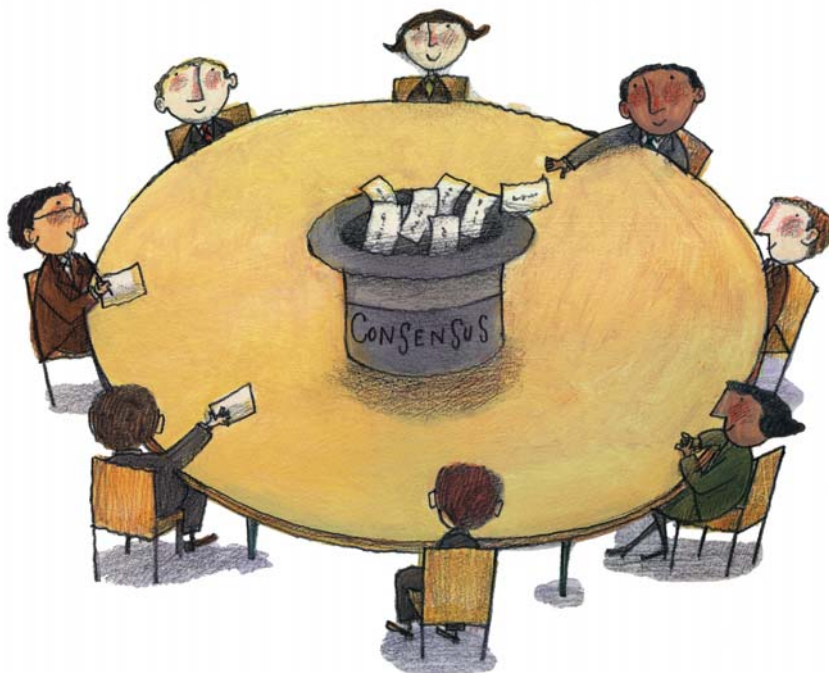


A question of leadership



John Mellor makes the case for a more robust approach to self regulation

Business is groaning under the weight of corporate governance rules and regulations. The Foundation for Independent Directors and the recently established All Party Parliamentary Corporate Governance Group (APPCGG) are both concerned to address this state of affairs. My role as policy advisor to the APPCGG links the two, allowing the foundations work to inform the parliamentary discussion and debate on corporate governance and contribute to the writing of policy papers.

The foundations strongly held view is that corporate governance should be supportive of enterprise and wealth creation. Corporate governance boils down to the responsibility of a company's board of directors to exercise direction, leadership and control of an enterprise, at the same time achieving the highest professional and ethical standards. To drive this understanding home it might be helpful to replace governance with leadership and to perceive corporate governance as corporate leadership.

When corporate governance is inadequate company performance over the long term suffers, access to capital for expansion becomes

more difficult and costs increase. Ultimately, enterprises are more likely to lose value, or in extreme circumstances fail, with the all too familiar consequences for shareholders, other stakeholders and economies.

However, business today confronts an ever-present danger to its mission of wealth creation – the tendency of policy makers to go overboard on legislation and excessive conformity. To counteract this, the voice of business needs to be heard and understood in parliamentary discussion and debate on corporate governance. For its part, business needs to apply itself to making the comply or explain principle at the heart of self-regulation effective. The investment community, too, needs to play an active role as responsible and supportive owners.

Rigid rules

The APPCGG was formally established in July 2004 and now has over 100 members representing a cross section of parliamentarians from both houses. The group aims to develop and enhance understanding of corporate governance amongst parliamentarians and to influence future policy making so as to achieve a proper balance between legislation and self-regulation. It will hold four policy meetings a year, write policy papers and hold a series of seminars where members of the group and leading figures from business can discuss and debate the issues of corporate governance. Sir Derek Higgs, author of the Higgs Report on non-executive directors, addressed the first seminar, which was held in the middle of October.

Many MPs and peers are concerned at the way that corporate governance guidance is operating in practice, Francis Maude, MP, and APPCGG chairman, told the *Financial Times* on October 18. Parliament has not been as well informed on this issue as it might have been and we hope that this group will help correct that. Updated governance guidelines are in danger of ossifying into rigid rules.

Corporate governance is one of those subjects about which everybody seems to have a point of view. To some extent, this reflects the sound principle that no one size fits all, but it might also reflect a fundamental misunderstanding. Sticking with the self-regulatory approach and making it effective requires business to take on board the

principle that codes are not meant to be taken as rules so much as guidelines for best practice, to be interpreted and applied on a case by case basis. The same is equally relevant for shareholders, financiers generally and others, such as rating agencies, who have a need to evaluate and make decisions on a company's governance.

Evolving understanding

Any code of best practice will never be cast in stone but must be expected to evolve as the understanding of best practice grows. In other words, a code of practice is dynamic and as such demands responsible understanding and behaviour from all parties involved, particularly companies and investors. These parties, the two sides of the corporate governance coin, are equally responsible for making the self-regulation approach effective and both need to be properly engaged. Experience to date might suggest that although not everything is satisfactory on the corporate side, the investor side also has some catching up to do.

There are a number of issues that will be of concern to the APPCGG, supported by the foundations research:

- The regulation, behaviour and standards of governance of financial institutions to support investment in industries vital to the country's prosperity;
- Shareholder engagement with boards through disclosure and face-to-face communication;
- The application of corporate governance to smaller companies without stultifying innovation and growth.

And, on boards and directors:

- The selection of a suitable and effective board, including an objective appointment process for directors;
- The recruitment of non-executive directors – from increasing sources and enhancing diversity to raising professional standards and understanding legal liabilities;
- A board's responsibility for achieving the highest professional and ethical standards, transparent communication, and the establishment of a culture of trust.

Since its establishment in 2002 the foundation has been building on its objectives in corporate governance to use cases, supporting research and publications for enhancing professional and ethical standards, in education and in contributing to the agenda for parliamentary discussion. Thus, in its own right, and in its support of the APPCGG, the foundation has

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embarked upon a programme of research that is advised by a group of senior representatives from among institutional investors, corporations, the professions and academia (the Research Advisory Board). This ensures the research's relevance to business needs.

Three areas of research

Three areas of research in particular overlap with the APPCGG's concerns, informing the parliamentary discussion and debate and helping with the writing of policy papers to ensure that they are based upon evidence and not just conjecture. Of these, investment and governance of financial institutions is especially pertinent to the financial community and will be considered in greater detail.

The first area is directly concerned with achieving a balance between legislation and self-regulation by observing companies' effectiveness in applying the comply or explain principle, and the investment community's response. Are both sides making progress in applying a pragmatic and responsible approach? A second aspect of this research concerns observing the application of codes of practice and self-regulation in countries outside the UK, particularly in Europe, and learning from relevant comparisons. Particular attention also is being paid to the relevant government draft bills and the draft directives emanating from Brussels.

In a similar vein, the second area of research is concerned with smaller companies, i.e. those outside the FTSE 350 as well as private companies. The Combined Code applies only to quoted companies on the Official List, but there is every reason to be concerned about corporate governance strictures spilling over to companies not on the list and stifling enterprise and innovation. Sound corporate governance is important to the health and prosperity of these companies. As they grow and their need for capital intensifies, their understanding and

A code of practice is dynamic and demands responsible behaviour from all parties



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embracing of corporate governance guidelines also will need to grow in order to gain the confidence of investors.

Investment and governance

Working with the Quoted Companies Alliance (QCA), a body representing the interests of quoted companies outside the FTSE 350, the foundation will be taking a closer look at these companies response to and application of Combined Code principles. At the same time, the foundation will be examining the investment communitys engagement with these smaller companies, including their response to explanations for non-compliance.

When it comes to investment and governance of financial institutions, the foundation is concerned with three issues in particular:

- **Shareholder engagement with company boards.** Albeit in a fiduciary capacity, institutional shareholders have a responsibility as owners on behalf of the ultimate beneficiaries of collective investment schemes. A review of institutional investors governance policies and, more particularly, their voting records provides some insight into their engagement with company boards. It must be a sensible proposition that most of the face-to-face engagement should take place in private. However, many questions arise, including the points for engagement. In what areas is it right for shareholders to engage with boards so as not to interfere with the running of the business? There are some obvious ones, such as executive remuneration, that are accepted as legitimate; but there is not a complete understanding and acceptance of what these areas should be. Strategy, board composition, major investments or divestments come to mind, but there is clearly work to do in clarification, an important area of research for the foundation. A second question relates to the quality of the dialogue between the parties. This depends on the people involved and the importance of a match of experience and maturity. It is not helpful for company directors to be discussing matters of strategic importance with members of the financial community who cannot properly engage at this level.
- **The relationship between corporate governance and investment.** This covers, from the investment communitys perspective, investment time horizons, the confidence to invest and returns for shareholders. From the

corporate perspective, it also includes investment horizons (i.e. short-term versus long-term) and, importantly, access to and cost of capital. Long-term investment is clearly needed to support innovation and build global and world beating enterprises in areas key to the economy, such as science-based industries. In essence, companies governance structures and standards, the investment communitys confidence to invest, at what cost to companies and over what time horizon are all inextricably linked.

- **Governance of financial institutions.** Equity as an important source of finance is combined with debt finance, long- (e.g. bonds) and short-term (e.g. bank lending) in most cases. Financial institutions generally are the sources of these funds and their own governance is of vital importance to the working of the market for finance in support of business. This side of the governance coin has been relatively little explored to date and is another important aspect of the foundations research programme. Financial institutions include insurance companies, investment managers, banks, including investment banks, and others. While some categories of financial institution may be more advanced in their own governance than others, there is evidence to suggest that standards need to be improved so as not to undermine the market for financial services and importantly the support for business.

Shared responsibility

There is a governance interface between sources of finance, shareholders and business. The investment community and business share in the responsibility for governance. Take the role of investment banks involved in both the equity and debt sides and as advisors on mergers, acquisitions and divestitures. As has been demonstrated by some well-publicised and relatively recent examples, Enron and Parmalat among them, governance issues that arise include financing and investment policies, managing conflicts of interest and ethical standards. Lapses under any or all of these headings have proved disastrous for shareholders, other financiers and stakeholders alike. It is arguable that catastrophes for companies and their investors could have been avoided if more attention had been paid to understanding and applying principles of sound corporate governance. ■

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