Who should be covered by codes?

WHAT WE THINK: A DIALOGUE IN CORPORATE GOVERNANCE

NEW CHALLENGES INITIATIVE

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The ICAEW thought leadership initiative *Dialogue in Corporate Governance: New challenges* is considering five questions arising from recent events and seeing how they affect the foundations of existing corporate governance frameworks. We intend to explore these questions in a series of bite-size thought leadership projects.

While accepting that there are no easy solutions, we hope to bring greater clarity to people's thinking through dialogue with a range of interested parties and stakeholders including boards, investors, and academics.

Five questions

1. **What should companies be responsible for?**
2. **What are the overarching principles of corporate governance?**
3. **When is comply or explain the right approach?**
4. **How diverse should boards be?**
5. **Who should be covered by codes?**

A number of major changes have taken place in capital markets over recent years. These include: the growing importance of non-equity financial instruments; new types of equity owners; changes in the services offered by, and the use of, intermediaries; and pressures to harmonise internationally diverse practices in corporate governance.

Furthermore, a number of major business controversies are discussed as corporate governance issues, for example: state bail-outs of failing financial institutions during the economic crisis, public outcry over executive remuneration, and the lack of diversity on boards.

These changes and controversies present significant challenges to existing models of corporate governance built around the agency theory which sees boards of listed companies acting as agents of absent equity owners. Moreover, the changing nature of capital markets tests the validity of existing models of corporate governance.

Rather than treat current controversies as topical and fleeting matters, we intend to explore them as symptoms of misalignment between today's markets and corporate governance frameworks. We invite anyone interested in corporate governance to join our dialogue at Talk Accountancy www.ion.icaew.com/talkaccountancy or email corporategovernance@icaew.com

Who should be covered by codes?

Discussion of question 5

We expect directors of listed companies to follow codes that promote good governance. Institutional investors, auditors, remuneration consultants and executive search firms are also following that example. Is this a welcome trend and if so, how far should it go?

This paper makes a proposal for harnessing the energy behind the growing number of group-specific codes related to corporate governance. We explore how we can ensure that this enhances public confidence in companies rather than creating complexity and confusion.

A PROPOSAL FOR A CORPORATE GOVERNANCE CODE FOR ALL

We propose that there should be a set of fundamental principles that would promote a good culture of corporate governance across society as well as within individual companies. We call such a set of principles a framework code.

Principles-based corporate governance codes can help facilitate better behaviour. In the wake of the global financial crisis, we have seen codes developed for groups and sectors as governance related issues are identified. Individually developed codes for specific groups may address specific concerns but they run the risk of inconsistency when taken as a whole.

As we discussed in our paper *When is comply or explain the right approach?*, the effectiveness of codes depends on the existence of shared beliefs about what constitutes good governance and on institutional arrangements that guide and enforce behaviour. Development of a framework code could articulate and nurture shared beliefs, and group-specific codes that embed the framework code could in turn enhance shared beliefs and institutional arrangements. Codes for specific groups, if developed in isolation, tend to lack guiding principles and institutional support and potentially give rise to conflicts.

A broad range of stakeholders should take part in the development of a framework code, including all those who may be covered by it. Taking part should bring both educational and promotional benefits among participants and facilitate buy-in among others, helping develop shared beliefs. A framework code would provide a basis to develop supplementary codes that set specific expectations for the behaviour of specific groups. Group-specific codes are particularly useful for groups whose actions are fundamental to good corporate governance.

A framework code would apply to everyone involved in corporate governance. 'Everyone' in this case would typically include directors, shareholders, auditors, and remuneration and recruitment consultants. Where specific codes already exist, they should be tested against the framework code. A framework code would also cover all intermediaries in the investment chain, such as proxy agents, as well as other types of finance providers such as bondholders and lenders, the media, professional bodies, NGOs, governments and regulators in so far as their actions affect corporate governance at individual companies or more widely.

WHY CODES ARE ATTRACTIVE

Our answer to the question 'Who should be covered by codes?' is that everyone involved in a system of corporate governance should be covered by a framework code. Groups whose actions are fundamental to good corporate governance may also need their own specific code. The framework code should set expectations for the behaviour of other groups and prevent unmitigated proliferation of codes leading to complexity and confusion.

The successful development and application of codes for boards has encouraged imitation for other groups involved in corporate governance and proliferation of codes is already taking place in the UK. Over the past 10 years, we have seen codes developed for asset managers, audit firms, private equity investors, remuneration consultants and executive search firms. The growing importance of intermediaries in corporate governance means that this trend is likely to continue.

Normally, outside pressures provide the impetus for developing a new code. Public concern at perceived governance failings finds expression through legislators, regulators, and industry forums. A group under pressure may start developing a code when it sees damage to its reputation or the threat of external regulation being introduced as sufficiently serious. This is why governance codes for boards and asset managers came into existence.

Group-specific codes need not deal exclusively with corporate governance issues. For example, the code of ethics for professional accountants deals with their involvement with all professional and business activities. Areas that concern their role in corporate governance however should be aligned with a framework code and other areas should be checked for consistency.

BENEFITS OF A FRAMEWORK CODE

We believe that there are important benefits from a combination of a framework code and supporting group-specific codes.

This approach acknowledges and accommodates important recent changes in the dynamics of corporate governance. The number and types of organisations and intermediaries involved have significantly increased. One natural reaction to reports of perceived failures of corporate governance is to raise expectations about how various groups should behave. Codes that apply to specific groups have become popular, and have the potential to align their behaviour with the overall objectives of the corporate governance system. These trends, however, give rise to risks that codes get out of line with each other and create complexity.

By having a framework code, we can deal with ever-increasing calls to develop specific codes for various groups and do this when it is absolutely necessary. This is because a framework code, if principles based, can ensure a degree of consistency and empower people outside the system to hold groups to account without a group-specific code. We believe this should make the world of corporate governance simpler.

Our proposal also enables us to maintain the benefits of a code-based regime. Many corporate governance failures are about human behaviour and principles-based codes are better at addressing this than other regulatory approaches. When people accept principles and expectations set out in codes, their behaviour should become more predictable and this should enable others to plan ahead. We presented the benefits of comply or explain-based codes in the paper '*When is comply or explain the right approach?*' in terms of innovation, proportionality, substance over form and long-term learning.

By promoting consistency between different groups acting within the system, our approach encourages a shared sense of accountability across groups and enables peer pressure to enforce responsibility. It recognises that individual groups in isolation cannot deliver a corporate governance system that commands public confidence and trust. This approach also treats everyone equally, eliminating the sense among some groups, for example boards of directors, that they are being asked to bear a disproportionate burden of responsibility.

A final benefit is that drafting a framework code will require long-term holistic thinking. It will force all those involved in corporate governance to think deeply about what their shared values and expectations are in relation to companies. The answers will also be important because they will underpin the contents of supporting codes. Starting points for the fundamental principles of a framework code are set out in our earlier papers: '*What should companies be responsible for?*' and '*What are the overarching principles of corporate governance?*' For example, we discussed four fundamental responsibilities of companies, which are:

- Achieving a business purpose;
- Behaving in a social acceptable way;
- Meeting legal and regulatory requirements; and
- Stating how responsibilities are met.

EXAMPLES AND THE CASE FOR CHANGE

While our proposal may appear new, there are already real-life examples of framework codes.

The City Takeover Code in the UK provides a clear example of a framework code. Ten general principles and 38 rules apply to all those who are involved in acquisitions of companies with any public shareholder involvement in the previous 10 years. Its overriding aim is to ensure that a target company's shareholders are treated fairly and equally and that the target company's board has sufficient time to set out its views on a takeover offer to its shareholders. The Code and its application are the responsibility of the Takeover Panel that has the ability to exclude anyone breaching the Code from the UK financial markets. The Takeover Code dates back to 1968. It continues to be central to the conduct of corporate acquisitions and its principles remain at the heart of public policy debate. It has not been necessary to develop supporting codes applicable to specific groups.

The OECD Principles of Corporate Governance support an effective corporate governance framework that applies at a country level and promote transparent and efficient markets, consistency with the rule of law and a clear division of responsibilities among different supervisory, regulatory and enforcement authorities. Its six principles cover different aspects of corporate governance, such as the rights and functions of shareholders, the role of other stakeholders and the need for disclosure and transparency. Although addressed mainly to government authorities responsible for establishing effective corporate governance systems, it has helped policy makers, investors, companies and other stakeholders worldwide by providing an international benchmark for discharging their responsibilities.

The OECD principles are different from the UK Corporate Governance Code. The foundations of the UK Code were established by the Cadbury Committee at a time when many principles of corporate governance were already contained in a body of company law that was based on shareholder interests. Nevertheless, it is worth recalling that the UK Code was originally a set of high-level principles that applied both to companies and institutional investors. It is now essentially a detailed code for one group, namely boards, which is supplemented by group-specific codes such as the UK Stewardship Code for asset managers and the Audit Firm Governance Code for auditors.

We argue for introducing a new framework code. Our case is supported by the emergence of new stakeholders, regulators and governance intermediaries; fundamental questions raised by the global financial crisis; and doubts about the quality of the governance of some international companies listed in international capital markets. More specific ally at a national level are public concerns. For example, the Kay Review questioned whether UK corporate governance is achieving its avowed purpose of facilitating 'effective entrepreneurial and prudent management that can deliver the long-term success of the company'.

CHALLENGES TO OUR PROPOSAL

The position we advocate in this paper involves challenges, particularly in the context of global competition among capital markets and wide international variations in ways of doing business.

A framework code reliant on comply or explain will only work if there are shared beliefs within a market or country about what constitutes good corporate governance. As we have argued in our paper on comply or explain, shared beliefs also need to be supported by institutional arrangements. This means that we must assess whether institutional arrangements will be robust enough to enable a framework code to work. For example, the various groups involved including investors, legislators and regulators should uphold the framework code by applying peer pressure to each other. If not, there will be a need for a new authority to play a role in corporate governance similar to that of the Takeover Panel in company takeovers by monitoring and enforcing appropriate behaviour.

The same considerations related to shared beliefs and institutional arrangements would equally apply to the supporting group-specific codes if these are to work on a comply-or-explain basis. Codes for groups developed in the heat of public concern at allegations of failure might not satisfy these conditions. The Stewardship Code is seen as having limited success in encouraging better engagement between companies and shareholders. Moreover, encouragement of new codes that fail to function successfully on a comply or explain basis could weaken the credibility of other codes.

The ambition to establish a framework governance code will encounter challenges but we face them anyway in developing group-specific codes. Our paper on the overarching principles of corporate governance discusses desirable characteristics of high-level principles that would characterise a framework code. Debate about a framework code may be far reaching and take us beyond the traditional boundaries of corporate governance into company responsibilities, ethics and behaviour. However, this debate is necessary if it will help us understand better the values companies espouse today and institutional arrangements to uphold those values.

SUMMARY

We think that there is a need for all who are involved in corporate governance to be covered by a code that sets a framework for their involvement. This framework code should provide a context for developing supporting codes that set expectations for the behaviour of groups whose actions are fundamental to good corporate governance.

This combination of framework and supporting codes will allow the development of group-specific codes while mitigating risks associated with code proliferation. It will enhance the shared beliefs and institutional arrangements on which principles-based codes depend. It will enable people outside the system to hold those inside to account. It will highlight the importance of shared responsibility for governance outcomes.

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