency Rules, the Market Abuse Regulations, and the requirement to prepare a strategic report under the Companies Act 2006 (CA 2006), s 414A.

⁵¹ Grant Thornton Corporate Governance Review 2017 at 8.

⁵² *Ibid* at 8.

for making compliance mandatory; but, as Cadbury articulated, the Code should be implemented flexibly.⁵³ The listed-company world encompasses an expansive diversity. A standard governance structure may suit some companies but not others, and one-size-fits-all governance is therefore not the optimum approach.⁵⁴ As Keay stated, ‘The whole point of comply or explain is to permit companies not to comply if they explain their reasons for deviating from code provisions.’⁵⁵ Box-ticking implicitly undermines flexibility. Empirical evidence suggests that granting flexibility to companies is not simply of quixotic relevance. It has not even been conclusively proved, empirically, that two of the more fundamental and celebrated governance norms, splitting the roles of CEO and chair, and increasing the numbers of independent directors on boards, improve firm performance in developed countries.⁵⁶ Some authors have explained the inconclusiveness of the empirical evidence by asserting that although the principles behind such requirements are sound, companies should consider the means of implementation on a case-by-case basis since ‘one-size-does-not-fit-all’.⁵⁷ Broader studies examining governance have shown that companies that do not comply with the Code, but provide good and genuine explanations for non-compliance, outperform companies that are in full compliance,⁵⁸ with the authors opining that flexibility, as opposed to perfunctory adherence, is essential to the success of the Code. A recent study also finds that firms with a single dominant shareholder are less likely to comply with the Code, but such non-compliance is not associated with worse performance; the authors attribute this to the Code provisions having less relevance to such

⁵³ n 1 above at para. 1.10.

⁵⁴ Arcot and Bruno (2007) (n 36 above 2).

⁵⁵ A. Keay, ‘Comply or explain in corporate governance codes: in need of greater regulatory oversight’ (2014) 34 Leg. Stud. 279, 289.

⁵⁶ For a summary of the relevant literature: L. Heracleous, ‘What is the Impact of Corporate Governance on Organisational Performance?’ (2001) 9 Corp. Gov. 165, 167; S. Bhagat and B. Black, ‘The Uncertain Relationship Between Board Composition and Firm Performance’ (1999) 54 Bus. Law. 921, 945; P. Brown, W. Beekes and P. Verhoeven, ‘Corporate Governance, accounting and finance: A review’ (2011) 51 Accounting and Finance 96, 119; R. Krause, M. Semadeni and A. Cannella Jr., ‘CEO Duality: A Review and Research Agenda’ (2014) 40 J. Manag. 256, 258; Simpson Thacher & Bartlett LLP and Rivel Research Group, ‘CEO/Chairman Structure & Company Performance’ (July 2017).

⁵⁷ Arcot and Bruno (2007) (n 36 above 8); Brown et al (2011) (ibid 118); and Heracleous (2001) (ibid 170). For some companies, the costs entailed in complying may outweigh the benefits (Arcot and Bruno (2007) (n 36 above 6)).

⁵⁸ Arcot and Bruno (2007) (n 36 above 19); MacNeil and Li (2006) (n 37 above 490).

firms.⁵⁹ These broader studies give greater credence to the importance of flexibility than studies that examine the influence of individual governance standards. Although it should be recognised that flaws are likely to exist in all empirical studies (due to difficulties in isolating governance against firm performance in a regression analysis, and from endogeneity issues⁶⁰), it is apparent that little evidence exists that prescriptive governance standards result in better performing companies in all cases.

Second, in relation to following form over substance, box-ticking is indicative of directors either consciously or subconsciously pursuing the easiest option. The principles of the Code are formulated to cause boards to carefully design the company's governance to ensure that it supports the goals that the principles are attempting to achieve. Box-ticking can give boards a velour of credibility to shareholders even if they are not genuinely engaging with governance principles, and from the board's perspective, boards can indulge in the illusion that they have fulfilled all their governance duties simply by ticking all the boxes. Box-ticking a governance check-list does not guarantee that a company is being governed well nor that the principles are being applied in a meaningful way. As the FSA has pontificated: 'Process alone may involve little more than a box-ticking affirmation that the formal structures required for discussion and decision-taking exist.'⁶¹ Taking the previous version of the Code, an example is where a company ticks the box on splitting the roles of CEO and chair⁶² in apparent fulfillment of the principle that no one individual should have unfettered powers of decision-making.⁶³ If the CEO, in fact, dominates the board in the face of a

⁵⁹ S. Arcot and V. Bruno, 'Corporate Governance and Ownership: Evidence from a Non-Mandatory Regulation' (2018) 3 JLFA 59, 77.

⁶⁰ For example, firm performance may influence governance structure as much as *vice versa*. A poorly performing company may proactively bring itself into full compliance to protect against claims that the board is not observing good governance (a manifestation of the comply-or-perform mentality referenced above). Equally, a well-performing company may be more courageous in implementing alternative governance mechanisms, or simply ignoring certain governance norms on the basis that it is unlikely that shareholders will be critical when performance is good.

⁶¹ The failure of the Royal Bank of Scotland: Financial Services Authority Board Report (December 2011) at 223.

⁶² Provision A.2.1 of the April 2016 version of the Code.

⁶³ Principle A.2 of the April 2016 version of the Code.

subservient chair, ticking that box has not served the underlying purpose of the principle.⁶⁴ Another example is where a board provides a viability statement confirming the long-term health of the company in accordance with the provisions of the Code,⁶⁵ without fully considering whether the company has maintained sound risk management and internal control systems in accordance with the principles.⁶⁶ If the company has merely box-ticked, the viability statement will be meaningless and, again, provides boards, shareholders and proxy advisors with an illusion that the company has engaged in good governance. Such behaviour can apply both to boards wishing to avoid the underlying rationale of a principle in order to engage in acts not in the interests of the company, and to boards that are not intentionally seeking to act in an egregious manner, but are lazily box-ticking and not considering the principle meticulously. In both cases, as above, box-ticking against the relevant provisions will likely satisfy shareholders. Box-ticking of this nature could also explain the lack of conclusive governance-performance empirical evidence – if companies are simply box-ticking and not faithfully applying the principles, fully complying with the provisions will not necessarily improve firm performance.

BACK TO THE FUTURE: THE NEW CORPORATE GOVERNANCE CODE

The current zeitgeist for 80s and 90s nostalgia seems to have been embraced by the FRC. Although there is no DeLorean in sight, the New Code is very much a scaled-back product in that it is more closely entwined with the ideology of the original Cadbury Code of 1992. The New Code emphasises

⁶⁴ An example of sorts can be seen with the Royal Bank of Scotland (RBS). In 2003, the FSA had identified the dominant position of RBS' CEO as a risk factor (n 61 above 233 and 242). However, in successive annual reports, RBS confirmed that it had complied with the provision recommending the CEO-chair split (for example, RBS Annual Report and Accounts 2007 at 99), without discussing how the risk that had been identified had been allayed to ensure that the company was applying the principles appropriately.

⁶⁵ Provision C.2.2 of the April 2016 version of the Code.

⁶⁶ Principle C.2 of the April 2016 version of the Code. In fact, Carillion plc (Carillion) published a viability statement and a three-year going concern determination (in accordance with the provisions of the Code) in its annual report for the financial year prior to the company entering into liquidation (Carillion Annual Report and Accounts 2016 at 57).

the spirit of the principles, and that boiler-plate reporting and a ‘tick-box’ approach should be avoided.⁶⁷ With this iteration of the Code, such words are not merely idle commentary. The number of provisions has been trimmed significantly, with a substantial number of provisions being moved to the Code’s guidance document – ‘Guidance on Board Effectiveness’ (the Guidance). After an inflation phase lasting twenty-five years, during which successive versions of the Code have expanded the levels of disclosure, the FRC has, finally, shortened the Code, reducing the number of provisions to 41.⁶⁸

Obviously, skimming back the provisions reduces the number of boxes to tick, thereby emboldening boards to follow the spirit of the principles. Another progressive step is that prescriptive recommendations on directors’ performance-related remuneration set forth in Schedule A of the previous version of the Code have now either been incorporated into the front-end provisions of the New Code, or deleted. The New Code has also split the first two sections of the Code into three, and, in so doing, better links the principles to the subject matter of each of those sections. Constructively, aspects embracing ‘Relations with Shareholders’ have been removed as a separate section, since treating engagement with shareholders in isolation with an absence of context can lead boards to produce quite generic statements of general shareholder engagement without explicitly outlining how the board has engaged on specific issues. The principles under the New Code remain relatively faithful to the original 19 broad recommendations of the Cadbury Code, and, crucially, the New Code has dispensed with the concept of ‘supporting principles’, removing one of the more confusing aspects of the Code and eliminating an additional driver toward boiler-plate reporting.

Overall, the surprising direction that the FRC has taken to reducing the breadth of the Code, after years of expansion, is a step in the right direction with respect to eliminating box-ticking, and is tacit acceptance that the years of expansion have not been beneficial to corporate governance. The question persists, though, as to whether the New Code has gone far enough.

⁶⁷ The New Code at 1 and 2.

⁶⁸ The New Code comprises 18 principles and 41 provisions, as compared to the previous version of the Code which consisted of 18 principles, 55 provisions and 27 paragraphs of supporting principles.

**RUNNING WITH THE BALL:
RE-ENGINEERING THE CODE**

Evolution rather than revolution has been the order of the day since 1992. Finally, though, the FRC has published a Code that scales-back on prescription, recognising the sophisticated governance norms apparent in a UK-listed company governance world that had moved on since 1992. Picking-up the baton, an opportunity now exists to reform the Code so that it is fit-for-purpose in a mature business environment.

The New Code does not go far enough. It is hereby submitted that, in fact, the provisions of the New Code are no longer essential, and that the Code would be better served if it were comprised entirely of principles. Many provisions that have been consistently impressed on companies for decades are now treated, by shareholders and companies alike, as requirements. Their mainstream acceptance as corporate governance norms mean that the Code no longer needs to promote them on a prescriptive basis. Indeed, Fasterling posited that the primary value of disclosure obligations against codes of best practice is to develop governance norms, rather than, arguably, the more laudable goal of ‘soft’ regulation to instigate genuine transparency in issuer governance structures so that shareholders can assess their appropriateness.⁶⁹ Compliance disclosure regimes are therefore well-suited to developing markets, particularly where no positive correlation currently exists between governance standards and share price.⁷⁰ Interestingly, although, as above, empirical evidence has suggested that companies in developed countries that embrace flexibility seem to perform better than those in full-compliance, in developing countries, where codes of best practice have been introduced on a non-mandatory basis, the opposite is found.⁷¹ This suggests that in developing countries where norms have not yet been established, companies are not only non-compliant, but have not established other governance structures that adhere to the principles upon which the recommendations have been formed. Therefore, in such circumstances, prescriptive provisions are useful in bringing poorly governed companies to at least a minimum level of ‘good governance’ even if the structure is not the

⁶⁹ B. Fasterling, ‘Development of Norms Through Compliance Disclosure’ (2012) 106 J. Bus. Ethics 73.

⁷⁰ Ibid 80; Canker (2005) (n 36 above 301).

⁷¹ Arcot and Bruno (2007) (n 36 above 6).

optimum for specific companies. Once those norms have been established, their inclusion in ‘codes of best practice’ starts to diminish the flexibility of companies to implement more beneficial structures that do not conform to such norms,⁷² and the process of continual engagement between issuers and shareholders is undermined.⁷³ In a mature market, the key, now, is to create an environment where shareholders will more readily accept credible justifications by companies where alternative governance arrangements are germane. A system without prescriptive provisions but consisting of broad principles which elicit sufficient disclosure by issuers as to what corporate governance processes have been put in place and how such processes correspond to the spirit of the principles will be conducive in this regard. Companies will still need to be persuasive in their narratives, since, even though no boxes remain to be ticked, shareholders will require good explanations for deviations from ingrained corporate governance norms.

An argument could be made, though, that where the FRC determines that new elements should be introduced to the Code, provisions are beneficial since the relevant requirement has not yet formed part of a mature corporate governance environment. However, one should not lose sight of the underlying mechanic of the Code - the successful operation of the Code hinges on sufficient information being distributed to shareholders so that they can act if necessary. This shareholder-focus of the Code resonates with the industry-led approach of the Cadbury Committee, and, ideally, the Code should reflect market consensus.⁷⁴ From the perspective of an industry-led approach, examples of ‘worthy’ and ‘unworthy’ new inclusions can be identified in the New Code. For example, the New Code has extended the recommended vesting and holding period for share awards to five years from three years.⁷⁵ Institutional investors had been pushing for such longer periods for some time,⁷⁶ and such a recommendation is therefore ‘worthy’. For ‘worthy’ provisions, the conveyance of market expectations, with which boards would nevertheless be under pressure to comply, could instead be

⁷² n 69 above 75.

⁷³ *ibid* 80.

⁷⁴ The business community and institutional investors were represented on the Cadbury Committee (Cheffins (1997) (n 9 above 374). Also, see: n 1 above 12 - ‘Indeed the Code closely reflects existing best practice.’

⁷⁵ New Code, provision 36.

⁷⁶ For example, The Investment Association, ‘Principles of Remuneration’ (11 November 2015) at 10.

fulfilled by setting-out the expectations of various principal industry bodies in the Guidance, making it easier to discuss flexibility with shareholders where the board does not have to expressly declare that it is patently in non-compliance with a provision. On the unworthy side, certain provisions, such as those on worker engagement, have been inserted at the behest of the Government.⁷⁷ This aligns with the FRC being a public body.⁷⁸ Although inclusion as provisions (rather than Guidance) may prompt better compliance with new recommendations not born of market expectation, the use of the Code to advance governmental agenda does not sit comfortably with the original purposes of the Code. It has given the legislators the opportunity to pass-the-buck to a comply-or-explain regime rather than owning the policy and enacting legislation. In relation to workers engagement in particular, the Government can thus present the illusion that it has adhered to its initial proposal to mandate board-appointed employees⁷⁹ without, in fact, specifically requiring boards to do so. The Code operates as a shareholder disclosure regime, giving shareholders the information they require to act - if the relevant information is not important to, or valued by, shareholders, the validity of requiring disclosure under the Code can be doubted, especially when combined with prescriptive provisions. That is not to say that companies should not be subject to new requirements that are not industry-led, but such requirements are not well-suited to the Code. Provisions that are proposed to satisfy broader societal benefits rather than directly benefiting shareholders are better suited to, and achieved, through legislation rather than through the Code. This presents a further reason to eliminate provisions from the Code over and above a desire to lessen box-ticking.

In evaluating the provisions of the New Code, they can, generally, be placed into four categories. Firstly, several provisions in the Code, although meritorious in expression, are, in practice, meaningless in application. Such provisions are common sense instructions with which no board would ever have the temerity to disclose non-compliance, and which are so vague that it is impossible to ascertain compliance. An example is the provision that states, ‘The board should take

⁷⁷ nn 100, 104 and 107 below.

⁷⁸ The Independent Review of the Financial Reporting Council (6 June 2018) at 13 notes the risk to independence apparent from the FRC’s relationship with the Government.

⁷⁹ ‘...we’re going to have not just consumers represented on company boards, but employees as well.’ - Teresa May, July 2016.

action to identify and manage conflicts of interest, including those resulting from significant shareholdings, and ensure that the influence of third parties does not compromise or override independent judgment.’⁸⁰ No board would ever acknowledge that it does not ‘identify and manage conflicts of interest’; it will simply confirm compliance. Equally, no directors would divulge that their independent judgment has been compromised, essentially confessing that they have breached their directors’ duties.⁸¹ If the subject matter of such provisions is critical from a governance perspective, they should be modified into principles,⁸² and, otherwise, they would sit better alongside the current advice in the Guidance since they direct boards to consider how they should palpably act in applying the principles.

Second, and crucially from the standpoint of box-ticking, a number of provisions that are intended to be flexibly applied have taken the form of pseudo-mandatory requirements; those provisions with which shareholders insist that companies comply, such as the CEO-chair split.⁸³ In order to re-engage boards, and shareholders, with the essence of the principles, it would be better to remove such provisions from the Code, or include them as examples of governance structures that assist in applying the principles in the Guidance. Over time, the flexibility for companies to propose alternates would not be so readily rebuffed by shareholders.

Third, certain provisions, such as annual re-election of directors,⁸⁴ with which there are currently extremely high levels of compliance, appear to be primary objectives of the regulator, notwithstanding assertions of the right to be flexible. If that is the case, it becomes better for the regulators to be forthright in their attitudes. Such effectively mandatory provisions have infiltrated the Code partly as a result of governmental influence as described above, and also as a result of the FRC discerning over time that certain standards are imperative and not equally served by alternative

⁸⁰ New Code, provision 7.

⁸¹ CA 2006, s 173 requires directors to exercise independent judgment.

⁸² For example, rather than a requirement to manage conflicts being a provision, it would be better if there were a principle that effectively requires the board to disclose conflicts and explain what processes have been implemented to mitigate against potential conflicts.

⁸³ n 109 below and accompanying text.

⁸⁴ n 141 below and accompanying text.

arrangements. They cross-contaminate other provisions in the Code which are intended to apply on a comply-or-explain basis, thereby promoting a box-ticking culture. An alternative would be to emulate the treatment of directors' long-term incentive schemes under the Listing Rules, which must be approved by shareholders,⁸⁵ unless 'established specifically to facilitate, in unusual circumstances, the recruitment or retention of the relevant individual'.⁸⁶ Similarly, provisions of this sort could be moved to the Listing Rules in a manner that specifies that non-compliance mandatorily requires prior shareholder approval, unless there are exceptional or unusual circumstances for not seeking such approval, in which case the company must disclose such circumstances immediately and be prepared to explain them in the annual report.⁸⁷ Equally, provisions that expressly require disclosure in the annual report do not conform with the comply-or-explain nature of the provisions. A provision that states: 'The annual report should set out the number of meetings of the board and its committees, and the individual attendance by directors'⁸⁸ is, effectively, a mandatory requirement; it would be extremely difficult for any board to justify non-compliance. Significantly, a large minority of companies perpetually ignore certain annual report disclosure elements in the Code yet still contend full compliance with the Code given the difficulty in justifying non-compliance⁸⁹ – integrating these elements into the mandatory annual report disclosure requirements of the Listing Rules should give them more weight in the consideration of boards.⁹⁰

Fourth, some provisions, and, to a lesser degree, principles, are duplicative of legislation, regulations or requirements specified outside the Code, which can result in confusion between competing regulatory protocols. In many cases, this has occurred as a result of changing governmental, EU and regulatory perception as to the imperative of various standards over time. For

⁸⁵ LR 9.4.1.

⁸⁶ LR 9.4.2(2).

⁸⁷ Similar to LR 9.4.3.

⁸⁸ New Code, provision 14.

⁸⁹ n 51 above 27 - for example, although provision E.1.2 of the previous version of the Code required companies to outline in the annual report the steps taken to understand the views of major shareholders, 22% of FTSE-350 companies did not make the necessary disclosure, even though they asserted full compliance with the Code.

⁹⁰ LR 9.8.

example, certain audit committee provisions mirror mandatory requirements that have been implemented as a result of EU directives.⁹¹

Below, it is argued in relation to each of the New Code's five sections how the current provisions can be categorised broadly within the classifications outlined above, and therefore eliminated.

Board Leadership and Company Purpose

The first section of the New Code comprises five principles and eight provisions. Some provisions produce meaningless outcomes, including the requirement with respect to conflicts of interest as outlined above.⁹² Additionally, one provision deals with company 'culture' requiring the board to assess and monitor culture, and ensure that management has taken corrective action if business behaviour is not aligned with the company's purpose, values and strategy.⁹³ It is highly unlikely that any board would disclose non-compliance with such a provision. Clearly 'company culture' as a concept has become an integral part of the governance conversation stemming from persuasive arguments that embodying a healthy culture within a company contributes to success.⁹⁴ Superficial compliance with the recommendations on culture and conflicts could be avoided by adapting them into principles that essentially require boards to describe what they have done to ingrain culture and mitigate conflicts.⁹⁵

⁹¹ n 160 below.

⁹² n 80 above and accompanying text.

⁹³ New Code, provision 2.

⁹⁴ In particular, see: the FRC report on 'Corporate Culture and the Role of Boards: Report of Observations' (July 2016).

⁹⁵ Other meaningless provisions that could simply be moved to the Guidance include requirements on the chair and committee chairs to seek engagement with shareholders (New Code, provision 3), and for board minutes to record any concerns of directors (and for resigning non-executive directors to be required to provide a written statement of concerns) (New Code, provision 8). Additionally, in relation to the provision on shareholder engagement, this overlaps with principle D of the New Code which already states that boards should ensure effective engagement with shareholders and other stakeholders – LR 9.8.6(5) would require the company to discuss adherence to this principle in the first instance, rendering a

A further provision requires the board to assess the basis on which the company creates value over the long-term, and to disclose how risks and opportunities have been assessed, the sustainability of the business model and how governance contributes to strategy.⁹⁶ It is difficult to see what this provision materially adds beyond what is already required by the Code's viability statement requirement (as further discussed below)⁹⁷ and the legislative requirements to prepare a strategic report,⁹⁸ and is therefore duplicative. The only potentially useful requirement is to discuss how governance structure contributes to delivery of the strategy, and, therefore, it is hereby advocated that this element be included as a positive requirement as part of the principles.

Provisions have been inserted in the New Code pursuant to Government recommendations initiated by its recent Green Paper.⁹⁹ One aspect relates to stakeholder engagement, requiring boards to 'understand the views of key stakeholders', and, in relation to the workforce, use specified engagement methods.¹⁰⁰ Principle D already requires boards to ensure effective engagement with all stakeholders. A simple addition to that principle to expressly require disclosure of the methods of stakeholder engagement,¹⁰¹ with the Guidance including the examples of appropriate methods to establish the views of the workforce would promote more meaningful adherence to Principle D and allow shareholders (and employees and the public generally) to opine on adequacy. There is also a level of duplication, since recent legislation requires large companies to include a statement in the

separate provision on the requirements of the chair and committee chairs unnecessary (which could be included in the Guidance to direct boards as to what could be done to ensure appropriate levels of engagement).

⁹⁶ New Code, provision 1.

⁹⁷ New Code, provision 31.

⁹⁸ CA 2006, s 414A.

⁹⁹ Department for Business, Energy and Industrial Strategy Green Paper, 'Corporate Governance Reform' (November 2016).

¹⁰⁰ New Code, provision 5. Workforce engagement should be through one or a combination of: workforce board membership, workforce advisory committee and through a non-executive director designated as a workforce liaison. This was a Government proposed measure set out in the Department for Business, Energy and Industrial Strategy report, 'Corporate Governance Reform: The Government response to the green paper consultation' (August 2017) (the Government's Green Paper Response) at 33.

¹⁰¹ Principle E could also be expanded to require narrative pertaining to the establishment and disclosure of whistle-blowing procedures, rather than including these as a meaningless provision (since no board would admit non-compliance) as is currently the case under provision 6.

directors' report summarising how the directors have engaged with employees, and how they have had regard to employees' interests and the need to foster the company's relationships with suppliers, customers and others.¹⁰² A level of scepticism may be directed at the efficacy of amending the principle and moving the worker engagement methods to the Guidance, given that such methods are entirely novel in concept to the Code. However, if the aim is to ensure that companies implement one of the three methods, it should be moved to mandatory legislation, which, as discussed above, better tallies with the governmental policy-driven nature of the proposal. The New Code also includes, at the behest of the Government,¹⁰³ provision for circumstances where a company encounters significant voting opposition from shareholders to any resolution.¹⁰⁴ This new provision is a very clear, prescriptive instruction as to the process to be followed by companies. It harks back to the criticism of prescriptiveness under the Higgs Report in a more palpable respect.¹⁰⁵ It would be more suited to the Listing Rules or mandatory legislation. If the FRC intends the provision to be applied on a more voluntary, comply-or-explain basis, which is certainly not obviously the case, then the provision should be moved to the Guidance or consigned to the realm of private enforcement through shareholder pressure as also recommended by the Government.¹⁰⁶

The Government's Green Paper Response has also influenced the inclusion of a provision requiring annual report disclosure as to how the matters set out in the Companies Act 2006, s 172

¹⁰² The Companies (Miscellaneous Reporting) Regulations 2018, regs 11 and 11(B), amending The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 7.

¹⁰³ Government's Green Paper Response at 18.

¹⁰⁴ New Code, provision 4. The provision states, or more fittingly requires, that where voting opposition of more than 20% is received, the company must disclose what actions it intends to take to understand shareholder views, and publish up-dates and summaries going forward in relation thereto.

¹⁰⁵ n 28 above 107.

¹⁰⁶ The Government has advised that the Investment Association (a representative body for asset owners) should keep a record of companies that have received significant opposition and their actions in relation thereto (Government's Green Paper Response at 19).

have impacted the board's decision-making.¹⁰⁷ This is unnecessary, and duplicative, given recent mandatory legislation obliging large companies to make the relevant disclosure.¹⁰⁸

Division of Responsibilities

The four principles and eight provisions of this section include a number of much discussed aspects of corporate governance relating to the composition and independence of the board. Front and centre is a provision declaring that the roles of chair and CEO should not be exercised by the same individual.¹⁰⁹ The principle to which this provision relates affirms that no one individual or small group of individuals should dominate the board's decision-making, and that there should be a clear division of responsibilities between the leadership of the board and the company's business.¹¹⁰ As considered above, the separation of chair and CEO is a prominent example of box-ticking, giving boards the opportunity to discuss application of the underlying principle merely by confirming compliance with the separation of the two roles. Further, by including the requirement to separate chair and CEO roles as a provision, shareholders and proxy advisors have often treated any deviation as a breach. In 2017, only around 3 per cent of FTSE-350 companies did not comply with this provision.¹¹¹ If it were clear that simply separating the two roles results in better firm performance, then box-ticking of this nature would garner beneficial consequences. However, the empirical evidence is inconclusive at best.¹¹² Although controversial, it is hereby submitted that the provision requiring the chair and CEO roles to be separated should be deleted. This would bring more prominence to, and give more scope to companies to align with, the underlying principle that no one individual should dominate, by using the most beneficial governance structure. It is acknowledged

¹⁰⁷ New Code, provision 5.

¹⁰⁸ The Companies (Miscellaneous Reporting) Regulations 2018, reg 4 (inserting CA 2006, s 414CZA) requires directors to describe in the strategic report how they have had regard to the stakeholder interests set out in CA 2006, s 172.

¹⁰⁹ New Code, provision 9.

¹¹⁰ New Code, principle G.

¹¹¹ n 51 above 28.

¹¹² n 56 above.

that, in most cases, companies will continue to split the two roles in order to properly apply the principle on ‘division of responsibilities’. Isolating the concept from any other consequences, the splitting of the roles will, *ceteris paribus*, create a stronger division at the top of the company. However, as above, including the requirement as a provision promotes companies justifying that there is a clear division of responsibilities merely by splitting the roles without drilling-down into how the company’s arrangements as a whole constitute the appropriate checks-and-balances over the CEO, especially where the chair is cowed, or heavily influenced, by the CEO. Over time, with the provision removed, better narration would be required to justify the particular governance structure. Furthermore, a company may feel that the detriments (such as power struggles, unclear responsibilities of leadership, marginalisation of other non-executive directors, and greater difficulties in the board understanding a highly technical business¹¹³) inherent in splitting the two roles outweigh the benefits given the business of the company and a strong independent element on the board.¹¹⁴ In such a case, a strong senior independent director on the board backed by challenging and respected non-executives could satisfy the principle more satisfactorily, in the overall context of the company’s requirements, than separate CEO/chair roles. The FRC should not fear that deletion of the provision will result in widespread reversion to joint CEO and chair roles, particularly since twenty-five years on, the concept of splitting the CEO and chair roles is seen as customary practice. After all, the original Cadbury Code did not explicitly require separation of the two roles, and until 2003, the Combined Code merely recommended a division of responsibilities;¹¹⁵ even so, within three years of publication of the Code, a substantial proportion of listed companies reported splitting of the two roles.¹¹⁶

¹¹³ D. Lund, ‘Nonvoting Shares and Efficient Corporate Governance’ (2019) 71 *Stan. L. Rev. (forthcoming)* 1, 28.

¹¹⁴ W. Allen and W. Berkley, ‘In Defense of the CEO Chair’ (September 2003) *HBR*; J. Lorsch and A. Zelleke, ‘Should the CEO Be the Chairman’ (Winter 2005) *MIT SMR* 70, 72; T. Vo, ‘To Be or Not to Be Both CEO and Board Chair’ (2010) 76 *Brook. L. Rev.* 65, 78.

¹¹⁵ The 2000 version of the Combined Code only required joint CEO / chair roles to be publicly justified.

¹¹⁶ E. Dedman, ‘The Cadbury Committee recommendations on corporate governance – a review of compliance and performance impacts’ (2002) 4 *IJMR* 335, 340 cites a number of studies, using different samples, that found that between 70% and 86% of companies split the roles. Additionally, the Cadbury Committee’s ‘Compliance Review’ (May 1995) found that ‘although not a requirement of the code, 95% of the top 500 companies have either split the roles of chairman and chief

A similar argument can be made to the provision requiring the appointment of a senior independent director.¹¹⁷ Again, it is likely that most companies will continue to appoint a senior independent director to apply the underlying principles, but, by removing the provision, boards would be encouraged to discuss such appointments or non-appointments in the full context of the composition of the board, and provide greater leeway to deviate if more beneficial to the company overall. For example, if the chair is truly independent and serves as an effective bulwark to the CEO, the appointment of a senior independent director could undermine the authority of the chair and ingrain confusion as to leadership of the board.¹¹⁸

A related issue pertains to provisions requiring a minimum number of independent non-executive directors.¹¹⁹ Although a similar provision educed the lowest levels of compliance amongst the FTSE-350, compliance was still at more than 91 per cent.¹²⁰ Principle G of the New Code already requires that the board should ‘include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors)’. With such high levels of compliance, the question remains as to whether boards are merely box-ticking, or truly implementing the most effective board composition in line with the underlying principle. It may be more favourable for certain companies, particularly young, growing companies, to prioritise board appointees with the appropriate degrees of expertise and skill rather than independence *per se*. The New Code has, curiously, also taken somewhat of a misstep as regards reducing box-ticking, by removing the ‘smaller company exemption’ of the previous version of the Code,¹²¹ stating that: ‘the Code sets good practice and that even smaller companies should strive for the highest standards of corporate

executive or, where combined, have a strong independent element on the board with a recognised senior member’ (A. Cadbury, ‘Companies’ Compliance with Cadbury Code’ (1995) 73 *Management Accounting* 4, 4).

¹¹⁷ New Code, provision 12.

¹¹⁸ n 23 above 36.

¹¹⁹ At least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent (New Code, provision 11).

¹²⁰ n 51 above 27.

¹²¹ Provision B.1.2 previously stipulated that ‘smaller companies’ (being those outside the FTSE-350) need only appoint two independent directors rather than requiring that at least half the board be independent.

governance'.¹²² Although smaller companies always have the option to 'explain' rather than 'comply', by not including an express exemption, a smaller company will feel more pressure to comply with the majority independence requirement, box-ticking itself into a costly¹²³ board structure that does not necessarily promote optimum success. Although provocative given the history and context of the Code, it may now be time to remove the independence prescription from the Code, and, instead, modify the underlying principle to require companies to provide more information as to how the independence element on the board is appropriate to the individual circumstances of the company, and on what basis boards have determined certain directors to be independent. The empirical evidence on whether greater independence on boards results in better firm performance is, again, inconclusive,¹²⁴ and a veneer of independence will not necessarily achieve the checks-and-balances sought by the Code.¹²⁵ In most cases, for large, mature companies, half the board being independent may be the most appropriate structure (and shareholders will continue to insist on such a board composition), but more flexibility is required to the extent that credible justifications can be made. One of the reasons why the empirical evidence may be inconclusive is that directors deemed by boards to be independent are not in fact as objective as proclaimed. The New Code includes a list of circumstances in which independence may be impaired.¹²⁶ However, it can not be guaranteed that freedom from those circumstances will ensure that the director is truly independent.¹²⁷ By including the list as a provision, the temptation would be for a board to label non-executives as independent if

¹²² n 4 above 11.

¹²³ The Higgs Report noted the challenge, from the perspective of compliance costs, in smaller company compliance (n 21 above at para. 16.5).

¹²⁴ n 56 above.

¹²⁵ Although Carillion complied with the Code's independence provisions, its non-executive directors were accused of not sufficiently challenging management nor providing adequate oversight House of Commons Report on Carillion: Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017-19 (16 May 2018) at 31.

¹²⁶ New Code, provision 10.

¹²⁷ For example, the genuine independence of non-executive directors who may be exclusively and unilaterally dismissed by a controlling shareholder can be questioned, even if they do not fall within the New Code's list of relationships where independence may be compromised (B. Reddy, 'The Fat Controller: Slimming Down the Excesses of Controlling Shareholders in UK Listed Companies' (2018) 38 OJLS 733, 754).

they are not covered by the provision's list, without genuinely considering whether such directors really are impartial. Furthermore, certain directors may be tainted by relationships on the list, but are, in fact, independent of thought and judgment in their conduct. An obvious example would be where a director has served for more than nine years; although such a director would, as a result of such tenure, be included within the independence impairment list, there is no real reason why such director should arbitrarily become less independent a day after his or her ninth anniversary as a board member (and *vice versa*).¹²⁸ The list could, instead, be moved to the Guidance as examples of where independence may be compromised, and a more progressive mechanic would be to allow shareholders to decide whether they agree with the independence adjudications of boards based upon the justifications given pursuant to a modified principle as espoused above.¹²⁹

Provision 9 of the New Code also states that a CEO should not go on to chair the same company. The statement is somewhat contradicted by the next sentence that states that in exceptional circumstances where this occurs, major shareholders should be consulted. It is easy to discern the potential ramifications of a CEO (or, indeed, any non-independent individual)¹³⁰ going on to the role of chair. The incoming CEO may be overawed by the previous CEO, and it would be difficult for the new CEO to instigate new strategies and policies within such a structure, particularly if that CEO has been groomed by, and is therefore submissive to, the previous CEO. On the other hand, it would be a shame if companies routinely check-the-box on this provision in a scenario where significant benefits could be gained by ensuring that the retiring CEO remains in a leadership position with the company to provide stability during a turbulent transition and continues to benefit the company through his or her experience and knowledge. The objectives of the recommendation could be better achieved by including a principle that the board should consult with major shareholders (to the extent such

¹²⁸ In 2017, only in 36 instances did FTSE-350 companies use the flexibility of the Code to claim that directors with greater than nine years of tenure were still independent (n 51 above 34).

¹²⁹ Shareholders are emboldened in this regard, since most premium-listed companies adhere to a provision requiring annual re-election of directors (n 142 below).

¹³⁰ Provision 9 of the New Code also requires that the chair be independent on appointment.

shareholders are willing to so engage)¹³¹ on all senior board appointments and board composition; this would reduce box-ticking mentality while satisfying the regulatory priority to improve shareholder engagement.

Other provisions in this section stress the desired roles and functions of various company actors, and the need to take account of a potential director's other commitments before making an appointment.¹³² These can be labeled as 'meaningless' provisions on the basis that they are unverifiable and no company would ever declare non-compliance. Additionally, further provisions requiring annual report disclosure of reasons for appointments and information relating to board meetings¹³³ should be moved to the Listing Rules as mandatory requirements,¹³⁴ since it is difficult to judge that the FRC intends such requirements to merely be applied on a comply-or-explain basis.

Composition, Succession and Evaluation

The three principles and seven provisions of this section mainly convey how directors should be appointed. This is the first section of the New Code to reference the use of committees, requiring a nomination committee, comprising a majority of independent non-executive directors, to lead the process for appointments.¹³⁵ Compliance with the composition requirements in 2017 was high.¹³⁶ The essential aspect is that the committee should be making decisions unfettered by any desires of the executive team to make unchallenging, conflicted or incestuous appointments. Ensuring that a majority of the committee consists of independent non-executive directors will not be adequate where a CEO who wields overbearing influence is also a member of the committee. To avoid box-ticking

¹³¹ Some shareholders may be unwilling to engage if they could become privy to inside information which locks-up their investment until such information is made public.

¹³² New Code, provisions 14, 15 and 16. In relation to time commitments, rather than prescriptive provisions limiting the extent of other commitments, the Listing Rules should be amended to require disclosure of all director time commitments, to allow shareholders to discern whether such time commitments are detrimental to director performance.

¹³³ New Code, provisions 14 and 15. Also, see: n 88 above and accompanying text.

¹³⁴ LR 9.8 already requires substantial annual report disclosures on a mandatory basis.

¹³⁵ New Code, provision 17.

¹³⁶ Only around 3.5% of FTSE-350 companies did not comply (n 51 above 28).

compliance, the provision should be deleted, with the relevant principle that requires a formal, rigorous and transparent procedure¹³⁷ amended to reflect the need for independence in decision-making. This would require the board to explain in detail how its process is robust, which may well involve including significant independent director membership of the committee. Provision 23 of the New Code requires that various aspects of the work of the committee be disclosed in the annual report – this disclosure requirement is so prescriptive that it would be better sitting within the Listing Rules requirements for annual report contents.¹³⁸ In relation to the use of external recruitment consultants, rather than providing that other connections between those consultants and the company or directors should be disclosed,¹³⁹ it would be better for the underlying principle to state that there should not be any conflict between the role of the consultant in identifying board candidates and any other connection with the company or directors. Such a principle would generate the same disclosures while guiding the board to the substance of the principle rather than box-ticking disclosure. In a welcome development, provision 23 of the New Code requires disclosure of the policy on diversity, its objectives and achievements. As with committee activities above, though, such a requirement should be made mandatory under the Listing Rules, and also better-linked to the principles.¹⁴⁰ Short of quotas, this will progress the diversity agenda by promoting more meaningful disclosures rather than the fairly vapid diversity aspirations currently disclosed by companies.

An extremely important aspect of the New Code is the provision recommending annual re-election for directors.¹⁴¹ Annual re-election is nearly ubiquitous at FTSE-350 companies.¹⁴² Previous versions of the Code included a smaller company exemption, but clearly the FRC now believes that

¹³⁷ New Code, principle J.

¹³⁸ LR 9.8.

¹³⁹ New Code, provision 20.

¹⁴⁰ Currently, the diversity-related elements of principle J of the New Code could easily be satisfied by a statement that the board has the correct balance of diverse skills, and the nomination process has had due regard for gender, social and ethnic backgrounds. Therefore, the principle should be amended to bring it in line with the new requirement under provision 23 for annual report diversity disclosure, so that companies are required to be transparent as to their policies and targets on diversity.

¹⁴¹ New Code, provision 18.

¹⁴² In 2017, this provision was not even within the top-10 contravened provisions by FTSE-350 companies (n 51 above 28).

all premium-listed companies should aspire to this norm.¹⁴³ As alluded to above, the ability to opine upon the tenure of directors on an annual basis is a fundamental power of shareholders in terms of giving the Code teeth. If shareholders are not content with company disclosures pursuant to the Code, the ultimate sanction would be for shareholders to remove directors from the board.¹⁴⁴ Therefore, there is a strong argument that such a provision should be made a mandatory requirement. It is difficult to foresee why premium-listed companies require the flexibility of the Code to permit longer tenures. Although the smaller company exemption perhaps gave smaller, growth companies more stability in board composition, surely shareholders would be unwilling to remove directors upon annual re-election if the company has clearly expressed the value of those directors on the board, and, in any case, such stability is an illusion in light of the ability of shareholders to remove directors at will through operation of legal powers.¹⁴⁵ There may be exceptional circumstance where longer terms are required, such as in relation to recruitment and retention, and, as such, it is hereby proposed that the requirement be moved to the Listing Rules in a format similar to LRs 9.4.1 and 9.4.3, such that all directors should be subject to annual re-election, unless there are unusual and exceptional circumstances, in which case those circumstances should be clearly and carefully explained in the annual report or prior to the relevant AGM.

Provisions requiring annual internal, and, for FTSE-350 companies, triennial external, board evaluations are included in this section of the New Code.¹⁴⁶ Only around 4.5 per cent of FTSE-350 companies did not comply with a similar requirement in 2017.¹⁴⁷ FTSE-350 companies may feel pressure to submit to unnecessary, costly annual external evaluations which serve little purpose. A better way forward would be to implement a principle that requires boards to submit to internal and external evaluations as regularly as is appropriate for the size and complexity of the business, and the

¹⁴³ B.7.1 of the April 2016 version of the Code only required companies outside the FTSE-350 to implement up to triennial re-elections.

¹⁴⁴ Although shareholders are able to instigate director removals at any time as a matter of law (CA 2006, s 168), annual re-election eliminates the collective action issues inherent in having to rely upon calling an extraordinary general meeting (CA 2006, s 303) or proposing a resolution for inclusion at the AGM (CA 2006, s 338) for shareholders to exercise their powers.

¹⁴⁵ Ibid.

¹⁴⁶ New Code, provision 21.

¹⁴⁷ n 51 above 28.

composition and diversity of the board. The principle should be drafted so that it generates disclosure of why the board has chosen the relevant evaluation schedule and how the results of such evaluations have been applied.

New provision 19 requires that the chair be replaced after serving on the board for more than nine years, presumably due to a perception that the chair's independence (if such chair were independent upon appointment in accordance with provision 9) would be significantly eroded over time. Tracking the same logic above in relation to ascertaining independence generally, the provision should be deleted to allow shareholders to opine, through a vote on annual re-election, on the chair's suitability rather than companies potentially succumbing to box-ticking adherence resulting in perfectly adequate chairs being removed arbitrarily. The Guidance could be amended to state that the longer the chair's tenure, the stricter the company's internal processes should be in ascertaining the continued suitability of the chair.

Audit, Risk and Internal Control

The penultimate section of the New Code, consisting of three principles and eight provisions, predominantly encompasses audit requirements, and comprises a number of duplicative or meaningless provisions.

Provision 30 requires an annual report statement as to whether the 'going concern'¹⁴⁸ basis of accounting is appropriate in preparing the financial statements. This is unnecessary - if the relevant company was not a going concern, it would have far larger problems than needing to make a statement in the annual report.¹⁴⁹ It is difficult to ascertain any material purpose for requiring this statement in the annual report, and it can become a box-ticking exercise.¹⁵⁰ In fact, the FRC, in 2014,

¹⁴⁸ 'Going concern' is an accounting term regarding the expectation that a business will continue to operate for the foreseeable future - generally regarded to be a period of not less than 12 months (IAS 1.26).

¹⁴⁹ For instance, if the company is not a going concern, the directors must take every step to minimise losses to creditors, usually by ceasing trading and commencing steps toward winding-up the company, to avoid falling foul of wrongful trading sanctions (Insolvency Act 1986, s 214).

¹⁵⁰ n 66 above.

proposed deleting the going concern statement from the Code¹⁵¹ on the basis that the requirements of International Accounting Standards (IAS)¹⁵² and the rules of the FCA's Disclosure Guidance and Transparency Rules Sourcebook (DTRs) already elicited sufficient disclosure. It seems that the FRC decided against deletion, during consultation, on the basis of investor perception that the statement would direct board attention to the issue. However, as outlined, directors are sufficiently motivated by other potential consequences to make this unnecessary.¹⁵³

Furthermore, provision 31 also requires a broader 'viability statement' to be made. The viability statement was a flagship addition under the 2014 Code revisions, with the FRC intending for it to produce meaningful disclosure relating to the future prospects of the company over a period potentially longer than twelve months, having regard to the principal risks and relevant qualifications or assumptions.¹⁵⁴ Although the FRC's goal is laudable in that it should promote effective disclosure as to the long-term prospects of the company, its effectiveness can be doubted. Compliance is pervasive with only one FTSE-350 company not publishing a viability statement in 2017, but of those complying, 51 per cent published statements that 'gave little or no insight into their viability in the face of key strategic risks'.¹⁵⁵ Furthermore, without meaningful explanations, there exists the inherent risk that boards are merely box-ticking.¹⁵⁶ Given the almost complete levels of compliance within the FTSE-350, it appears that most companies treat the provision as a mandatory requirement, and the

¹⁵¹ FRC Consultation Document, 'Proposed Revisions to the Corporate Governance Code' (April 2014) at 11.

¹⁵² Pursuant to CA 2006, s 403 and Article 4 of EC Regulation No. 1606/2002, listed companies must prepare their accounts in accordance with IAS. IAS 1.25, in effect, requires the making of a 'going concern statement'.

¹⁵³ The same argument can be directed to provision 27 of the New Code, which requires the board to state that it is responsible for preparing the accounts, and that such accounts are fair, balanced and understandable - the directors already have responsibility for preparing true and fair accounts under CA 2006, s 394, which must be externally audited (CA 2006, s 475). It is therefore unlikely that the accounts will not give the information necessary for shareholders to assess the finances of the company. Whether those accounts are 'understandable' will not be affected by whether the board makes a statement as such in the annual report.

¹⁵⁴ n 151 above 12.

¹⁵⁵ n 51 above 17.

¹⁵⁶ n 66 above.

FRC's implorations during consultation¹⁵⁷ suggest that it intends for all companies to comply; it is difficult to ascertain justifications to not comply. Therefore, given that the disclosures requested are viewed by the FRC and investors as essential, the requirement to make a viability statement should be made mandatory, possibly as part of the Listing Rules. This would also give the provision more weight, and negate the superficial adherence currently employed where the underlying requirement is, technically, voluntary.

Cadbury's Code of Best Practice first formally recommended the use of audit committees in the UK,¹⁵⁸ and this requirement, in one form or another, has remained as part of the Code.¹⁵⁹ However, subsequent to Cadbury's recommendations, the requirement to constitute an audit committee has become mandatory pursuant to EU obligations.¹⁶⁰ Although, initially, the Code's requirements were super-equivalent to those of the EU,¹⁶¹ over time, the EU's requirements have become more detailed, to the extent that the differences between the two regimes are now marginal. As with the contention above with respect to nomination committees, the New Code's audit committee requirements should be deleted, with the relevant principle amended to provide that the body responsible for the audit should be independent from management in its decision-making, to avoid box-ticking. The argument is even stronger for audit committees since DTR 7.1 already provides mandatory minimum requirements. Any aspects super-equivalent to DTR 7.1 can be included in the Guidance as examples of ways in which the body can be independent from the executive. Provision 25, which sets-out the functions of the audit committee, can also be safely deleted. DTR 7.1.3 itself delineates a comprehensive set of functions that are not dissimilar from those in the New Code. At best, the provision gives no real value, and at worst, it introduces confusion and uncertainty. Additionally, using the same reasoning applied to the activities of nomination committees above, the provision 26

¹⁵⁷ n 151 above 12.

¹⁵⁸ Code of Best Practice, para. 4.3.

¹⁵⁹ New Code, provision 24. In 2017, around 4.5% of FTSE-350 companies did not comply with the composition requirements for audit committees (n 51 above 28).

¹⁶⁰ In 2008, in implementation of EU Directive 2006/43/EU (Statutory Audit Directive), the DTRs were amended to include mandatory audit committee requirements, including the constitution of a 'body responsible' for the audit (DTR 7.1).

¹⁶¹ DTR 7.1.7 specifies that a company in compliance with audit requirements under the Code will be deemed to be additionally compliant with the requirements of DTR 7.1.

requirement, for the activities of the audit committee to be disclosed in the annual report, should be moved to the Listing Rules.

The New Code also provides that boards should undertake risk management, regularly assess risk and the risk management systems of the company, and ensure that adequate internal control systems are in place.¹⁶² The requirements could be described as meaningless, since boards are unlikely to disclose non-compliance. The value of these provisions lies in requirements to report on risk management and internal control systems, and the principal risks of the company and how they are being mitigated. Outlining these aspects, particularly the principal risks to the business, are critical to investor assessment. Therefore, rather than being included in the provisions, requirements should be maintained in the principles,¹⁶³ with annual report disclosure elements moved to the Listing Rules on a mandatory basis.

Remuneration

In assessing the New Code's provisions on remuneration, it is helpful to provide a brief synopsis of the history of shareholder 'say-on-pay' rights. In 1995, the Listing Rules first required the publication of a remuneration report setting-out executive pay.¹⁶⁴ In 2002, the obligation was given statutory footing,¹⁶⁵ with the details to be included in the report prescriptively governed,¹⁶⁶ and shareholders of quoted companies were given an advisory annual vote on the report.¹⁶⁷ Finally, in 2013, the disclosure requirements were reinforced,¹⁶⁸ and shareholders were now given a binding vote on the forward-

¹⁶² New Code, provisions 28 and 29.

¹⁶³ New Code, principle O already adequately sets-out requirements on risk management and internal controls, and should elicit suitable disclosure without reliance on provisions.

¹⁶⁴ What was paragraph 12.43A of the Listing Rules.

¹⁶⁵ What was Companies Act 1985, s 234B

¹⁶⁶ What was Schedule 7A of the Companies Act 1985 (as inserted by the Directors' Remuneration Report Regulations 2002).

¹⁶⁷ What was CA 2006, s 439. The vote was merely advisory with no formal or legal consequences.

¹⁶⁸ The contents of the report are now governed by Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (2013 Regulations).

looking policy elements of the report at least every three years,¹⁶⁹ and an annual advisory vote on how the policy had been implemented with respect to director pay over the previous financial year.¹⁷⁰

In 2000, the Combined Code introduced a plethora of provisions relating to directors' remuneration.¹⁷¹ By 2010, except for provisions relating to the contents of the directors' remuneration report, which now had statutory footing, the Code retained a majority of the provisions, notwithstanding that shareholders were granted voting rights in 2002.¹⁷² This could be justified, to a degree, by the fact that such resolutions were only advisory in nature. However, the 2016 version of the Code¹⁷³ differed very little from the 2010 version, even though, in the interim, shareholders were furnished with a binding vote on the remuneration policy. Quite prescriptive instructions to boards as to how they should be constructing remuneration policies are unnecessary in light of the powers of shareholders to approve or reject such policies. Equally, disclosure against such provisions is redundant given the extensive disclosure already dictated by legislation. Shareholders receive exceptionally detailed information on policies sufficient for them to make an effective assessment. Anecdotal evidence also suggests that boards are regularly consulting with major shareholders when such policies are fashioned prior to any vote taking place.¹⁷⁴ With three principles and ten provisions, the New Code should be condensed to avoid box-ticking and allow boards to construct the most beneficial remuneration policies in coordination with shareholders. Furthermore, provisions dealing with the appointment of remuneration consultants¹⁷⁵ are already covered by legislation.¹⁷⁶ Urgings

¹⁶⁹ CA 2006, s 439A.

¹⁷⁰ CA 2006, s 439.

¹⁷¹ Section B of the May 2000 version of the Combined Code.

¹⁷² Section D of the June 2010 version of the Corporate Governance Code.

¹⁷³ Section D of the April 2016 version of the Corporate Governance Code.

¹⁷⁴ See, for example: F. Ferri and D. Maber, 'Say on Pay Votes and CEO Compensation: Evidence from the UK' (2013) 17 RF 527, 546; R. Thomas and C. Van der Elst, 'Say on Pay Around the World' (2015) 92 Wash. U. L. Rev. 653, 730; CIPD Research report, 'Executive pay: Review of FTSE 100 executive pay packages' (August 2017) at 2; KPMG Board Leadership Centre, 'Guide to Directors' Remuneration 2017' (December 2017) at 11.

¹⁷⁵ New Code, provision 35.

¹⁷⁶ 2013 Regulations, Schedule 8, paras. 22(b) and (c). The requirement under the New Code that the remuneration committee choose remuneration consultants could be included in the Guidance, since it expands on Schedule 8 (which

that remuneration packages promote long-term interests¹⁷⁷ are also covered by legislative requirements that boards disclose how their policies support long-term strategic objectives.¹⁷⁸ Additionally, provisions that state that policies should enable the use of discretion to override formulaic outcomes, that workforce pay should be considered in setting executive remuneration, and how non-executive director pay and pensions should be formulated¹⁷⁹ are all needless, since shareholders can adequately opine upon these matters when assessing the directors' remuneration report.¹⁸⁰ Boards will be under pressure to implement such aspects whether or not they are included as provisions under the Code.¹⁸¹ As market expectations shift in relation to remuneration, new recommendations from credible industry bodies could be conveyed in the Guidance rather than as prescriptive provisions. In any case, even if not included in the Guidance, institutional investors have shown that they will make it clear to boards as to their expectations on remuneration.¹⁸² Likewise, the

simply requires companies to state by whom the remuneration consultant was appointed); but the more important aspect of the board to consider, beyond box-ticking that the committee has chosen the remuneration consultant, is that the consultant is providing independent advice, and this should be included in the principles.

¹⁷⁷ New Code, provision 36.

¹⁷⁸ 2013 Regulations, Schedule 8, para. 26(a). In relation to share award holding periods, see: n 75 above and accompanying text.

¹⁷⁹ New Code, provisions 33, 34, 37 and 38.

¹⁸⁰ For example, under the 2013 Regulations, Schedule 8, the level of discretion exercised or exercisable in relation to remuneration must be disclosed. Extensive disclosure is also required on how employee pay and conditions throughout the company has been considered in formulating directors' remuneration. Principle Q, however, should be adapted to expressly include that the remuneration committee itself should have regard to workforce pay and reputational risks when approving remuneration outcomes. Additionally, provision 40 of the New Code requiring clarity, simplicity, risk mitigation, predictability, proportionality and alignment to culture in formulating remuneration policy is meaningless as a provision and would be better suited to the Guidance, since it is unlikely that any board would admit non-compliance and shareholders can opine on these aspects with their 'say-on-pay' rights.

¹⁸¹ For example, in 2016, BP's remuneration committee exercised discretion to reduce CEO payments to avoid a formulaic outcome (BP's Annual Report and Form 20-F 2016 at 83). The version of the Code applicable did not require such implementation, but BP did so voluntarily due to pressure to avoid pay incommensurate to performance after the implementation of directors' pay for the previous financial year was voted down by shareholders on an advisory basis (RNS Number: 2816V (14 April 2016)).

¹⁸² n 76 above.

long-standing provision that director service contracts should be for terms no longer than one year¹⁸³ should be removed; legislation requires disclosure of the policy, on which shareholders have a binding vote, on notice periods, and payments for loss of office.¹⁸⁴ Shareholders will be unlikely to approve remuneration policies that permit terms of greater than one-year except in exceptional circumstances. In addition, any notice period of greater than two-years requires mandatory shareholders' approval.¹⁸⁵ With respect to composition and the activities of the remuneration committees,¹⁸⁶ the same treatments should be accorded as elucidated in relation to nomination and audit committees above,¹⁸⁷ while also, in relation to disclosure of activities, removing any duplication of the contents of the remuneration committee's chair's statement mandatorily required by the 2013 Regulations.¹⁸⁸

Conversely, it should be considered whether 'comply-or-explain' is sufficiently resolute in ensuring that companies incorporate claw-back mechanisms into remuneration policies.¹⁸⁹ Although, in 2017, 91 per cent of FTSE-350 companies incorporated such mechanisms, no company has ever exercised such power,¹⁹⁰ and unless such claw-back provisions are drafted carefully, they can lack teeth.¹⁹¹ Although companies are complying with the relevant provision in form, they do not appear to be exercising their powers in substance. Therefore, consideration should be given to ensuring that

¹⁸³ New Code, provision 39.

¹⁸⁴ 2013 Regulations, Schedule 8, paras. 36 and 37.

¹⁸⁵ CA 2006, s 188.

¹⁸⁶ New Code, provisions 32 and 41. In 2017, only around 6.0% of FTSE-350 companies did not comply with the Code's remuneration committee composition requirements (n 51 above 28).

¹⁸⁷ Provision 32 also introduces a requirement that the chair of the remuneration committee possesses at least 12 months of remuneration committee experience – it could be dangerous to create box-ticking adherence to this provision since there may well be circumstances where the remuneration committee is better served by a chair untainted by such experience.

¹⁸⁸ 2013 Regulations, Schedule 8, Part 2.

¹⁸⁹ New Code, provision 37.

¹⁹⁰ n 51 above 54.

¹⁹¹ For example, Carillion had implemented claw-back mechanisms in accordance with the Code, but they were too restrictive and did not correlate with market practice, and therefore bonuses paid to its executives in the year prior to its liquidation were not legally recoverable (n 125 above 34).

such provisions are required on a mandatory basis,¹⁹² unless otherwise agreed by the shareholders, and bare minimum circumstances in which such recovery or withholding can be exercised should also be mandated in order to at least harmonise a *de minimis* basis across all premium-listed companies.¹⁹³

THE LONG ROAD AHEAD: CONSEQUENCES OF THE NEW PARADIGM

A new way forward has been proposed, such that the Code will fully respect the maturity and sophistication of the environment in which it operates, in a manner that drives issuers towards meaningful shareholder disclosure. Fair challenges, though, are whether such a radical repositioning will, in fact, reduce box-ticking, or cause unintended consequences.

In relation to box-ticking, viewed in isolation, as outlined above, shifting to a principles-based regime should reduce the blind devotion to governance norms since those norms will no longer be specifically referenced in the Code. However, the re-engineering of the Code must also be viewed in the context of what has gone on before. Shareholders and boards, and, indeed, proxy advisors and rating agencies, will not immediately disremember the decades of corporate governance norms that have been ingrained throughout the market. The presence of market norms is not, in and of itself, pernicious. It would be reasonable to expect that in any governance environment, certain types of arrangements will develop as the most obvious means of satisfying particular principles, accordingly making certain arrangements more common than others. The two mischiefs against which this paper is attempting to mitigate, though, are where the provision is viewed as the only plausible approach when other means may be more beneficial to the overall health of the company, or the adherence to the provision is viewed as exhaustive in fulfilling the principle. Those mischiefs will persist if, after the Code becomes a principles-only model, the market continues to view the relevant provisions as *de*

¹⁹² The principles could also be amended to specifically state that boards should exercise powers of remuneration recovery or retention when appropriate.

¹⁹³ Justifiable flexibility may be required to lure executives with expertise to rescue a business in financial distress; however, in such circumstances, the shareholders should, to the extent that creditor interests have not yet intruded, have the right to pre-approve such waiver.

facto requirements. Admittedly, the process of de-linking the current provisions of the Code as bright-line market expectations will be gradual. Initially, the market will be sceptical of deviations from the former provisions in the same way that it is today. Importantly, though, those provisions would no longer benefit from formal endorsement by the Code nor a requirement to unequivocally state in the annual report whether the company has complied with the provisions. Ignoring, for the moment, the role of proxy advisors, it will become, over time, more difficult to insist on compliance where the board no longer expressly registers positive or negative compliance with specific requirements, and has clearly and credibly expressed how principles have been applied appropriately. Even if a shareholder wished to persist with box-ticking against the former provisions, that shareholder would need to assess the governance arrangements of the company based upon the narrative explanations as to how it has applied the principles in order to ascertain compliance. At the very least, this should give boards a fighting chance to explain alternative governance arrangements to even sceptical shareholders, and the re-engineered Code should progressively assist in legitimising alternative arrangements. Incrementally, as alternative governance arrangements become more common (assuming that they do not correlate with poor performance), the prevalence of shareholders merely box-ticking against the former provisions should decline. From the board's perspective, a board nervous about deviating from the former provisions will no longer have to make the perceptibly implicative statement: 'we are not in compliance with...'. Similarly, a lazy board, that has not applied the spirit of the principles, will not be able to take comfort from the statement: 'we are fully in compliance with the Code'.

A potential challenge could endure when proxy advisors and rating agencies are introduced into the discourse. Those advisors and agencies, particularly in the short-term, may continue to use checklists based upon the existing provisions. However, over time, it will become more difficult to justify the provenance of those checklist items if those norms are no longer prescribed by the Code and the regulator has not, tacitly, completed the task of compiling the list for them. Proxy advisors are evidently influenced by the provisions of the Code when creating their guidelines. For example, in the UK, in accordance with the Code, Glass Lewis recommends voting against the re-appointment of non-independent directors where at least half the board is not composed of independent directors, and, in assessing independence, considers a director to be 'affiliated' if he or she has served for more than

nine years, and, in line with the Listing Rules, deems a significant shareholder to be one holding more than 10 per cent of the company's share capital.¹⁹⁴ However, in the US, Glass Lewis recommends voting against inside directors if independent directors do not form at least two-thirds of the board, does not expressly specify that directors who have served for more than nine years will not be considered independent, and considers directors to be affiliates if they hold 20 per cent or more of the voting stock.¹⁹⁵ Clearly, Glass Lewis has been influenced by the Code,¹⁹⁶ since, fundamentally, an independent assessment of preferential governance arrangements should not result in such inconsistency in the approaches to the two jurisdictions, and the divergence becomes more difficult to justify in the absence of Code provisions.

However, another box-ticking challenge is that, notwithstanding the removal of the Code's provisions, proxy advisors will justify checklists of recommended governance arrangements on the basis of prevailing market norms (which, initially, may concur with the current provisions). Again, this becomes more difficult to justify without regulator endorsement, and the very exercise of studying narrative disclosure (in the absence of provisions) in order to ascertain compliance should draw greater attention to valid explanations. That said, the customary practice of using checklists will not be eliminated overnight. This could inhibit the propagation of alternatives, since the *status quo* would implicitly be maintained. If the behaviour of proxy advisors were to develop in this manner, after the re-engineering of the Code, further study should focus on how to encourage proxy advisors to assess narrative disclosures of companies on a case-by-case basis. Although beyond the scope of this paper, the Stewardship Code¹⁹⁷ (applicable to institutional investors, proxy advisors and other service providers) could, for example, be utilised to recommend that proxy advisors assess the individual disclosures of companies rather than assess companies on the basis of pre-prepared

¹⁹⁴ Glass Lewis UK 2018 at 6.

¹⁹⁵ Glass Lewis 2018, 'Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice' (United States) at 5 and 4.

¹⁹⁶ Even where proxy advisors entertain flexibility, they still tie justifications to the Code – for example, Glass Lewis does not automatically denounce staggered boards if valid explanations are given as to why annual re-election is not implemented in accordance with the Code (Glass Lewis UK 2018 at 3).

¹⁹⁷ FRC, 'Stewardship Code' (September 2012).

checklists, and that institutional investors, who are already guided under the Stewardship Code¹⁹⁸ to disclose how they use the recommendations of proxy advisors, only use proxy advisors' recommendations to facilitate their own assessment of the individual disclosures. Such promptings, although voluntary, could encourage a change in the model used by proxy advisors. Removing the provisions of the Code will not be a panacea to box-ticking, but it is an indispensable part of a measured process towards its elimination.

Another important factor is in the use of the Guidance. This paper has advocated moving the substance of certain provisions to the Guidance. If such provisions were simply included in the Guidance in a prescriptive manner, the danger exists that the Guidance will continue to be used as the basis for further box-ticking. Those provisions labeled herein as 'meaningless' that are moved to the Guidance comprise common-sense advice to satisfy the principles, which, in fact, sit well with other types of advice currently set-forth in the Guidance. In relation to other provisions moved to the Guidance, it is critical that they are included as options and linked closely to the principles, to prevent continued back-door box-ticking. For example, in relation to workforce engagement, rather than stating that one of the methods set-out in provision 5 of the New Code *should* be used, the Guidance should repeat Principle D (which already states that the company should ensure effective engagement, and, as above, should be amended to require thorough explanation of the methods by which it has effected adequate engagement), and only include the provision 5 list as potential examples of the methods that *could* be used.

A separate, reservation is that with an absence of provisions, it is more likely that different, potentially contradictory, expectations could be conveyed to companies. For example, other industry bodies may expect different vesting and holding periods to the five-year periods sanctioned by the Investment Association.¹⁹⁹ Even so, if such a scenario were to arise, it would become incumbent on boards to engage more carefully with shareholders to reconcile differing requirements. This should lend itself to detailed discussion of the actual governance arrangements of the company beyond box-ticking, and further the aspirations of the FRC to promote better shareholder engagement.²⁰⁰

¹⁹⁸ Stewardship Code, guidance to Principle 6.

¹⁹⁹ n 76 above.

²⁰⁰ B. Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73 MLR 1004, 1007.

Away from box-ticking, a contrasting consequence, that merits further discussion, is that removing the provisions could send the wrong message. A subset of companies currently box-tick from the perspective of not applying the spirit of the principles, possibly because they do not see their value. Such boards may take the re-engineering of the Code to mean that adherence to the values of the Code is no longer important nor essential, leading to boilerplate, shallow and unhelpful disclosures, on top of non-compliance with the former provisions. The argument can therefore be made that, by removing the provisions against which companies must comply-or-explain, shareholders will receive less useful information about the governance arrangements of those companies, and that a valuable bottom-line governance standard that restrains, albeit weakly, the most egregious of acts will be lost. However, the detrimental impact of deleting provisions should be negligible. Such provisions are well-known, respected and widely followed throughout the market, unlike in developing markets where it is hereby acknowledged that provisions could play a critical role.²⁰¹ As above, market norms consisting of the most common practices (which are beneficial to most companies but not all of them) will continue to exist. Boards will still need to consider common practices in the first instance as possible, partial components in satisfying the principles. In a mature governance environment, it is difficult to subscribe to the theory that governance will degrade to such an extent that ‘best practice’ is no longer recognised, but if it were to occur, the nature of the Code easily allows the FRC to reintroduce provisions. Also, poor disclosure, that does not even divulge adherence or not to the old provisions, is likely to irk shareholders, putting pressure on boards to improve the quality of disclosure. For many of the principles, detailed disclosure, which will be required by shareholders where box-ticking against comply-or-explain provisions is not possible, will give shareholders sufficient information to assess whether the firms are, in fact, in compliance with the old provisions, but in a manner that prioritises a holistic consideration of the principles. For example, it is difficult to envisage how a company can adequately disclose against the principle relating to appointing an appropriate number of independent directors without disclosing the board’s proportion of independent directors. Furthermore, with greater distance between the principles and the former provisions, those companies will be less able to justify adherence to the principles merely by asserting compliance. In fact, such behaviour more likely underlies the rationale for those companies

²⁰¹ See the discussion at n 71 above and accompanying text.

not following the spirit of the Code rather than simply seeing no value in the principles. Compliance is the path of least resistance and effort.²⁰² Companies will need to provide credible discourse on the application of the principles which should strengthen, not weaken, the effectiveness of the Code.

CONCLUSION

Ever since Cadbury pioneered the Corporate Governance Code more than twenty-five years ago, the perniciousness of box-ticking has undermined its effective operation. Successive attempts to alleviate the phenomenon have faltered. Boards, influenced by shareholder insistence on full compliance as exacerbated by the attitudes of proxy advisors and rating agencies, have tended toward rigid adherence to the letter of the provisions of the Code. This has resulted in boards forsaking alternative corporate governance structures that may be more beneficial to the success of the company, as well as also favouring paper compliance over application of the spirit of the principles of the Code.

With a drastic change of mindset, the latest edition of the Code has made a concerted effort to reduce box-ticking by reducing the number of prescriptive provisions. This change in tact evinces a recognition by the regulators that the corporate governance environment of the UK is mature and has attained a level where corporate governance norms are known and widely-respected without the need for prescription by the authorities.

However, it is submitted that the FRC has not gone far enough. A number of subsisting provisions are either meaningless in that they merely provide guidance against which no board would ever divulge non-conformity, or are duplicative of existing legislative or regulatory requirements. Certain provisions have taken on a pseudo-mandatory identity, undermining the flexibility of the Code by becoming elements on which shareholders insist compliance, and with which boards almost universally comply. A handful of further provisions do not sit well within a ‘comply-or-explain’ structure since they are seemingly provisions which the regulator, sometimes in the shadow of the Government, desires to see ubiquitously observed. Many of these issues have resulted from years of

²⁰² n 17 above.

additions during which the FRC has been unwilling or unable to remove outdated or unnecessary concepts.

With the FRC now in deflation mode, the opportunity arises to completely remodel the Code into a regime that is fit-for-purpose in the modern listed-company sphere. As outlined in this article, the Code can be comprehensively curtailed so that it comprises solely of broad principles drafted in a manner that prompts useful and clear disclosures. By removing the provisions, shareholders will be more likely to accept company explanations of governance structures that do not exactly correspond to governance norms. Over time, especially if reinforced with further enabling approaches, proxy advisors and rating agencies will develop systems for rating companies based upon how their bespoke governance structures adhere to the spirit of the principles of the Code. Together this will lead to boards pursuing substance over form and taking advantage of the flexibility intended by the Code. Finally, by thinking outside the box, the Corporate Governance Code can fulfill the purposes for which Cadbury had intended over a quarter of a century ago.