GOVERNANCE

June 2019 Issue 298

## Is your board fit for the digital age?

'For 30 years boards have viewed technology as an operational matter, best delegated. Now, in the digital age, society is different; business is different; risks are different. Does your board have the right conversations – and the right skills?'

*Stephen Page*

## Corporate governance – a radical rethink

'So, if we are really honest about it, the regulatory regime has failed, and the time has come to dismantle it and start again. The new start should concentrate on training in behaviours and values, and encouragement by shareholders and employees for companies to design the governance which works for them.'

*Richard Smerdon*

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# Corporate governance – a radical rethink

**Richard Smerdon** puts the case for a complete rethink about corporate governance and dismantling the current UK regime.

**Introduction**

This is the first of two articles which will appear in successive editions of *Governance*.

The purpose of these articles is to argue, firstly in this article, that the mend and make do rickety structure of UK corporate governance regulation and quasi-regulation built up since 1992 should now be dismantled and abolished. At the same time Companies Act 2006, s. 172[1] should be beefed up by allowing direct shareholder action against directors for breaches of that section. Secondly, in the next edition of *Governance*, the author will argue that the exorbitant time and resources and energy devoted over the years by boards to largely ineffectual corporate governance regulatory compliance should, in the light of the sustainability crisis now facing the planet, be devoted to a new philosophy of governance. Namely, the 'Governance of Sustainability' under which companies of a material size would be required to say how, and then execute, a reduction to zero of their net carbon output, the largest by 2030 and the smaller by 2050, policed by investors under the monitoring of the Bank of England.

**The dismantling of the UK corporate governance regime**

The dismantling of the corporate governance regime would require the following:

1. the abolition of the UK Corporate Governance Code;
2. the removal of all corporate governance responsibilities from the successor body to the Financial Reporting Council, currently to be called the 'Audit, Reporting and Governance Authority', and the consequent renaming of the Authority;
3. the removal of any requirement for listed companies to make an annual statement of 'appliance' and 'compliance' as required by the Listing Rules, and with it, therefore, inevitably, the scrapping of the 'comply or explain' approach to UK corporate governance;
4. the scrapping of the Wates principles and The Companies (Miscellaneous Reporting) Regulations 2018;
5. companies would actively be discouraged from making statements about their corporate governance in the annual report on the grounds that it would re-start the competition in meaningless statements which currently operates;
6. companies developing and designing their own corporate governance regimes to suit their particular circumstances, but these would essentially be matters for the company and its workforce and for the company and its investors and not for wider publication.

The author currently envisages that the dismantling process would NOT require the following:

1. revision to the current or a developed regulatory regime regarding the reporting of pay of senior executives. Despite the manifest evidence that the current disclosure and stewardship responsibilities by investors regime has done nothing to curb excessive pay or rewards for failure[2] there nevertheless seems merit in continuing the efforts to obtain transparency about pay and subjecting that transparency to public obloquy (or approval, for that matter) and for continuing to put pressure on institutional investors to play their part in curbing excessive pay;
2. the abandonment of the Stewardship Code. Again, despite evidence that this Code is ineffectual largely because so many investor institutions are based outside the UK and don't care that much, it seems worth keeping as a reminder of where the pressure should be coming from;
3. the reform of the audit profession and sanctions for poor auditing;
4. arrangements for developing and enforcing accounting standards coming under the supervision of the new Audit, Reporting and Governance Authority and giving that Authority powers to fine and/or disqualify finance directors.

**The case for dismantling the corporate governance regime**

The author has been writing about, teaching, and advising on corporate governance since the Cadbury Code in 1992: which was itself born out of the scandals of Maxwell, Polly Peck, Coloroll etc. Since then, we've had Hampel (1993), Higgs (1993), Greenbury (1995), Walker (2009}, the Stewardship Code (2012) and by my reckoning, at least 15 iterations of corporate governance codes (currently called the UK Corporate Governance Code 2018). Each report/code has attempted in entirely good faith and with the best of intentions to shut stable doors before further notorious escapes so as to reflect the disquiet following the last lot of governance disasters and pay scandals.

# Feature

They have failed, however, to stop scandals and poor behaviour.

Thus, we have Carillion – a former FTSE 250 company which on 18 January 2018 went into liquidation. A basic student text book example of failed governance: Just the sort of box ticking governance I and the reports and the codes have been trying to exhort against for years.

Of course it would be irrational to argue that on the basis just of Carillion one should scrap the whole of the corporate governance regime, but my argument is that Carillion is simply the latest example of many examples (think, for example, of the major banks at the time of the financial crisis in 2007/8) of appalling governance *at a fundamental level* since Cadbury and despite all the reports and codes and regulation and quasi-regulation since that date.

To put it another way, effective corporate governance fundamentally depends and has always depended upon (good) behaviours and values, not on codes and regulation. The Walker review on the governance of banks in November 2009 emphasised this. Companies where values and behaviours are poor will always tend to fall down on governance: where they are 'good', governance will naturally build itself into the very DNA of the company, regardless of codes. There is no conclusive, or even partly conclusive, evidence to show that 'good' corporate governance improves company performance: you really would have thought after all these years that the pattern would be clear, but it isn't. It is probably true that the availability of capital and the price of that capital does have some correlation to standards of governance, but the point is that the providers of capital can easily satisfy themselves about governance standards in a particular capital raising company: simply referring to the annual, vacuous corporate governance statements is not going to tell them anything.

So, if we are really honest about it, the regulatory regime has failed, and the time has come to dismantle it and start again. The new start should concentrate on training in behaviours and values, and encouragement by shareholders and employees for companies to design the governance which works for them.

### A beefed up Companies Act 2006, s. 172

If the corporate governance regime has failed to stop poor behaviours as exemplified in Carillion, might company law concentrate the minds of directors to encourage better behaviours? In particular might s. 172 be used to enforce higher standards?

Section 172 requires, in terms, that directors have a duty to promote the success of a company for the benefit of members as a whole, having regard (amongst other matters) to six factors which include, for example, the interests of the company's employees, the impact of the company's operations on the community and the environment and the need to act fairly as between members of the company.

However, the problem is that it is a fundamental principle of UK company law that *only the company*, not individual shareholders, can sue directors for breach of duty.

Thus, in practice, actions can only be taken by the company through a new board (for example following a sale of the company) or by the liquidator. However, the fact is that since the introduction of s. 172 there has not been a single reported case in any of the higher courts interpreting s. 172. Thus, people attempting to advise boards or liquidators on what s. 172 means in specific situations are doing so in a vacuum of no judicial interpretation. It is true that many public companies now include in agendas and board minutes specific references to the need for their boards to consider s. 172 in making decisions, but the limitations of certainty of interpretation and enforceability still remain the same.

The author's proposal, therefore, is that the law should be amended so that individual shareholders can take action against directors, subject only to the High Court being satisfied that the claim is in good faith and has prima facie merit. This would give greater chance of judicial interpretation and would also, surely, concentrate the minds of directors on their duties.

### Conclusion

The UK corporate governance regulatory regime has failed to stop poor governance and should now be decently buried. Directors can then concentrate resources on the real issue of our time, namely, the governance of sustainability. The article in the next edition of *Governance* will explain why and how.

1. See above in this article: 'a beefed up s. 172.'
2. 'The Myth of Shareholder Stewardship: how effectively do shareholders oversee FTSE 100 CEO pay?', 2 May 2019, High Pay Centre.

*Richard Smerdon. Author, 'A Practical Guide to corporate governance', 1st to 4th editions, Sweet & Maxwell. Former tutor to the Financial Times Non-Executive Directors Diploma. Former corporate finance partner, Osborne Clarke.*

*The writer is writing in a personal capacity and none of the views expressed are to be attributed to any of the organisations above mentioned.*

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The needs of ethical directors illustrate the irrelevance of so called 'good' governance principles or practices. Its time to replace them with outcomes that can make corporations a common good and capitalism compatible with sustaining humanity on the planet.

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4. Barwon Cotton Ltd. and JAC Tractor Ltd. described in Turnbull, S. 2002. Corporate Watchdogs: Past, present and future? At: <https://ssrn.com/abstract=608244>.

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6. <https://www.bloomberg.com/quicktake/dark-pools>.

*Dr Shann Turnbull is the Principal of the International Institute for Self-governance who initiated and co-authored in 1975 the first educational qualification in the world for company directors. He can be reached at sturnbull@mba1963.hbs.edu*

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'*Governance* provides a very useful summary of key issues.'

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