

Beware the Gospel according to London!

The New UK Corporate Governance Code (Part II)

Unrealistic idealism in parts of the new UK Corporate Governance Code is something I raised yesterday. One of my worries is the topic of independence and Board “*refreshment*”. The new UK Code recommends that all directors of the FTSE 350 companies should be subject to annual re-election. This is said to encourage greater accountability, but it’s dangerous, and not just in our environment.

First, the prospect of losing a first rate director after only one year is appalling to shareholders. Continuity, knowledge of the industry and the peculiarities of the company are valuable and need to be retained. Much important knowledge isn’t acquired in one year, no matter how good the directors’ orientation programme; it takes time to realise the full contribution potential of a director.

What of the individuals? They have their own self-esteem; it’s why they are good at what they do. To be removed after a year would be unacceptable to them. Damage to reputation is one aspect; being unable to make a genuine contribution to the company is another. The good director would likely decline the appointment.

And how might this affect the independent director in a company with a significant or controlling shareholder? If the independent director was an impediment to the controlling shareholder’s views, it would be easy to orchestrate a quick exit for the recalcitrant individual. Again, the good director would likely decline the appointment.

If prospective directors refuse to serve because of this recommendation, how can companies benefit, let alone be enriched or refreshed? Certainly, we do not have the luxury of a pool of directors deep enough to accommodate this provision here in Malaysia.

Board performance evaluation, on the other hand is given a higher profile with should be externally facilitated at least once every three years. This is a genuine advance. In-house evaluations can be very clubby affairs and internal facilitators are seldom willing to upset Board harmony and equilibrium, or their own world, by asking difficult questions.

However, I fail to see the logic in retaining the old requirement that re-election of anyone who has served for more than six years is subject to “*rigorous*” review. Re-election every three years is accepted by most. It allows time for contribution to be demonstrated. So, why not make rigorous evaluation the norm for every director standing for re-election? With a three year rigorous review cycle, and Nominations Committees that are prepared to be transparent about the evaluation process and explicit about why an individual should be re-elected, the safeguards are in place.

Time expiry for independence is another feature retained in the new UK Code: after nine years a director can no longer be considered independent and must offer himself for annual re-election thereafter. The objective is Board refreshment, but the new UK Code seems to be wedded to the notion that this is best achieved through new faces. That’s narrow-minded and problematic in our environment.

Education for Directors, new ideas in old heads, has huge value because it retains all the knowledge and the nuances acquired though years of service. I’m not convinced that

extinction and replacement are preferable to evolution, or that genuinely independent directors cease to be so because of the passing of time. Indeed, many of these laudable individuals have an insatiable appetite for learning and self-improvement. If there's such an individual on the Board of a company in which I am invested, I want to see that person stay. I certainly don't want to see him lost because of some prescription in the Code. What I want is a Board that is thinking about its composition, that doesn't welcome seat warmers, and applies a thorough process for evaluation to every director, regardless of status or length of service. *Apply and explain!*

However, external validation of Directors' performance every three years is a peripheral improvement. It should be part of a bolder move not present in the new UK Code.

The argument for external overall governance reviews is compelling. No-one today needs convincing that governance issues can bring down a company just as quickly as accounting issues. Indeed the numbers are really a reflection of governance. Yet, we insist that financial accounts are externally validated annually, but accept bland assurances from the Board that all is well with corporate governance. A more transparent discourse from the Chairman on how governance works inside the company will certainly be beneficial, but it is still an internal assurance.

It would be far better if the quality and effectiveness of governance in its totality were externally validated through a process of independent review. The frequency of review is a matter for debate, but it should probably be no less often than three years. The effectiveness of all the corporate governance structures and processes should be examined; this should not be an attestation of compliance with the Code. Internal controls and the risk management environment should also be included in the review.

In 2010, it is no longer regarded as credible by most corporate stakeholders to have directors give an unsupported statement that all is well. Let's apply the principles and provide a validated explanation of the positive impact on the company.

The lessons of the recent past have shown that quality Boards and good governance are essential to the economic well-being of the entire developed world, because corporate entities represent so great a part of the real world economy. Against this background, I had expected the new UK Code to attempt to make an impact. Many people rely on companies one way or another; they need the comfort that the governance framework is not a matter of chance. Prudence need not smother the entrepreneurial spirit, but the new UK Code is timid; it addresses small matters and is satisfied with making incremental gains. The challenge was always addressing the core of governance and delivering a framework that provides greater certainty and confidence for the corporate stakeholder.

Malaysia can set the international benchmarks; we face the same challenge as we look at our own corporate governance framework. We must remain focused on the core, be brave enough to grapple with the whole, and resist temptations to settle for less. There is an opportunity for Malaysia to adopt cutting edge practices as the standard. Apply and explain is the next step; we can lead the way.

The new UK Corporate Governance Code is not without its merits, but it is not a gospel which warrants unquestioning adoption and belief. We can do better; we can be world class and benefit the nation immensely as a result.

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