



FINANCIAL REPORTING COUNCIL

**2007 REVIEW OF THE COMBINED CODE:
REPORT ON THE MAIN FINDINGS OF THE REVIEW**

NOVEMBER 2007

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EXECUTIVE SUMMARY

The Combined Code continues to have a broadly beneficial impact, and is seen as having contributed to higher overall standards of governance among UK listed companies and to more professional boards. Preoccupation with following the Code should not, and in general does not, undermine the board's ability to provide entrepreneurial leadership, although it will be necessary to keep under review the impact of the Code and regulation more generally on how boards spend their time and on the supply of potential non-executive directors.

While there are many positive indicators to suggest that the 'comply or explain' approach is working fairly well, such as the increase in resources devoted to engagement by institutional investors, there is also a good deal of frustration with its day-to-day operation. In particular, investors are concerned by what they consider to be the poor quality explanations provided by some companies, while companies consider some investors and voting advisory services to be guilty of 'box-ticking' and failing to give sufficient weight to explanations. This view was held most strongly by smaller listed companies who perceive themselves to be of lower priority to investors.

While it appears that there is currently a critical mass of institutional investors who devote the necessary time and resource to constructive engagement needed to make 'comply or explain' work, it will be necessary to keep the health of the engagement process under review in the light of changes in ownership patterns and increased outsourcing of voting and engagement activities. Action may also be needed to address structural barriers to constructive engagement.

There is little support for widespread derogations from the full Code to apply to smaller companies.

There has been a gradual but discernible improvement in the overall quality of disclosure, although the general perception among investors and other observers is that there remains scope for considerable further improvement. Better communication will be an important element in improving the effectiveness of 'comply or explain'.

In light of these views it is considered that the FRC should focus its efforts on improving the practical application of the Code as this will be of greater benefit than a major overhaul of the content of the Code, which enjoys broad support. Only two amendments to the Code are proposed; these will be the subject of further consultation.

THE REVIEW PROCESS

1. The FRC held a series of meetings with company chairmen and institutional investors during 2006 and the first quarter of 2007. The views expressed at these meetings helped to determine the scope of the review.
2. A public consultation exercise was held between April and July 2007. Copies were sent to the chairmen of UK listed companies and to over 40 institutional investors, as well as being made available through the FRC website. Views were invited on any aspect of the implementation of the Code, but in particular on the following questions:
 - Does the Code support better board performance over time?
 - Is the 'comply or explain' approach working effectively?
 - What impact has the Code had on smaller companies?
 - Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?
3. In total 107 responses were received, including 56 from listed companies and 19 from institutional investors and their representative bodies. A document summarising the main issues raised by respondents can be downloaded from <http://www.frc.org.uk/corporate/2007review.cfm>, from where copies of individual responses are also available.
4. In addition to the public consultation the FRC analysed research and data on the implementation and impact of the Combined Code published during 2007 and commissioned additional research, including data analysing compliance with selected Code provisions among a sample of 465 companies outside the FTSE 350. The FRC also studied a selection of corporate governance statements in annual reports, and held meetings with representative bodies.

THE IMPACT AND IMPLEMENTATION OF THE CODE

Does the Code support better board performance over time?

5. While acknowledging that it is difficult to demonstrate conclusively that following the principles of the Combined Code will lead to improvements in board and company performance, the majority of respondents to the consultation considered that the Code, supported by constructive engagement between boards and shareholders, has had a broadly beneficial impact. Investors perceive that there have been continued improvements in the overall governance standards of UK companies; 79% of pension funds surveyed by the NAPF considered that standards continued to improve, while none felt they had deteriorated¹.
6. In the opinion of the Institute of Directors, “the Code has helped to provide a basis for the growing recognition of the need for a professional and systematic approach to performance and governance, and if correctly applied by companies and interpreted by investors the Code provides an appropriate balance between the corporate performance and compliance aspects of the directors’ role”. The Association of British Insurers shared this view, commenting that “the operation of the Code has been a powerful spur to increased professionalism of Boards and to ensuring that the unitary board system works well in a practical way that is consistent with its objectives”.
7. A number of respondents singled out the Code’s recommendation that boards should carry out regular evaluation of their performance as having been particularly beneficial. This view was endorsed by the chairmen of FTSE 350 companies surveyed by Independent Audit, of whom over 90% had found the exercise to be useful².
8. One of the reasons for undertaking regular reviews of the Combined Code is to ensure that it is not having any unintended negative effects; for example, that the time needed by the board to deal with the Code and other governance matters is not hampering the board’s ability to address adequately the strategic matters that should be its primary focus. While some respondents to the consultation felt this to be the case, it was a view held by only a small minority.
9. This is consistent with the findings of the Independent Audit survey, which found that only four percent of chairmen felt that the board was not able to devote enough time to strategic issues and leadership. However the fact that 69% of chairmen considered that “strategic issues do get crowded from time to time” indicates that it will be necessary to guard against regulatory growth that might

¹ *Pension Funds’ Engagement with Companies*; National Association of Pension Funds; August 2007

² *Four years on – what’s changed? A survey of governance practice in the FTSE 350*; Independent Audit Ltd; September 2007

tilt the balance and undermine the board's ability to provide entrepreneurial leadership.

10. A small number of other perceived negative effects were raised by respondents which, while there is no evidence that there is immediate cause for concern, will need to continue to be monitored. They include:

- The supply of suitably qualified individuals willing to serve on the boards of publicly listed companies. There are concerns that an increase in the regulatory requirements placed on directors and their exposure to liability and reputational risk, together with the competing attractions of private equity, make it more difficult for listed companies to recruit board members. At the FRC's meetings with company chairmen held in 2006, the majority reported that it was still possible to find sufficient good quality candidates, although some believed it was likely to become more difficult in future. Deloitte surveyed listed companies on this issue and found that 40% of respondents from FTSE 350 companies considered it had become more difficult to recruit non-executive directors, compared to less than 20% of smaller listed companies³. The survey found some evidence that companies were looking beyond traditional sources when recruiting new directors.
- Related to this, however, there was a specific concern that the increased responsibilities and workload of the audit committee made it more difficult to recruit suitable members, and in particular finance directors of other listed companies. The Independent Audit survey found that 30% of FTSE 350 companies were finding it difficult to recruit new audit committee members.
- Concerns that some companies have chosen to comply with the Code's recommendation that at least 50% of the board should be independent non-executive directors by reducing the number of executive directors. If there were to be a significant fall in the average number of executive directors on boards this would be a cause for concern; the Code recommends that there should be a "strong presence on the board of both executive and non-executive directors" (Principle A.3). Research by Deloitte found that there has been some decline in the number of executive directors on the boards of FTSE 350 companies in recent years; however, the same research found that there is still an average of four executive directors on those boards⁴.

³ *At The Helm: 2007 survey of board structure and non-executive directors*; Deloitte; May 2007

⁴ *Board Structure and Non-Executive Fees*; Deloitte; September 2007

Is the 'comply or explain' approach working effectively?

11. On the face of it, evidence suggests that the 'comply or explain' approach is working fairly well. As noted in paragraph 5, investors consider that overall standards of corporate governance have improved and continue to do so. The evidence from Grant Thornton's annual report on FTSE 350 companies shows that the rate of compliance with most Code provisions is high and getting higher⁵, and available information on compliance amongst smaller listed companies shows similarly positive trends. On the investors' side, recent surveys by the NAPF and the Investment Management Association (IMA) show that resources dedicated to engagement with investee companies have increased⁶.
12. Despite these many positive indicators, responses to the public consultation revealed a fair amount of frustration at the way in which 'comply or explain' is felt to work in practice. Many aspects of the process were commented on. For example, the pressure placed on boards by their own advisers to "play safe" and comply, and the perception among some companies that there was a shortage of suitably qualified people in institutional investors' corporate governance teams, and that these teams were not always appropriately engaged with the fund managers. But two issues were most prominent: investors were concerned by what they considered to be the poor quality explanations provided by some companies (this is discussed in more detail in the section on disclosure which begins at paragraph 24); while companies complained about what they perceived to be the 'box-ticking' approach taken by some investors and voting advisory services.
13. It is difficult to state with any accuracy to what extent the charge of 'box-ticking' is justified. There will be cases where investors or their advisers will have given insufficient consideration to the company's explanation, or will be reluctant to agree to a different approach in case it is seen as setting a precedent; but there will also be cases where the company has failed adequately to explain its reasons for deviating from the Code, or where there is simply a legitimate difference of opinion between the board and the shareholders about what the appropriate governance arrangements should be. It is only to be expected that boards and shareholders will not always agree on the right approach, but even in those instances clear and timely communication by both parties can help to reduce the frustration.

⁵ *Fifth FTSE 350 Corporate Governance Review 2006*; Grant Thornton; December 2006

⁶ *Pension Funds' Engagement with Companies*; NAPF; August 2007 and *Survey of Fund Managers' Engagement with Companies for the year ended 30 June 2006*; Investment Management Association; August 2007

‘Comply or explain’ case study: Long-serving independent directors

One test of whether ‘comply or explain’ is working effectively is to look at how shareholders vote when presented with a situation where the company has chosen to explain. This can most easily be done by looking at voting patterns in relation to the election or re-election of the chairman or other directors.

Provision A.3.1 of the Combined Code lists a series of circumstances in which there might be a debate about whether the individual could be considered to be independent, but goes on to say that the board can still classify them as independent notwithstanding these circumstances. However, if they choose to do so they must explain to shareholders why they believe this to be the case. One of the criteria that has provoked most controversy relates to length of tenure: the so-called “nine year rule”. As well as requiring companies to provide an explanation if they classify as independent a director who has served ten years or more, the Code also recommends that these directors be put up for re-election annually.

Research published by Deloitte found that, while there had been some decline in the overall number of long-serving directors, it was not significant and that in 2007 nine to 11% of all independent non-executive directors of FTSE 350 companies had served more than nine years.

The FRC commissioned Manifest to analyse a sample of 3,500 election and re-election resolutions in the calendar years 2004 to 2006 to see if there was any significant difference in voting patterns where directors had served more than nine years. The sample covered all sizes of listed company. The findings are summarised in this table:

| % votes against | 2004 | 2005 | 2006 |
|------------------------|-------------|-------------|-------------|
| All resolutions | 2.95% | 2.47% | 2.69% |
| Tenure under 9 years | 1.83% | 1.57% | 1.61% |
| Tenure over 9 years | 6.60% | 4.83% | 5.26% |

Note: these figures show votes against as a percentage of total votes cast. Abstentions or votes withheld are not included.

The figures show that long-serving directors received on average between 93% and 95% support from shareholders who cast votes. This was between 3% and 5% lower than for directors who had served nine years or less, but is still a very high level of support. It appears to suggest that, while length of tenure may have an influence on the voting behaviour of a small number of shareholders, in general they are willing to support the board where an explanation has been provided.

14. The FRC recognises the need to keep a close watch on the health and prevalence of the engagement process. For 'comply or explain' to work effectively there needs to be a critical mass of institutional investors who are willing to take their ownership responsibilities seriously and devote the necessary time and resource to constructive engagement with companies. Available evidence such as the NAPF and IMA surveys and the increase in voting levels in recent years suggests that this currently exists, and initiatives such as the Institutional Shareholders Committee's voluntary framework for voting disclosure published in June 2007 are encouraging for the future. But it cannot be assumed that it will always be the case.
15. There have been significant changes in share ownership in the London market since the concept of 'comply or explain' was first advocated by the Cadbury Committee in 1992. For example, the combined market share of UK pension funds and insurance companies – who have traditionally been at the forefront of engagement with listed companies – has fallen from 52% in 1992 to 27% in 2006 as they have diversified their portfolios into other markets and other forms of investment. Overseas investors, for many of whom it will understandably be more difficult to engage directly with the boards of UK companies and who may be unfamiliar with 'comply or explain', now own 40% of total equity, compared with only 13% in 1992⁷. While there is no suggestion that these and other changes in ownership patterns will necessarily lead to a decline in the level of engagement, they may affect the dynamics of the relationship between companies and investors.
16. In parallel with changes in ownership, there has been an increased trend for institutional investors to outsource their voting and/or engagement activities. Voting advisory services came in for particular criticism from listed companies which responded to the consultation. The FRC intends to hold further discussions with the sector to see whether there are steps that might be taken to increase the understanding and transparency of their activities in order to address the perception of 'box-ticking'.
17. The review has also highlighted some features of the AGM and related voting processes that can significantly constrain the ability of investors and their advisors to give proper consideration to the company's corporate governance arrangements. While these do not fall within the FRC's direct remit, they are of direct relevance to the success of 'comply or explain'.

⁷ *Share Ownership: A report on ownership of UK shares as at 31 December 2006*; Office for National Statistics; 2007

18. One such feature is the bunching of annual general meetings. As most companies' financial years end either in December or March, the majority of AGMs are concentrated into a very short period. Data produced by Manifest, the voting services agency, shows that during a five week period in April-May 2007 they had to advise clients on over 300 AGMs in the UK alone (the figures are even higher when companies in other markets are included as well)⁸. Investors and voting service agencies have finite resources, and at peak periods such as this it is not realistic to expect them to be able to give each company's governance arrangements the level of consideration that companies understandably believe they deserve. If companies believe there are any aspects of their proposed arrangements that might give shareholders cause for concern, it would be desirable for them to initiate communications at the earliest possible stage rather than wait until the run-up to the AGM before doing so.
19. The situation is exacerbated by the deadlines for processing proxy voting instructions imposed by voting agents and custodians. This issue was highlighted by Paul Myners in his most recent report to the Shareholder Voting Working Group, in which he notes that fund managers are often required to submit their voting instructions at least ten working days or two weeks before the meeting. As he explains, "as the Companies Act 2006 requires public companies to give their members 21 days or three weeks notice of an annual general meeting... this can mean that managers have only one week to decide how to vote. This can result in managers having to vote before the voting agencies have issued their voting recommendations"⁹. It also means that, in cases where companies are willing to make changes in order to address shareholder concerns, it may be too late to affect the outcome of the vote.
20. Paul Myners made a number of recommendations addressing this issue in his report. The FRC will provide support as appropriate to ensure they are acted upon.

⁸ *Proxy Voting 2007: A Pan-European Perspective*; Manifest; November 2007

⁹ *Review of the impediments to voting UK shares: Report by Paul Myners to the Shareholder Voting Working Group – an update on progress three years on*; July 2007

What impact has the Code had on smaller companies?

21. For the purposes of the Combined Code, “smaller listed companies” are defined as being companies listed on the Main Market that are outside the FTSE 350. AIM companies are not included as they are not subject to the Listing Rules requirement to report against the Code. The FRC held a series of meetings with chairmen of smaller listed companies in the last quarter of 2006, and a number of them responded to the public consultation in 2007.
22. As noted in paragraph 11, available evidence suggests that rates of compliance with the Code among smaller listed companies continue to rise and for some important provisions are already high; for example, it appears that over 90% of companies now have at least two independent non-executive directors (in addition to the company chairman) as recommended in the Code. Many respondents to the consultation - including some smaller listed companies - perceived that adherence to the Code was helpful early tuition for growing companies and one which could also inspire greater confidence on the part of investors, and that its impact had therefore been broadly beneficial. For these reasons, and because the principles of the Code are considered to be equally applicable to companies of all sizes, there was little support among respondents for widespread derogations for smaller companies.
23. However, it is the case that the costs of complying with the Code, as with regulation, are proportionately greater for smaller listed companies. It was also clear from the meetings and responses that these companies perceive themselves to be of lower priority to investors, with the result that they feel the frustrations referred to in the previous section more acutely than larger companies. Prompted by the review, the Quoted Companies Alliance - the organisation that represents the interests of smaller quoted companies - and the Association of British Insurers have started an initiative to improve dialogue between investors and smaller listed companies. This is a very welcome development, and the FRC would encourage further contacts of this nature.

Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?

24. The review sought evidence on two related issues: the cost to companies of meeting the disclosure requirements of the Combined Code, and whether the resulting disclosures were of value.
25. While some companies who responded to the consultation considered some of the Code disclosures to be unnecessary, and a number advocated greater use of communication via a website rather than the annual report to convey information, in general they were seen as a reasonable burden in the interests of demonstrating Code compliance. Many companies were concerned by the increasing length of annual reports, but attributed this to IFRS, EU and UK company law, and financial market regulations rather than to the Code.
26. The quality of disclosure is a different matter. The general perception among investors and other observers is that while there has been a gradual but discernible improvement in the overall quality of disclosure, there remains scope for considerable further improvement. Independent Audit, which has carried out regular surveys of annual reports, notes that while there are many good examples of informative reports, they are “surrounded by frustratingly large quantities of predictably standard statements”¹⁰.
27. Judging by the selection of reports analysed as part of the review, the FRC would agree with this assessment. Good communication is the bedrock of effective engagement; boilerplate disclosures simply get in the way. Better communication will undoubtedly be an important element in improving the effectiveness of ‘comply or explain’.
28. From the investors’ perspective, the single most important issue is the quality of the explanations provided by companies when they choose not to follow the provisions of the Combined Code. As with disclosure more generally, the perception is that it varies considerably.
29. In considering any explanation it is necessary to distinguish between whether it is appropriate, given the particular circumstances of the company, and whether it is informative. The first is a matter of judgement for the board and shareholders, the second is simply good practice. Shareholders will be better able to reach a considered opinion on the appropriateness of an explanation, and may as a result be less inclined to ‘box-tick’, if they are given the information that will enable them to do so. The FRC believes that it would also be very helpful to shareholders if, as part of the explanation, companies were to state how, through their actual practices, they are nonetheless applying the associated Code principle.

¹⁰ *Board Reporting in 2006: A survey of FTSE 100 annual reports*; Independent Audit; 2006

PROPOSED AMENDMENTS TO THE CODE

30. There was very little appetite among respondents to the consultation for substantial changes to be made to the Combined Code. There was an element of “regulatory fatigue”, with companies and investors alike commenting that as they already had to implement the Companies Act 2006 and other changes in the regulatory framework they would not welcome further change at this point without strong justification.
31. But it was also considered that the FRC should focus its efforts on improving the practical application of the Code, to tackle some of the issues summarised in earlier sections of this report and ensure that ‘comply or explain’ worked effectively. It was felt that this would be of greater benefit than overhauling the content of the Code, which enjoyed broad support.
32. Notwithstanding these views, many respondents also identified specific changes that they considered should be made to the Code. The proposals that were put forward most frequently are listed in the summary of responses (available at <http://www.frc.org.uk/corporate/2007reviewresponses.cfm>).
33. As announced in October, the FRC proposes to consult only on two possible changes to the Code:
- **Removing the restriction in provision A.4.3 on an individual chairing more than one FTSE 100 company.** The case for removing this restriction was best expressed by the ABI, which argued that “the need for individuals to have sufficient time to provide to the role and to be available in the event of crises is already made clear in the rest of this paragraph of the Code. The efficacy of the prescriptive provision is also in doubt since it focuses narrowly on the holding of other company chairmanships within one part of the listed market and ignores time commitments elsewhere both inside and outside the corporate sector which, individually or cumulatively, might be very significant”.
 - **For listed companies outside the FTSE 350, amending provision C.3.1 to allow the company chairman to sit on the audit committee where he or she was considered independent on appointment.** A number of respondents to the consultation argued that it should be possible for smaller companies to continue to classify the chairman as independent if they were so considered on appointment. It was argued, inter alia, that this would help these companies cope with the Code’s recommendations on the composition of the board committees, and that in the particular case of the audit committee the chairman would often be the board member best qualified to sit on the committee.

The FRC has rejected that proposal. It is difficult to argue that the status of the company chairman is determined by the size of the company; and it might inadvertently send a signal to smaller companies that it was no longer considered best practice to have at least two independent non-executive directors on the board. However an amendment to allow the Chairman to sit on the audit committee might deliver the same benefits without raising these issues.

34. In addition to these proposed changes to the provisions of the Code, the FRC will also update the Preamble to the Code. This is an opportunity to reinforce important messages about the way in which the Code should be viewed and implemented, for example to emphasise that good governance should support wealth creation and entrepreneurship as well as protect shareholder value, and to encourage companies to make relevant and company-specific disclosures.
35. Consultation on the proposed amendments will be carried out in parallel with an FSA consultation document on the proposed revisions to FSA Rules needed to implement the corporate governance requirements in the 4th and 8th Company Law Directives (which respectively require listed companies to produce a corporate governance statement and to have an audit committee). It is also the intention that the revised Rules and any changes to the Code should take effect at the same time; it is provisionally intended that this would be in June 2008. At that time the FRC will also revise Schedule C to the Code so that it summarises all the revised disclosure requirements.
36. A number of respondents to the FRC's consultation raised points relating to the current Listing Rules requirements. For example, some considered that a change of terminology from 'comply or explain' to 'apply or explain' might help to remove any misconceptions about the status of explanations, while others commented that the requirement in the Listing Rules for companies to state how they apply the principles of the Code, as well as to comply or explain with its provisions, may inadvertently be contributing to the problem of boilerplate disclosures. The FRC has brought these issues to the attention of the FSA.
37. As a result of the recommendations of the Market Participants Group looking at choice in the audit market, the FRC will be consulting separately on possible amendments to the Smith Guidance for audit committees. The intention is to publish draft revised guidance for comment in the first quarter of 2008.



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