



FINANCIAL REPORTING COUNCIL

**REVIEW OF THE IMPACT OF THE
COMBINED CODE**

APRIL 2007

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Introduction

The FRC is seeking views from listed companies, directors, investors and other interested parties on their experience of implementing the Combined Code. Comments are requested by 20 July 2007.

The main purpose of this review is to consider whether the Combined Code is appropriately enabling UK listed companies to be led in a way which facilitates entrepreneurial success and the management of risk (Strategic Outcome 1 in the FRC's Regulatory Strategy). The FRC will undertake an analysis of available data on the impact of the Code as well as seeking views on its effectiveness.

While views on the contents of the Code are welcome, there should be no presumption that the review will lead to revisions being made. No additions or deletions will be proposed unless there is clear justification, for example in order to eliminate duplication or inconsistency between the Code and any DTI regulations or FSA Rules introduced to implement the new EU requirements on corporate governance which will come into effect in 2008.

The FRC will publish its findings before the end of 2007. If any changes are proposed there will be a separate consultation supported by a Regulatory Impact Assessment; if any changes were to be agreed as a result, the expectation is that they would take effect from 1 November 2008.

Background

The Financial Reporting Council carried out a review of the implementation of the 2003 Combined Code during 2005¹. The review found that overall the Code was bedding down well and having a positive impact, contributing to improvements in corporate governance practice and disclosure and greater engagement between boards and shareholders. There was no need or demand for significant changes to be made to the Code, although two changes were proposed: to allow the chairman of the company to sit on the remuneration committee, and to provide a 'vote withheld' option on proxy appointment forms to enable shareholders to indicate if they had reservations on a resolution but did not wish to vote against. Following further

¹ The report summarising the main findings of the 2005 review can be found at: <http://www.frc.org.uk/corporate/reviews.cfm>. The 2006 edition of the Combined Code is at <http://www.frc.org.uk/corporate/combinedcode.cfm>.

consultation these changes came into effect for reporting periods beginning on or after 1 November 2006.

The 2005 report also identified a number of issues that were to be kept under review to ensure that the Code was not having an adverse effect. These included the use that was being made of the 'comply or explain' mechanism, the compliance burden (in particular for smaller listed companies), and the availability of non-executive directors.

During 2006/07 the FRC held a series of meetings with company chairmen and senior investors to hear their views on the impact of the Combined Code and the effectiveness of the UK's corporate governance framework. The feedback from these meetings was broadly consistent with the findings of the 2005 review. The Code was considered to be working reasonably well but concerns were raised about the tendency towards 'box-ticking' and the potential compliance costs for smaller listed companies.

Separately, there are new requirements on listed companies coming out of Europe. The DTI is currently consulting on implementation of the 4th and 8th Company Law Directives, which introduce mandatory requirements for corporate governance statements and audit committees respectively². These will take effect from April 2008, and they overlap with some of the Code requirements.

Against this background the FRC is seeking views on the impact and effectiveness of the Code. As noted above, there is no presumption that the review will lead to the Code being revised. No changes will be proposed unless there is clear justification, and if any changes are proposed they will be the subject of a separate consultation.

Issues for comment

Comments are welcome on any aspect of the Combined Code, but the FRC would particularly welcome views and evidence on the following issues.

1. Does the Code support better board performance over time?

The Code's primary principle is that every company should be headed by an effective board, which is collectively responsible for the success of the company. This necessitates priority emphasis on strategy, performance and Board cohesiveness.

² The DTI's consultation runs until 1 June and the consultation documents can be found at: <http://www.dti.gov.uk/bbf/eu-company-law/directives/page19528.html>

Feedback from company Chairs suggests that the Code has contributed to boards becoming more professional, but that strong and good leadership by the Chair, working with the CEO, is necessary to overcome two challenges. The first is to make the monitoring role of the non-executives effective but compatible with the Board's cohesiveness. The second is not to let the Board's real priorities become subordinated by too much attention and time being given to following the letter rather than the spirit of the Code. The majority of Chairs considered that these challenges were being overcome.

2. Is the "comply or explain" approach working effectively?

The "comply or explain" mechanism is a cornerstone of the Code's flexibility.

Feedback indicates that while both companies and investors consider that the Code has contributed to more constructive engagement, there are aspects of "non-compliance" which can frustrate the mechanism working properly. Companies do not want to invite adverse publicity or adverse votes arising from a "box-ticking" approach to the Code by investors or those who advise them; and they may be deterred by the time required to "explain". For their part investors, who may hold equity in many hundreds of companies in the UK and overseas, may simply consider themselves unable to deal adequately with all explanations in detail. They may also consider that some companies do not adequately explain their reasons when not applying the Code.

The FRC wants to assess how serious the above frustrations are and, if their effects are material, to consider how best to mitigate them.

3. What impact has the Code had on smaller companies?

The size range of the quoted companies to which the Code applies is huge. The FRC recognizes that the potential compliance costs are proportionately higher for smaller companies, particularly bearing in mind the possible frustrations of "comply or explain" referred to above. If these are considered to outweigh the benefits associated with the Code, there may be an argument on regulatory impact grounds for some modification to what is required from smaller companies. On the whole, the 2006 consultations with the Chairs of smaller companies were not compelling on the point, but the sample was small and continuing open-mindedness on the FRC's part is appropriate.

4. Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies? If not, in what respects and how do you believe they should be modified?

How to comment

Comments should be sent by 20 July 2007:

by e-mail to codereview@frc.org.uk

or by post to:

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Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
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Unless otherwise stated, responses will be regarded as being on the public record. Respondents should indicate specifically whether their responses should be treated as confidential (standard disclaimers in responses received by e-mail will be disregarded for this purpose).