CHARTERED SECRETARIES

CONSULTATION
March 2010

ICSA Review of the Higgs Guidance

The Institute of Chartered Secretaries and Administrators
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Background

In its Final Report on the 2009 review of the Combined Code (likely to be called the UK Corporate Governance Code – 'the Code'), the Financial Reporting Council explained that it had '...commissioned the Institute of Chartered Secretaries and Administrators (ICSA) to work with others on its behalf to update as necessary the good practice guidance from the 2003 Higgs Report ... in the light of the proposed changes to the Code and economic and other developments'. Elsewhere in the Final Report, the text makes clear that the commission refers to the 'Higgs Guidance' (Good Practice Suggestions from the Higgs Report), last reissued in 2006.

As part of this remit, the FRC has asked ICSA to consider whether additional guidance should be given on a number of related issues raised in Sections A (Leadership) and B (Effectiveness) of the Code. Given the focus of these additional areas, and their link to the content of the Higgs Guidance, ICSA has entitled the consultation paper 'Improving board effectiveness' to assemble the various strands of advice under one of the principal themes of the Code review.

The FRC's intention is that the guidance should be consulted by boards when considering how to apply the relevant principles of the Code.

Steering Group

ICSA has established a Steering Group to assist it in its task. Its members are:

Nilufer von Bismarck	Partner, Slaughter and May
Andrew Campbell	Director, Strategic Management Centre, Ashridge Business School
John Coombe	Chairman, Hogg Robinson plc
Sir John Egan	Chairman, Severn Trent Plc
Philippa Foster Back OBE	Director, Institute of Business Ethics
Chris Hodge	Head of Corporate Governance, FRC
Simon Lowe	Partner, Grant Thornton
Ben Mathews	Company Secretary, Rio Tinto plc
Peter Montagnon	Director, Investment Affairs, ABI
David Wilson	Chief Executive, ICSA

Consultation arrangements

There will be two consultation stages. The first, seeking responses to the questions posed in this paper, will be completed by May. ICSA will issue a further consultation draft in June, with comments to be submitted by the end of August. Completed guidance will be submitted to the FRC in October, to ensure sufficient time for consultation.

ICSA has organised a series of meetings with some 200 FTSE chairs and company secretaries to address the issues raised in this paper. For those replying separately in writing, comments are sought to the following questions by **16 April 2010:**

1. Do you agree with the purpose of the guidance as set out on page 4 of this paper?
2. Do you agree that the paper has identified the right areas where the existing guidance could be enhanced?
3. Are there other areas which the guidance should look at?

How to comment

Responses should be sent by e-mail to policy@icsa.co.uk.

Or in writing to:

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Director of Policy
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Source documents

A list of source documents is appended as a bibliography.

It is ICSA's policy to publish on its website all responses to this consultation unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. We do not edit personal information (such as telephone numbers or e-mail addresses) from submissions. Only information you wish to be published, therefore, should be submitted – or else you should clearly mark the top of your response, or the part you wish to remain confidential, 'NOT FOR PUBLICATION'.

Consultation on ICSA's review of the Higgs Guidance – Improving board effectiveness

Introduction

ICSA's review of the Higgs Guidance is based on the premise that corporate governance should not be presented as a universal panacea to all cases of corporate collapse or significant value destruction. Occasional commercial failure is an inevitable consequence of operating in an efficient market system – business models become inflexible and outdated in the face of a wide range of competitive and economic forces, with poor judgement, weak decisions and bad timing also acting as contributory factors.

Nevertheless, the nature and scale of the value destruction triggered by the failure of some banks to anticipate and adapt to significant market corrections, and the related economic downturn, has raised a number of valid questions about governance issues. These include the degree to which governance processes – including some boards' failure to understand the risks their companies were assuming, and inappropriate remuneration and incentive structures – were partly to blame.

The evidence produced in the report by Sir David Walker into corporate governance in UK banks and other financial industry entities, and the Code review, confirms that strong corporate governance systems and performance are fundamental to the successful formulation and execution of a company's strategy. The Code review, which applies to all companies with a Premium Listing, emphasises that the corporate governance challenge is one for all organisations – not just banks and other financial institutions.

The business case for good governance practice

Effective boards are a legitimate focus for public policy and regulation, both of which seek to reinforce and, where necessary, re-establish, confidence in UK companies as a source of strength in the performance of the economy, and the operation of the wider capital markets.

The message underpinning the revised Code, however, is that there are also compelling commercial reasons for pursuing good governance.

Good governance practice supports the formulation of a company's strategy, and delivers, through executive management, the conditions for its efficient and effective delivery. Good governance is a foundation of, and not a replacement for, or competitor to, a robust strategy, and is an important factor in delivering ongoing business sustainability and success.

Good governance practice delivers competitive advantage because it strengthens the process and quality of the board's primary responsibility of decision-making, resulting in effective boards. A performing board signals to investors, and other stakeholders, that it is capable of delivering its strategy. As Sir John Parker, chair of judges in the ICSA Hermes Transparency in Governance Awards, recently stated: '... good governance is a business enabler and the best companies demonstrate that governance is truly embedded in the company and is not regarded as a compliance exercise to be completed once a year'.

Building an effective board is therefore a key feature of the governance journey to building a successful company, and constitutes the rationale for ICSA's focus on the Code's board effectiveness theme.

Purpose of the guidance

The aims of the review are therefore to offer guidance which, without being prescriptive, assists boards in understanding and implementing the purpose of the Code and, in so doing, delivers practical advice to boards on how they can apply the Code to enhance their effectiveness.

Question 1: Do you agree with the purpose of the guidance as set out above?

Building board effectiveness

ICSA considers the component parts of an effective board can be assembled around five headings:

- Roles and responsibilities of the board and its members
- Skill levels in the boardroom
- Board decision-making
- The individual on the board
- Accountability

These components form the backbone of the proposed new guidance, and the contents of each section are explained in greater detail below.

Question 2: Do you agree that the paper has identified the right areas where the existing guidance could be enhanced?

Question 3: Are there other areas which the guidance should look at?

1 Roles and responsibilities of the board and its members

1.1 The purpose of the board

The guidance will reiterate the purpose of the board as the key decision-making body of the company responsible for its leadership, integrity, performance and risk profile; and define the purpose of board meetings. The guidance will reassert the distinction between governance and operational matters.

Consistent with the message underpinning section A.1 of the Code, the guidance will emphasise the importance of a board proactively crafting policies, processes and systems to ensure the delivery of its strategic objectives; and that governance mechanisms evolve by default, and sometimes not in the way intended, in the absence of such leadership. This applies particularly to areas which revolve around the concept of ‘tone from the top’, and the need for the board to determine the appropriate organisational culture, vision and values which drive individual and collective behaviours.

The guidance will refer to ethical sensitivity, and the need for the board to take account of ethical issues in setting business strategy and the manner in which business is undertaken.

The guidance will also consider how boards, collectively and in terms of individual contributions, might improve the overall effectiveness of their responsibilities in areas such as decision-making, strategy development and financial analysis.

1.2 The different roles in the boardroom

Chair
A key outcome of the Code review is the acknowledgement '…that the crucial role of the chairman should be given more prominence in the Code…'. The emphasis in the Code text on such issues as leadership, effectiveness, strategy, board culture, independence and challenge make it clear that the contribution of the chair is critical to the building of the effective board and to the success of the company. A good chair makes the key difference to the running of the board, especially in creating a positive atmosphere which allows constructive challenge to take place. In updating the text in the Higgs Guidance, greater emphasis will be placed on the increased importance and profile of the role under the new regulatory framework, and reflect the view that a performing chair can transform the way in which a board is run.

Senior Independent Director (SID)
The Walker Report stresses the importance of the role of the SID, and the related draft Code provision emphasises the role of the SID as a sounding board for the chair and as an intermediary for the other directors. The guidance will emphasise the potentially-critical role played by the SID when a board is under stress, the importance of the relationship between the chair and the SID in such circumstances, and the possible conflicting pressures a SID may experience in attempting to resolve difficulties without undermining his or her role as a member of a unitary board.

Non-executive director
The Code recommends a pronounced role for non-executive directors in terms of offering constructive challenge and in the development of strategy. ICSA considers that the existing text in the Higgs Guidance needs to be updated to reflect this increased emphasis, as well as to incorporate other important changes relating to issues such as time commitment, continuing development, and information and support.

Executive director
With the Code's emphasis on the effectiveness of the board as a whole, the guidance will cover the role, responsibilities and contribution of all boardroom members. In reality, executive directors, and new executive appointments in particular, are likely to have needs relating to continuing development, and information and support, which are as important as those of their part-time non-executive colleagues. As well as covering these points, the guidance will identify the need for executive directors to manage the tension which exists in their role as board members (one step down from the owners) and as operational directors (one step up from management). This may be particularly evident as executive directors understandably, and often justifiably, seek to present a united front in board meetings, calling into question their ability to fulfil the role of providing effective challenge.

1.3 Board composition

The Walker Report and the FRC's Final Report identify board composition and the need for a properly balanced board, as a fundamentally important aspect of delivering high-performance. The guidance will stress that the required attributes of skills, experience, independence and company knowledge should not be approached from an 'either/or' perspective – all are necessary, desirable, and possible across the board as a whole. The guidance will reflect the discussion, and subsequent changed emphasis, in relation to the 'independence' criterion, acknowledge that there is no single answer to the challenge of optimising a board's composition, and will consider issues such as diversity and the widening of the gene pool as mechanisms for helping boards introduce, or deepen, required attributes. The guidance will also consider how boards can distinguish the appropriate psychological traits which identify candidates able and willing to challenge convention and groupthink, and 'ask the basic question'.

1.4 Appropriate boardroom behaviours

Both the Walker and Code reviews conclude at an early stage that the quality of corporate governance ultimately depends on behaviour, not process. While acknowledging the difficulty of codifying behavioural governance without becoming prescriptive, the guidance will identify the factors which allow for the development of a culture of constructive and robust challenge in the boardroom, and the avoidance of a groupthink culture. The guidance will also cover interrelationships in the boardroom, and the importance of group dynamics, as well as the contribution of (key) individuals.

2 Skill levels in the boardroom

2.1 Establishing directors' skill base – induction

Both the Walker and Code reviews contain a number of induction-related points which ICSA considers can be used to strengthen the existing Higgs Guidance.

2.2 Maintaining directors' skill base – development

The guidance will build on the conclusions of the FRC in its Final Report that, while board composition and boardroom culture are essential to creating an effective board, '...the support provided to the board, and the ongoing development of the directors, collectively and individually, are also important components...'. The guidance will advise on meeting the increased emphasis given to development activities outlined in the Code, the emphasis on all directors having current knowledge of the company and access to its operations and staff, and the recommendation that the chair should agree and review development requirements with each director.

2.3 Benchmarking directors' performance – evaluation[1]

Within companies, evaluation is increasingly seen as a valuable tool at the disposal of the chair and the other directors to accelerate, measure and assess the effectiveness of the board. From an external perspective it is clear investors are attributing a much greater importance to companies' use of board evaluation processes, and are increasingly demanding information about the outcomes, and follow-up actions. The guidance will consider the issues raised by the Code in relation to the frequency and facilitation of board evaluation, and the management of potential conflicts of interest; the nature of the board evaluation specification, the importance of evaluations meeting quality standards, how the company can reassure investors and other stakeholders alike that the process is generating benefits and leading to the creation of a more effective board, and how the outputs of the process can be meaningfully disclosed without compromising the confidentiality of the exercise.

3 Board decision-making

3.1 Audit

The FRC has signalled that it may wish to propose limited changes to its existing guidance to audit committees depending on the outcome of work being undertaken by its Auditing Practices Board on the provision of non-audit services and audit partner rotation. It has also indicated that it will conduct a limited review of the Turnbull Guidance on internal control, on which there will be separate consultation. The guidance will therefore refer to the fact that, pending the outcome of these other reviews, advice on audit committees is already contained in the FRC Guidance on Audit Committees. It will limit its comment briefly to the outcome so far of the Code review, namely the increased emphasis to be given to

1 ICSA runs a board evaluation service and has an interest in the guidance offered in this area. For this reason it will not take part in the Steering Group discussion on this issue, to allow the guidance to be fully objective.

issues such as the board's consideration of matters relating to risk appetite and tolerance, the maintenance of a sound system of risk management and internal control, and the board satisfying itself that appropriate systems are in place to identify, evaluate and manage the significant risks faced by the company.

3.2 Nomination

The guidance will update the description of principal duties contained in the Higgs Guidance to reflect issues referred to in both the Walker and Code reviews, emphasising the significance of the nomination mechanism in delivering strategically-important Code outcomes relating to board composition, diversity, and executive and non-executive succession planning.

3.3 Remuneration

The guidance will acknowledge the content of the Higgs Guidance, and update it to reflect the more general issues raised by the Walker and Code reviews relevant to the principal duties of the remuneration committee. Given the extent, and speed, of advances in the overall area of remuneration, and the fact that legislation may be introduced to reflect developments in the domestic and EU policy agendas, the guidance will remain general and not move into detail.

3.4 Support for directors

Drawing on the increased emphasis given to this area by both the Walker and Code reviews, and reflecting the provisions of the proposed Section B.5 of the Code, the guidance will offer advice on how all directors can become more effective in their roles by the development and fine-tuning of the company's information and support mechanisms.

4 The individual on the board

4.1 Joining the right board – due diligence; terms of engagement; letter of appointment

The Higgs Guidance recognises that board effectiveness depends on getting the right directors onto a board and helping them contribute effectively as quickly as possible. The guidance will review the advice on helping potential directors make the right choice initially, identifying the expectations of the role and securing directors' commitment to, and alignment with, the board's practices and culture.

4.2 'Staying out of trouble' – directors' liability

It is ICSA's experience that guidance for directors on 'how to stay out of trouble – and jail' is often a much sought-after piece of advice. Mechanisms such as the operation of D&O liability insurance have their limitations. Moreover, the legal and regulatory framework under which directors operate has changed significantly since the inception of the Companies Act 2006. The guidance will offer an up-to-date review of the former Schedule B of the Code.

5 Accountability

In his closing remarks in the Preface to the formal consultation document ('Consultation on the Revised UK Corporate Governance Code') Sir Christopher Hogg states that 'It is hoped that chairmen will choose to report personally in their annual statements how the principles (in Sections A and B of the new Code) relating to the role and effectiveness of the board have been applied. Not only will this give investors a clearer picture of the steps taken by boards to operate effectively but also, by providing fuller context, it may make investors more willing to accept explanations when a company chooses to explain rather than to comply with one or more provisions. Above all, the personal reporting on governance by chairmen as the leaders of boards might be a turning point in attacking the fungus of ‘boiler-plate’ which is so often the preferred and easy option in sensitive areas but which is dead communication.’

The guidance will reflect the increased emphasis placed by the Code on the various disclosure obligations, the benefits in using disclosure to signal to investors and other market participants that the board and the company are well run, and its role in allowing stakeholders to make independent assessments of the degree to which the company has successfully instilled a corporate governance culture.

6 Conclusion

It is clear from the Code review that board effectiveness is considered one of the main drivers of good corporate governance in UK companies. The guidance will seek to help directors and company secretaries understand the issues which need to be thought through and implemented as they aim to deliver the purpose of the Code; and assist stakeholders to appreciate the roles, responsibilities and dynamics of the boards in which they have a strong interest.

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