Do not Simply Tick the Box: The Effectiveness of the Corporate Governance Code 2018 in the Absence of an Implementation Mechanism

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Abstract

This paper evaluates the UK Corporate Governance Code 2018 vis-à-vis its predecessors with a view to determine its effects on corporate governance reform in the UK. The leitmotif of the paper is that while the concise nature of the Code has the potential to reduce the corporate practice of box-ticking thereby making the application of the Principles more effective, the absence of an enforcement mechanism still puts its overall effectiveness in doubt. The paper, however, concludes that the proposal to replace the Financial Reporting Council with a new body giving it enforcement powers is a step in the right direction and that this strengthens rather than threatens the shareholder primacy position of British corporate governance.

Introduction

This paper analyses the recent UK Corporate Governance Code 2018 and how it differs from preceding Codes in terms of its structure, contents and the implementation mechanism of its principles with the view to determining the effectiveness of corporate governance reform in the UK in the light of recent corporate failures. In fact, the UK has seen a spate of high-profile corporate failures in the past two years alone. This includes: Carillion in January 2018, British Steel in May 2019 and Thomas Cook in September 2019. These failures followed the collapse of BHS in April 2016. The paper argues that while the 2018 Code maintains the same course as its predecessors, its streamline nature means that it potentially does a better job of avoiding the corporate practice of tick-boxing than its predecessors. The paper exposes the paradox of the flexible nature of the UK Corporate Governance Code leading to companies choosing the tick-box approach thereby applying the letter rather than the spirit of the Code, a situation which the Cadbury Report 1992 was paradoxically keen to avoid when it expressed its preference for a voluntary Code rather than statutory rules. The paper, however, questions the absence of an implementation mechanism to ensure compliance with the Code and argues that this puts its effectiveness in doubt. The paper concludes that the proposed replacement of the Financial Reporting Council (FRC) with a new body with stronger enforcement powers is a step in the right direction.

1. The UK Corporate Governance Code 2018: What is New?

The Code was published in July 2018 by the FRC following a period of extensive consultation with stakeholders, which ended in February 2018. The Code came into force on 1 January 2019 and applies to all companies with a premium listing of shares, whether incorporated in the UK or elsewhere. According to the FRC, the Code broadens the definition of corporate governance and emphasises the importance of: positive relationships between companies, shareholders and stakeholders; a clear purpose and strategy aligned with healthy corporate culture; high quality board composition and a focus on diversity and remuneration which is proportionate and supports long-term success.[1] In short, the Code emphasises among others, the importance of businesses building trust by forging strong relationships with key stakeholders.[2] It focuses on a revised set of principles that emphasise the value of good corporate governance to long-term sustainable success.[3]

Unlike earlier Codes which contained very few changes to the preceding ones, the 2018 Code makes far-reaching changes. The areas that have been subject to some major changes in the Code include: workforce and stakeholders,[4] succession and diversity, culture, and remuneration. One of the main changes in the 2018 edition of the Code is the emphasis that remuneration committees should take into account workforce remuneration and related policies when setting director remuneration. This is a response to public concern over executive remuneration.[5] Principle P of the Code embeds the idea of linking executive pay with the long-term success of the company. The Code also emphasises the need to refresh the board and undertake succession planning. For example, boards should consider the length of term that the chair remains in post after nine years. The aim is to ensure that boards of directors of listed companies have the right mix of skills and experience.[6]

A brief comparison with previous Codes should help us to appreciate the extent of the changes introduced in the 2018 Code. The 2018 Code which the FRC describes as "shorter and sharper" is more concise, containing only 18 principles and 41 provisions spread over 15 pages compared to the old Code's conflation of 99 principles, supporting

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[1] FRC, "Revised UK Corporate Governance Code 2018 Highlights", https://www.frc.org.uk/getattachment/524d4f4b-62df-4c76-926a-66e223ca0893/2018-UK-Corporate-Governance-Code-highlights.pdf

[2] Company Lawyer, 2018, 39(10), 326.

[3] Company Lawyer, 2018, 39(10), 326.

[4] These changes have already been a source of criticism. For example, the Code has been criticised for focusing heavily on workforce rather than the wider stakeholder interest. Esser Irere-Marie, Ian MacNeil and Chalaczkiewicz-Ladna, K., "Proposed Revisions of the UK Corporate Governance Code: A Step Forward in Recognizing a Company's Responsibilities towards wider Stakeholders?" (2018) 39 *Company Lawyer* 8, 254-256.

[5] Provision 33. See also, Peter Bailey, "It Looks Like Corporate Governance is starting to Toughen up (at last)" (2018) 409 *Company Law Newsletter*, 1-3.

[6] Bailey, ibid.

principles and provisions spread over 32 pages. Prior to the 2018 Code, earlier Codes consisted of a set of recommended Principles of corporate governance made up of five main Principles (the 'Main Principles') which were supplemented by Supporting Principles and more detailed Code Provisions, which largely amplified the Main Principles.[7] The 2018 Code contains a simple introduction. This replaces the introduction sections of the 2016 Code, which contained different parts such as, the Preface, 'Comply or Explain', the Main Principles of the Code. The other parts such as 'Comply or Explain and the Main Principles are not removed. Rather they are simply incorporated into the introduction and the substantive section of the Code.[8] The shortened version of the new Code has been welcomed as reflecting the FRC's renewed focus on principles.[9]

The Main Principle of section A1 of the earlier Codes has now been framed in less prescriptive terms as Principle A of the 2018 Code as follows "A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company." Whereas the Main Principle in the earlier Codes is prescriptive in that it prescribes who should head the company and what their responsibility is, Principle A of the 2018 Code does not begin in such a prescriptive tone. The language is definitional in the beginning. It is only in the second limb of the sentence where it prescribes the role of the board. Principle G reproduces the Supporting Principles of section B of the earlier Codes, which require the board to include an appropriate combination of executive directors and NEDs, while principle H deals with their role in a similar manner as section A.4 of the earlier Codes.

Although the 2018 Code maintains the same number of main Principles or sections as its predecessors, it nevertheless does some re-wording of the section headings, removing "Relations with Shareholders" as a separate section. The five main Principles of the pre-2018 Codes were: leadership, effectiveness, accountability, remuneration and relation with shareholders. Those of the 2018 Code are: board leadership and company purpose; division of responsibility; composition, success and evaluation; audit risk and internal control and finally remuneration. Relations with Shareholders which was in section E of the 2016 Code is now dealt with somewhat pervasively throughout the 2018 Code. Although the 2018 Code reiterates the importance of shareholders in the corporate governance structure in terms of emphasising their role in appointing and monitoring directors, evaluating the principles applied by the board, etc, it is uncertain if removing "relations with shareholder" as a separate core principle and instead dealing with shareholder concern in a pervasive manner in the Code signals a gradual shift from the traditional shareholder-primacy position that defines UK corporate governance. However, it may be the case that this pervasive structure requiring the board to consider shareholder interest pervasively rather than treating them in a separate section provides a context within which shareholder interests can be more effectively taken care of.[10]

[7] Jake Green, Lorraine Johnston and Bisola Williams, "Corporate Governance in Financial Institutions" [May 2017] 146 *Compliance Officer Bulletin*, 1-30, at p. 6.
[8] Peter Bailey, "Financial Reporting Council consults on proposed "Shorter and Sharper" UK Corporate Governance Code" [2018] 403 *Company Law Newsletter*, 1-3.
[9] Bobby V. Reddy; "Thinking Outside the Box – Eliminating the Perniciousness of Box-Ticking in the New Corporate Governance Code" (2019) 82 *MLR* 4, 692-726, p 704. Cited hereinafter as "Reddy".
[10] Reddy, p. 704.

Unlike the 2018 Code, previous Codes reproduced the preceding ones almost verbatim. This is the case with the 2016 Code which reproduced the 2014 Code almost in its entirety. The 2014 Code itself reproduced the 2012 Code in a similar manner. The only noticeable change to the body of the 2016 Code is the introduction of a new sentence at the end of section C.3.1 as follows: "The audit committee as a whole shall have competence relevant to the sector in which the company operates." This is followed by a few amendments in Schedule B, apparently aimed at strengthening audit and disclosure requirements. There are also a few negligible changes to the footnotes such as the removal of the words "and Ireland" in footnote 10, section C; the introduction of a new short sentence in footnote 12 and the addition of a new footnote 13 and footnote 20 to the 2016 Code which moves subsequent footnotes back by one. However, it should be pointed out that the 2010 Code has been lauded for its clarity in identifying best practice as well as for overhauling earlier Codes and introducing some changes in terms of restructuring these Codes and introducing a new stand-alone section on effectiveness and a new preface.[11] But this is unsurprising since the 2010 Code was the first UK Corporate Governance Code consisting of the Combined Codes of 2006 and 2008. As the first Corporate Governance Code, it was expected that changes would be introduced. However, these are nuanced changes and as observed above, there were hardly any substantive changes to the preceding Codes.

2. Reinforcing the Flexible Principle System

The UK Corporate Governance Code is both principle-based and principle-led. This paper focuses on the latter. It is principled-based in that as stated in the Cadbury Report itself, the Code is based on the principles of openness, integrity and accountability.[12] It is principled-led in that Cadbury advocated a principle-led approach which would enable boards to comply with the spirit rather than the letter of the Code in its application which might be the case under a rule-led approach.[13] Cadbury charged individuals and companies, in the light of their circumstances, with the responsibility of ensuring that their actions meet the spirit of the Code and to give precedence to substance over form in its interpretation.[14] This approach provided flexibility to companies in the application of the Code. Cadbury felt that this could be best achieved through what came to be known as

[11] Abigail Stewart and Terry McNulty, "Convergence around concepts of actual board effectiveness in hard and soft law" (2015) 9 *Law and Financial Market Review*, 1, 29-39.

[12] Report of the Committee on the Financial Aspects of Corporate Governance https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-(the-Cadbury-Code).pdf, para 3.2.

[13] Report of the Committee on the Financial Aspects of Corporate Governance https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-(the-Cadbury-Code).pdf. Para 1.10

[14] Paragraph 3.10.

"comply or explain." Comply or explain is a major feature of the UK Corporate Governance Code since Cadbury and was described by the FRC in the 2016 as "the trademark of corporate governance in the UK … and the foundation of its flexibility." It requires listed companies to state whether they are complying with the Code and to give reasons for any areas of non-compliance[15].

The flexibility provided by Cadbury was followed up by Hampel with the introduction of principles so that companies could follow the spirit of the principles without necessarily complying with the provisions. And, in order to encourage companies to comply with the spirit and not just the letter of the Codes,[16] the FRC has beseeched boards to avoid the tick-box approach, saying rather reassuringly that the Code is not a set of rigid rules. Instead it offers flexibility through the application of Principles and through 'comply or explain' Provisions and supporting guidance. This flexibility remains a mainstay of UK Corporate Governance. The FRC encourages companies, in the 2018 Code, to achieve good governance through the application of the spirit of the Principles.[17] As observed by Howard, directors might spend more time ensuring compliance than implementing the spirit and intent of Codes.[18] As seen earlier, a major difference between the 2018 Code and its predecessors is its size. Its sharper nature should make it easier for companies to focus on complying with the spirit of the Code, an approach long advocated by Cadbury. This is as opposed to its predecessors whose bloated contents consisting of main principles, supporting principles, provisions, etc. made it easier for companies to adopt a tick-box approach thereby focusing on implementing the letter rather than the spirit of the Code and giving precedence to form rather than substance.

Boards, in the main, did not heed the FRC's request to avoid a tick-box approach with the result that box-ticking became a common corporate practice. The 2018 Code focuses on understanding and applying the principles of good corporate governance rather than a mechanical compliance-led tick-box approach.[19] However, it is not prescriptive about how the principles are to be achieved.[20] The shortened nature of the Codes means that there will be fewer boxes to tick and this reflects the Code's emphasis on principles.[21] The intention is to allow companies to spend more time applying the principles of the Code rather than ticking boxes.

3. Box-Ticking as the Unintended Outcome of Comply or Explain: Compliance with the letter or Spirit of the Code?

[15] Paragraphs 1.3 and

[16] For an examination of the history of the tick-box approach and the reasons why companies tick the box, see Bobby V. Reddy "Thinking Outside the Box – Eliminating the Perniciousness of Box-Ticking in the New Corporate Governance Code" (2019) 82 *MLR* 4, 692-726.

[17] Financial Reporting Council, *The UK Corporate Governance Code*, July 2018. https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf, p. 1.

[18] Alistair Howard, "UK Corporate Governance: To What End Regulatory Framework?" (2006) 29 *West European Politics* 3, 410, 416.

[19] Company Lawyer, 2018 39(6), 183-184.

[20] https://www.airmic.com/news/guest-stories/2018-uk-corporate-governance-Code-emphasises-diversity-and-culture-and-reasserts-importance-risk

[21] Reddy, p. 704.

As stated in its introduction, the Code offers flexibility through comply and explain and through the application of principles, provisions and supporting guidance, but with no prescriptive implementation mechanism. The FRC leaves the application of the spirit of the Principles to companies saying that "it is the responsibility of boards to use this flexibility wisely and of investors and their advisers to assess differing company approaches thoughtfully."[22] The FRC maintains the Cadbury comply or explain approach. It states that the Principles in the 2018 Code could be effectively applied by reporting on its provisions using comply or explain which has been a defining feature of UK Corporate Governance since Cadbury. It cautions companies to avoid the tick-box approach. This approach shows a preference for self-regulation which relies on the stewardship of shareholders and the efficiency of the markets. This is an offshoot of the traditional shareholder-primacy position which dominates UK corporate governance. As shown on the diagram below, by giving companies the flexibility to apply the Principles of the Code, the FRC has moved further away from external regulation thereby entrenching self-regulation, a concept that defines UK corporate governance.

The flexibility offered by the comply or explain approach was intended to allow companies to apply the spirit rather than the letter of the principles by for example, avoiding a tick-box exercise.[23] Instead companies took advantage of this flexibility and chose to comply with the Code through box-ticking for various reasons.[24] But box-ticking would hardly produce the high-quality reporting that the 2018 Code requires for an effective application of the Principles, since it allows companies to comply only with the letter rather than the spirit of the Principle. The concise nature of the 2018 Code and the recommendation that companies should avoid tick-boxing reinforces the principle approach as these will enables companies to apply the principles of the Code rather than rules.

The point here is that we have witnessed nearly three decades of a paradoxical realisation of Cadbury's fears that statutory measures would lead to boards complying with the letter rather than the spirit of the law. Paradoxical because the flexible voluntary approach which Cadbury preferred over statutory measures seems to have ironically produced the unintended consequences of companies complying with the letter (using box-ticking) rather than the spirit of the Code which he feared would be produced by statutory measures. Cadbury believed that best practice could be achieved through a flexible compliance with a voluntary Code than a statutory Code. The Report warned that "statutory measures would impose a minimum standard and there would be a greater risk of boards complying with the letter, rather than with the spirit, of their requirements".[25] But this minimum standard has instead been produced by the flexible nature of comply or

[22] Financial Reporting Council, The UK Corporate Governance Code, July 2018, https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf, p. 1.

[23] Report of the Committee on the Financial Aspects of Corporate Governance https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-(the-Cadbury-Code).pdf.

[24] For reasons why companies tick the box, see Reddy, pages 698-701. The reasons he provides include; the huge volume of governance disclosure which companies have to make, the influence of corporate governance ratings firms, shareholders over-reliance on proxy advisors and corporate governance indices, shareholders equating good corporate governance with adherence to prescribed structural norms, etc

[25] Report of the Committee on the Financial Aspects of Corporate Governance, para. 1.10.

explain which has allowed companies in the main, to choose compliance with the letter of the Code by ticking the box rather than compliance with the spirit of the Code.

It is significant that although the FRC in the 2018 Code maintained the flexible approach in the application of the Principles of the Code, it nevertheless advised companies to avoid a tick box approach and urged boards to apply the spirit of the Principles. This is an obvious recognition of the nearly three decade long corporate practice of box-ticking. And, it is the first time that the Code advises companies to avoid a tick-box approach. Prior to that the phrase "box-ticking approach" had only been used in the 2010 Code, Schedule C, Supporting Principle B and was addressed specifically to institutional shareholders when assessing a company's corporate governance. This replicated the supporting principle in section 2 E.2 of the Combined Code 2008, a reproduction of the same provision in the Combined Code 2006. What the 2018 Code appears to have done apart from expressly advising boards to avoid box-ticking is to streamline the Code by reducing the number of provisions and removing the supporting principles probably in the hope that this will avoid boxing-ticking.

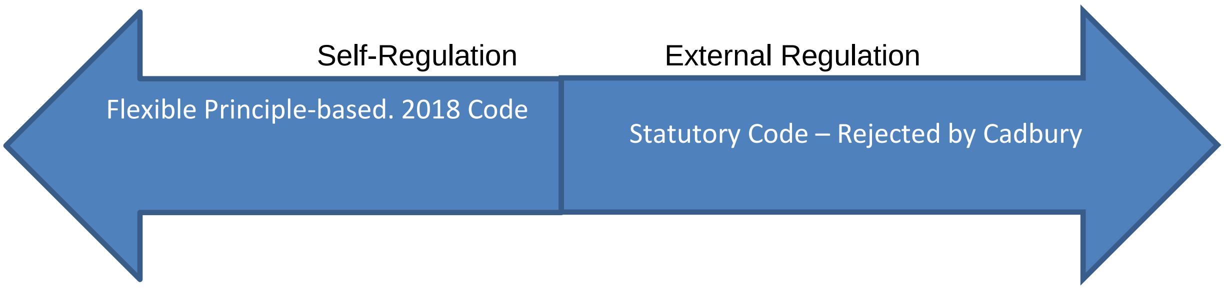
Although the 2018 Code has been given a warm welcome by commentators, with much optimism expressed about its effectiveness, they seem to have overlooked the absence of a compliance mechanism where companies fail to apply the principles of the Code as recommended by the FRC. Although the FRC does provide some assistance in the application of the Principles in a separate publication,[26] it is not prescriptive about how the principles in the 2018 Code are to be achieved. As seen above, the FRC leaves the application of the spirit of the principles of the Code to the company. Reddy notes that by adopting this flexible approach, the FRC allows companies the opportunity to implement their firm-specific corporate governance structures in a way that might not have been possible under the tick-box approach.[27] On the other hand, it has been seen that the approach might also be a recognition that under the tick-box approach companies complied with the letter rather than the spirit of the provisions. They did not fully embrace true corporate governance values. It remains to be seen whether offering companies flexibility in the way it applies the spirit of the Principles will enable the company to fully embrace the provisions of the Code and make it more effective. While the principle-based approach adopted by the FRC in the Code is flexible, this flexibility might be a problem itself as it does not provide for any compliance mechanism. It takes a hands-off approach and leaves it to the goodwill of the company.

It is submitted that a workable system needs some form of external monitoring and enforcement to ensure compliance. Similar views have been expressed by commentators on the subject. Keay analyses the comply or explain approach and considers the feasibility and desirability of establishing a regulatory body with monitoring and enforcement powers to determine if companies are actually complying with the Code.[28] While flexibility is a significant advantage of the comply and explain approach in the Code, this very advantage has ironically made it easier for companies to flout the corporate governance rules in the

[26] The Revised Guidance on Board Effectiveness published by the FRC in July 2018 to replace a previous version of 2011. The Guidance includes questions designed to assist boards in applying the 2018 Code.
[27] Bobby V. Reddy "Thinking Outside the Box – Eliminating the Perniciousness of Box-Ticking in the New Corporate Governance Code" (2019) 82 *MLR* 4, 692-726, at 692.
[28] Andrew Keay, "Comply or explain in corporate governance Codes: in need of greater regulatory oversight?" [2014] 34 *Legal Studies,* Issue 2, 279, 294.

absence of monitoring. In a recently published paper, Reddy lucidly argues that contrary to Cadbury's noble intentions, comply or explain led companies to treat the corporate governance codes as hard and fast rules and simply ticking the box with limited or selective compliance and avoid providing an explanation to shareholders.[29]

A Regulatory Spectrum of the Corporate Governance Codes



4. The Effectiveness of the Principle-Based System: What Compliance?

The idea behind corporate governance reform is to make corporate governance more effective. And, while these reforms cannot prevent corporate collapse in all cases, it cannot be denied that an effective corporate governance system will have an impact on the number of corporate failures. It is worth recalling, at this point, that the Cadbury Report, which pioneered the corporate governance code in the UK, came against the background of unexpected corporate failures. In an apparent recognition of the effect that an effective Code can have on corporate success, it stated that "had a Code such as ours been in existence in the past, we believe that a number of the recent examples of unexpected company failures and cases of fraud would have received attention earlier."[30] A question that arises in determining the effectiveness of the principle-based system in the 2018 Code is what is the difference between the tick-box rule-based approach which dominated corporate practice and the principle-based system espoused in the 2018 Code? The difference is significant in determining the effectiveness of the Code, particularly in terms of its implementation. Underneath virtually every law or rule is a fundamental principle that drives it and determines its objective. In other words, a law or a rule can be seen in this context as an instrument for achieving a particular principle – for example, a moral principle. It is one way of enforcing a principle. For example, the law not to drink above the legal limit and drive is driven by the principle of road safety. And, in order for the law to be effective, we have to comply with the spirit and not just the letter of the law enforcing the principle.

By analogy, if Rash drinks below the legal limit and drives, he is complying with the letter but not necessarily the spirit of the law - he is not necessarily embracing the principle. In order to fully embrace the road-safety principle behind the law, he would probably have to be teetotal when driving. Law sets a minimum standard of behaviour.

[29] Bobby V. Reddy, "Thinking Outside the Box – Eliminating the Perniciousness of Box-Ticking in the New Corporate Governance Code" (2019) 82 *MLR* 4, pages 694-5.

[30] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-(the-Cadbury-Code).pdf, para. 1.9

And, it was the fear of compliance with this bare minimum standard and nothing more that led Cadbury to reject a statutory Code for corporate governance preferring compliance with a voluntary code.[31] But the flexibility in the implementation of the Code has ironically resulted in companies complying with this bare minimum in the form of box-ticking. More than a quarter of a century of voluntary compliance has been in the form of rule-based box-ticking with companies applying the letter rather than the spirit of the Principles – a situation which Cadbury was keen to avoid. It is questionable whether box-ticking really embraces the principle behind the Code. Drink-driving is just one of many causes of road accidents and the drink-driving law is just one of many laws used to enforce the road-safety principle to keep the roads safe in the example above. If the government was to replace traffic laws with a flexible, sanction-free, principle-based system which relies on the benevolence of road users to keep our roads safe, the road safety principle would be seriously compromised and our roads would be chaotic death-traps as not every road user could be trusted to voluntarily uphold the underlying road safety principle. Yet, this seems to be the implication of the principle-based system embedded in the Code.

It is interesting to note that despite its flexibility and voluntary nature, listed companies are known to comply with the provisions of the Code. Indeed, Reddy informs us that since 2011 a majority of FTSE-350 companies have complied with all the provisions of the Code, and a significant majority have complied with all but one or two provisions of the Code[32]. However, it is also the case that many of the companies that went into liquidation had published reports claiming that they were complying with the provisions of the corporate governance Code, but this was later found not to be so. The question that arises is what is compliance? What were companies required to comply with when they took a tick-box rule-based approach? Were companies required to comply with the rule or with the principle behind the rule? In other words, were they required to comply with the letter or the spirit of the Code? This question can be easily dismissed with the observation that what is required is compliance with the principle since the Code takes a principle-based approach and clearly states that it is not a rigid set of rules. But how does the rule-based box-ticking practice meet this principle-led objective?

To progress the argument and determine what the companies were required to comply with, it is submitted that compliance here may have two meanings – a surface meaning where the company merely complies with the letter of the rule and a deeper meaning where it complies with the spirit of the rule as well. When a company reports that it has complied with the Code, which of the above meanings is it referring to? Compliance that is determined by a tick-box exercise in a voluntary code leaves much to be desired where companies face insolvency shortly after publishing good accounting reports. And, in the light of the foregoing discuss, it is only right to reiterate the question relating to the type of compliance in these cases. Was it a surface compliance where the companies merely followed the letter of the Code by, for instance, making sure that the position of chairman and CEO is not occupied by the same person (and ticked the box confirming it) although one controls the other or was the compliance deep with the company embracing the

[31] Report of the Committee on the Financial Aspects of Corporate Governance, 1 December 1992, https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-(the-Cadbury-Code).pdf, para. 1.10.

[32] Reddy, p. 692, 693.

underlying principle of the Code and ensuring that power was not concentrated in the hands of a single individual?

And, although companies are said to have complied with the provisions of the Code, it may be the case that it is the former (box-ticking) type of compliance inadvertently referred to in these cases, which is why in a significant number of cases, companies that had reportedly been complying with corporate governance rules are found to have fallen fowl of the same rules when they faced liquidation. The compliance was only on the surface and never deep. And, this type of compliance allowed the company to tick the box. Underneath, there were issues of non-compliance simmering which only emerged on the surface when the companies faced liquidation. It may be the case that an avoidance of box-ticking would lead to deep compliance. Splitting the role of the chairman and CEO in the above example would not suffice. Both must be independent of each other to ensure that power is not concentrated in the hands of one person.

Reddy[33] gives the example of a company that ticks the box indicating that it has separated the role of chairman from that of the chief executive officer (CEO) as recommended by Cadbury in apparent fulfilment of the principle that no single individual should have absolute powers of decision-making.[34] The company ticks the box because these two positions are actually no longer occupied by the same person in the company. Admittedly, there is some compliance so far. However, the chief executive officer is the dominant figure on the board and the chairman, who is a mere figurehead, acts as directed by him. Is the company correct in ticking the box saying that it has complied with the provisions of the Code regarding the separation of the role of the chairman and the CEO? The company has applied the letter but not the spirit of the Code. In other words, it has applied the rule that the role of the chairman and the CEO should be separate, but it has not embraced the principle behind the rule which is that power should not be concentrated in the hands of one person. As observed by Reddy, ticking the box, in this example, has not served the underlying purpose of the principle of separation of power.[35] The company may have complied with the provisions of the Code on the surface, but underneath the surface there are issues of non-compliance surfacing. And, in many cases, these usually surface when the company faces insolvency. Prior to that, the company had apparently been complying with the Code in the public eye. The contention, therefore, is the lack of a monitoring mechanism to ensure deep compliance with the Principle. The problem, however, is that compliance can only be effective where there is a robust system of monitoring or enforcement in place. The FRC consistently rejected any form of monitoring or enforcement and as seen later, the body's overall approach to its role made it seem powerless and this contributed to its replacement with a new body. Nearly three decades of box-ticking has shown that voluntary codes do not guarantee compliance with the spirit of their requirements.

5. A Sanction-Free Shareholder Primacy Corporate Governance System

[33] Reddy, op cit, p. 703.

[34] https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-(the-Cadbury-Code).pdf#page=1&zoom=auto,-71,850; para. 4.9.

[35] Reddy, p. 703

We return to the argument made earlier in this paper, although we never really departed from it. Although the emphasis placed on the principle-based approach by the FRC in the 2018 Code, as evidenced in its shortened nature, is generally seen as an improvement on its predecessors, its effectiveness is somewhat vitiated by the absence of an enforcement or compliance mechanism. By expressly placing the responsibility to apply the Principles and Provisions of the Code on the board and investors without any monitoring mechanism[36], the FRC is upholding the traditional sanction-free, shareholder primacy position which defines UK corporate governance. In its 2016 Report "Corporate Culture and the Role of Boards", the FRC took the view that "the UK governance model remains an efficient and effective means of meeting the objectives of, and arbitrating between, the many stakeholders in the market."[37] In the foreword to the Report, the Chairman recognised the importance of rules and sanctions, but noted that they will not "on their own deliver productive behaviour over the long-term."[38]

There is no regulatory body to check compliance with the Code or the adequacy of explanations for non-compliance, as UK corporate governance is traditionally averse to the idea of external regulation in the form of hard law. This develops from the Cadbury Report which expressly rejected statutory Code to enforce corporate governance rules. As mentioned earlier, this rejection by Cadbury was itself an expression of the traditional UK corporate governance preference for self-regulation or soft law at best. The position adopted by Cadbury and subsequent codes underlies the fact that UK corporate governance relies on the stewardship of shareholders and efficiency of the market.

In fact, the FRC has rejected attempts to move away from this traditional position many a time. Earlier in the decade, the FRC rejected an EC Green Paper proposal[39] for monitoring bodies such as securities regulators, stock exchanges or other authorities to be empowered to check statements and apply sanctions for non-compliance.[40] The FRC took the view that it was for shareholders to check the accuracy of statements or ultimately decide whether to dismiss the board. The FRC expressed its preference for self-regulation and was concerned that monitoring would amount to an usurpation of shareholders' rights to assess explanation which is essential to the comply or explain concept.[41] However, there are criticisms to the view that shareholders should check the accuracy of statements. A common argument is shareholder apathy, especially when the company is performing well and the fact that shareholders lack the technical knowledge to assess statements. Furthermore, as argued by Keay, shareholders monitoring is unregulated.[42] On the whole, the FRC has been resistant to change. This dogged resistance to change by the FRC was to contribute to its own undoing, as it was announced in March 2019 that the body would

[36] FRC, The UK Corporate Governance Code 2018, https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf, p. 1

[37] FRC, Corporate Culture and the Role of Boards: Report of Observations; https://www.frc.org.uk/getattachment/d246eacb-5774-4912-98e1-c03f1c8f692f/Corporate-Culture-and-the-Role-of-Boards-Report-of-Observations-tagged.pdf, p. 5.

[38] https://www.frc.org.uk/getattachment/d246eacb-5774-4912-98e1-c03f1c8f692f/Corporate-Culture-and-the-Role-of-Boards-Report-of-Observations-tagged.pdf, p. 2.

[39] Green Paper: The EU Corporate Governance Framework (COM2011) 164, Para 3.2; https://ec.europa.eu/transparency/regdoc/rep/1/2011/EN/1-2011-164-EN-F1-1.Pdf

[40] Andrew Keay, "Comply or explain in corporate governance Codes: in need of greater regulatory oversight?" [2014] 34 *Legal Studies,* Issue 2, pp 279-304, p. 296.

[41] Ibid, p. 297.

[42] Keay, op cit. p. 294.

be replaced with a new regulator, the Audit, Reporting and Governance Authority (ARGA). Interestingly, a major reason given for its replacement was the finding by Kingman that the FRC takes "an excessively consensual approach to its work."[43]

6. A New Regulator

The announcement of the creation of the new body, ARGA, was made following the publication of a review of the FRC (The Kingman Review) in December 2018.[44] The Review was commissioned by the Business Secretary after questions were raised about the role of the FRC following the collapse of BHS and Carillion.[45] The 76 page Report, which contains 83 Recommendations, identifies a number of weaknesses with the FRC in different areas including its status, its power, its source of funding and its staffing. The Review found that the FRC was deficient in its powers and failed to make the case for change or to make it persuasively. Furthermore, the Review felt that the fact that the FRC operates under the direction of the government, since 2016 requiring it to rely on delegation to industry bodies compromises its independence. In terms of its status, the Review noted that the FRC might have felt constrained by the name 'Council' (instead of 'Regulator' or 'Authority') from taking a more robust approach towards regulation.[46] A further problem is that the FRC lacks a clear statutory base provided by Parliament.[47] In this regard, it is possible that the body adopted a corporatist and self-regulatory mind-set because of the title 'Council'. This might explain the reluctance of the FRC to take a robust approach with regards to compliance with the Code as seen above.

In view of the weaknesses of the FRC, Kingman recommended that it should be replaced with a new body as soon as possible. It recommended, inter alia, that the new body should be independent, be accountable to Parliament and have stronger statutory powers, including the power to issue a public report if appropriate. The body will also have the power to impose a range of sanctions and to investigate directors and refer cases to the Insolvency Service. Its proposed functions will include; to set and apply high corporate governance, reporting and audit standards, and to report annually on the Code. It advocated a fundamental shift in approach regarding the revised UK Stewardship Code, currently overseen by the FRC, recommending that it should focus on outcomes and effectiveness and not on policy statements. It added that if this cannot be achieved, serious consideration should be given to its abolition.[48] The Review was welcomed by stakeholders.

[43] Independent Review of the Financial Reporting Council, December 2018; https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf, p. 8.

[44] Independent Review of the Financial Reporting Council, December 2018; https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf.

[45] Government Backs Kingman Call to Replace FRC: https://economia.icaew.com/news/march-2019/government-backs-kingman-call-to-replace-frc.

[46] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf. Ibid, p. 6.

[47] Ibid, p. 19.

[48] Ibid, pages 10 and 46.

Kingman's recommendation that the new body should have the power to enforce sanctions and report annually to Parliament on its enforcement performance[49] is a significant step away from the consensual approach adopted by the FRC. Enforcement is an underlying pervasive theme of the Review. It aligns with the principle-based model of the 2018 Code, particularly given that the focus will be on outcomes and effectiveness, rather than on policy statements. But the question that arises is whether this change in approach and the replacement of the FRC with the ARGA in general signals a general change in attitude in UK corporate governance. A note of caution is warranted.

Conclusion

A major theme of this paper is the need for an enforcement mechanism to ensure compliance with the principle-based model of the 2018 Code and corporate governance in general. The ARGA appears to provide something close to that since it will have statutory powers to impose sanctions. To that extent, it is a welcome development. Evidently, the call for a tougher regulator and the proposed replacement of the FRC with ARGA giving it powers to enforce sanctions is a sign that the mood, at least, in certain areas of UK corporate governance is shifting towards tougher regulation with a sanction-based regime as a result of corporate failure. But it would be unrealistic to interpret these developments as an overall change of attitude or direction in the fundamentally shareholder-centric UK corporate governance system. If anything, it only reinforces the shareholder-centric system. It stands to reason that a sanction-based system under ARGA will ultimately protect the shareholder interest more effectively than the sanction-free system under the FRC. It appears that the ultimate aim of corporate governance rules in a shareholder-centric system like the UK is to protect shareholders. Therefore, an effective corporate governance system equates to the effective protection of shareholder interest in UK corporate governance.

It is worth noting that the recommendation that ARGA should have the power to enforce sanctions adds an interesting twist to the corporate governance discourse in the light of the Brexit debate in the UK. As seen above, the FRC rejected a European Commission proposal in 2011 for monitoring bodies to check statements under the 'comply or explain' approach and apply sanctions for non-compliance.[50] In making the proposal for the monitoring of corporate governance statements, the EC recognised that in most member states responsibility for enforcing the obligation to publish is left to investors. Although the EU was referring to the publication of statements, it is interesting that this is the same position that the FRC took when it rejected the EC's proposal for a monitoring body to be empowered to check statements and apply sanctions, saying that it was for shareholders to check statements and sanction directors by removing them from office if they are not happy with their performance. This means that UK law in this area was similar to the law of most member states and the EC was proposing to move the domestic law of member states including the UK in a different direction. Ironically, the creation of ARGA with a strong mandate and power to enforce sanctions will have the effect of moving UK

[49] p. 10.

[50] https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0164:FIN:EN:PDF, op cit para 3.2.

corporate governance in this area closer to the EC proposal yet further away from the laws of most member states at a time when the UK is leaving the EU.