CFA UK is a member society of

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Financial Reporting Council
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13th July 2012

CFA UK response to the FRC's Consultation on the revisions to the Code for Corporate Governance

Dear Chris,

The Chartered Financial Analyst Society of the UK (CFA UK) welcomes the opportunity to share its views about the FRC's consultation on changes to the Code for Corporate Governance (Code). CFA UK welcomes any initiative that raises professional standards and market integrity. This response has been prepared by the CFA UK's Financial Reporting and Analysis Committee. CFA UK has not surveyed its members.

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees

Response

Overview

CFA UK welcomes the FRC's revisions to the Code for Corporate Governance and the importance placed on the spirit of the Code rather than the letter of the Code. These changes are long overdue and are supported by the assessment of the "Comply or Explain" approach carried out by Arcot and Bruno (2006)[1]. Based on their assessment Arcot and Bruno stated that "i*n conclusion, our analysis shows that the Combined Code and its "comply or explain" approach does not differ much from a prescriptive law. This highlights a common conformity with the letter but not the spirit of the regulation."*

Our response is brief and while we welcome many of the changes the FRC have proposed; our submission focuses on key areas that we consider to be pertinent regarding the effectiveness of Boards. In essence, it is how effective a Board is that will make the most positive contribution to the internal governance of a company and its ability to generate economic value.

We would agree that providers of capital to "Premium" listed companies should be a source of market discipline although would like to make the FRC aware of the limitations of this process. In our response to the Kay Review[2] we provided considerable evidence on why the equity market may not always impose the level of discipline desired. Recognition that publicly listed companies use a variety of sources of capital in addition to equity capital is welcome. Having the Board acknowledge this is also progressive although it should also be expanded to include loans that the company has taken out.

The recognition that companies use equity and non-equity sources of capital makes it even more important that the Chairman and Board members have the skills and understanding for each type of capital used by the company. They should be aware of the features of each source of capital and the differences that could have an influence on the company's operations and viability. For example debt has a favourable tax treatment for a company, whereas equity does not. and this creates an incentive to increase gearing. Investors that hold multi-asset portfolios will invest in asset classes in addition to bonds and equities. Often, the contractual terms associated with bonds and loans will be a more effective source of market discipline than by the equity holder. Companies that face challenges in obtaining non-equity funding or breach covenants are often poorly governed.

Similarly, in the same Kay Review response we set out UK evidence for the types of behaviour executives can undertake to serve their interests at the expense of generating economic value. It would valuable for Boards to be sensitive to such activities and act accordingly. Boards and the market should complement each other as checks and balances to ensure executives do not engage in value destroying behaviour. However, as recent examples have shown few Boards are held to account when evidence of poor governance comes to light.

We agree that the Code does not guarantee an effective Board although welcome FRC's attempt to make the Chairman and Board members realise the weight of responsibility that rests on their shoulders. The selection of Board members and a stronger Audit Committee should contribute to making Boards more effective. CFA UK welcomes the

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[1] In Letter but not in Spirit: An Analysis of Corporate Governance in the UK (May 2006) Arcot, Sridhar and Bruno, Valentina Giulia,. Available at SSRN: http://ssrn.com/abstract=819784 or http://dx.doi.org/10.2139/ssrn.819784

[2] CFA UK Response to the Initial Kay Review Call for Evidence, December 2011
https://www.cfauk.org/assets/2162/CFA_UK_response_to_the_UK_Equity_Market_Review_SENT.pdf

direction the FRC is taking with Audit Committees. As we have stated in our response to the Gender Diversity consultation, Boards need to have the appropriate skill sets to be impartial monitors of the use of corporate assets by the executive and limit value destroying behaviour. It would be useful to see to what extent the FRC undertakes an assessment of how Boards of listed companies act in the spirit of the Code and what metrics will be used to assess the effectiveness of Boards. In addition where Boards are found to be ineffective what actions will/can the FRC take? Over-reliance on market discipline will not be sufficient reason for the FRC not take action.

Comply or Explain

CFA UK supports the comply or explain approach although we would hope that the FRC is alert and prepared to take action should the "fungus of 'bolier-plate' explanations" reappear. CFA UK would hope that any review of the Code will also include an assessment of the quality of explanations.

Board Effectiveness

Board effectiveness is an integral part of market integrity. As we stated in our response to the Kay Review "UK publicly listed companies, like any business entity, are allocatively efficient when they generate economic profits... Too often, companies and investors focus on accounting profits – the published net profit figure which is then used to derive earnings per share. Companies and investors should value companies by determining the net present value of future free cash flows to the firm (FCFF) discounted by its weighted cost of capital (WACC – the rate of return required by investors for investing capital in the company)." The governance mechanisms within companies play a crucial role to ensure that these companies are allocatively efficient, otherwise shareholder value is destroyed. Similarly, where Boards are ineffective they should be held to account.

Boards should ensure their companies are allocatively efficient. Board members should have the capabilities, skills and expertise to ensure that shareholder interests are taken into account and that the executive is generating shareholder value. The effectiveness of the Board will be determined by having the appropriate diversity of skill sets. If attaining the appropriate mix of skill sets results in higher numbers of those considered under-represented on Boards, then this is a welcome secondary benefit. For Boards to have the appropriate diversity of skill sets, more reassurance may be required with respect to the Board selection process.

Integrity of the selection process and the supply of Board candidates

Greater weight should be placed on how Board members are selected and to assess whether or not the process identifies the most suitable candidates available at that time. Similarly, the selection process should be as transparent as possible so that any barriers that would hinder the identification of suitable candidates are greatly reduced. Where it transpires that Board selection raises concerns there should be a mechanism by which the selection process is subject to an independent review.

It is of course quite possible that the supply of suitably qualified candidates may be limited and this may have a bearing on the quality of candidates available. Here again, further investigation will be required to understand the supply of suitably qualified candidates. Perhaps this is an area where FRC could become more active. In addition, more could be done to train the next generation of Board members so that they learn the lessons from the past and obtain the skills and expertise to become effective Board members of the future.

Effective oversight and accountability

CFA UK appreciates that the Code for Corporate Governance is just that - a Code. However, as guardian of the Code, the FRC could do more to ensure that the spirit of the Code is being adhered to when it comes to the effectiveness of Boards. The recent and previous crises have demonstrated corporate governance failure but also market failure, which have yet to be addressed effectively. The FRC has the potential to play a key role in ensuring that Boards are effective in ensuring resources are allocated efficiently and that publicly listed companies generate value.

Continuous learning, professional development and the courage to challenge

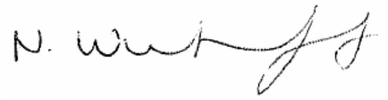
As with any professional, maintaining knowledge and expertise is vital. Inherent in this learning would involve understanding and applying the lessons from corporate history and being aware of research related to corporate governance that enables Board members to identify good practice as well as practices that undermine value generation. Board members have a duty of care. In its position paper “Financial Amnesia” CFA UK calls upon its members to learn from the lessons of history, in doing so the mistakes of the past can be learned and reduce the chance of them being repeated in the future. The financial crisis highlighted the types of behaviour and practices that undermined effective corporate governance. These lessons should be learned by all Board members regardless of the sector they operate in. Governance is not a sector specific issue but impacts all businesses. To contribute to this learning CFA UK has suggested a list of references that may be helpful (see Appendix).

One key lesson that needs to be learned at Board level is the ability to challenge without fear of reprisal. In fact it would be vital for Boards to take more notice when disconfirming evidence or views are put forward and so avoid collective cognitive dissonance. The FRC, all current and future Board members, and regulators should remember the experiences of Paul Moore, the former Head of Group Regulatory Risk at Halifax Bank of Scotland-

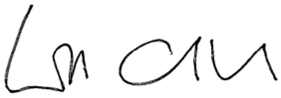
“I realised the bank was moving too fast and I raised those challenges very strongly at board level. I also raised issues of cultural indisposition to challenge and inappropriate behaviours, and ultimately I was sacked.... I raised and reported all of this whistle-blowing claim that I had with the FSA but they did nothing either.”

We hope our response is helpful and we would be open to discuss it further with you.

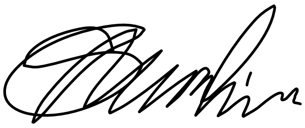
Yours,



Natalie WinterFrost, CFA FIA
Chair Professional Standards & Market Practices Committee, CFA UK



Will Goodhart
Chief Executive, CFA UK



Sheetal Radia, CFA
Policy Adviser CFA UK

APPENDIX

The evidence below should be useful to the FRC and perhaps existing and future Board members to become aware of the types of inappropriate and appropriate practices that have been documented. In doing so Boards will be equipped with information and knowledge to assist them in their duties. Summaries of the papers cited below and others related to corporate governance can be found at http://www.cfapubs.org/action/doSearch?type=advanced&target=advanced&displaySummary=false&journal=dig&filter=single&searchText=ceo&x=0&y=0

Are Incentive Contracts Rigged by Powerful CEOs?
Adair Morse, Vikram Nanda, and Amit Seru
Journal of Finance, October 2011, Vol. 66, No. 5: pp: 1779-1821

CEO Incentives and Earnings Management
Daniel Bergstresser and Thomas Philippon
Journal of Financial Economics, June 2006, Vol. 80, No. 3: pp: 511-529

CEO Pay Cuts and Forced Turnover: Their Causes and Consequences
Huasheng Gao, Jarrad Harford, and Kai Li
Journal of Corporate Finance, April 2012, Vol. 18, No. 2: pp: 291-310

CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?
Ivan E. Brick, Oded Palmon, and John K. Wald
Journal of Corporate Finance, Special 2006, Vol. 12, No. 3: pp: 403-423

Executive Stock Options, Differential Risk-Taking Incentives, and Firm Value
Christopher S. Armstrong and Rahul Vashishtha
Journal of Financial Economics, April 2012, Vol. 104, No. 1: pp: 70-88

CEO Incentives, Cash Flow, and Investment
John Paul Broussard, CFA, Sheree A. Buchenroth, and Eugene A. Pilotte
Financial Management, Summer 2004, Vol. 33, No. 2: pp: 51-70

Shareholders' Say on Pay: Does It Create Value?
Jie Cai and Ralph A. Walkling
Journal of Financial and Quantitative Analysis, April 2011, Vol. 46, No. 2: pp: 299-339

Why Are CEOs Rarely Fired? Evidence from Structural Estimation
Lucian A. Taylor
Journal of Finance, December 2010, Vol. 65, No. 6: pp: 2051-2087

The Internal Governance of Firms
Viral V. Acharya, Stewart C. Myers, and Raghuram G. Rajan
Journal of Finance, June 2011, Vol. 66, No. 3: pp: 689-720

Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?
Diane Del Guercio, Laura Seery, and Tracie Woidtke
Journal of Financial Economics, October 2008, Vol. 90, No. 1: pp: 84-103