



**FINANCIAL REPORTING COUNCIL**

**AMENDMENTS TO THE 2003 COMBINED CODE:**

**REGULATORY IMPACT ASSESSMENT**

**JUNE 2006**

## **REGULATORY IMPACT ASSESSMENT REVIEW OF THE IMPLEMENTATION OF THE 2003 COMBINED CODE**

### **Purpose and intended effect**

1. The Combined Code on Corporate Governance sets out standards of good practice for listed companies in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. All companies incorporated in the UK and listed on the London Stock Exchange are required under the Listing Rules to report on how they have applied the Combined Code in their annual report.
2. The Combined Code contains broad principles and more specific provisions. Listed companies are required to report on how they have applied the principles of the Code, and either to confirm that they have complied with the Code's provisions or - where they have not - to provide an explanation in the annual report (this is known as "comply or explain").
3. The Combined Code was last revised in 2003, having been updated to incorporate recommendations from the Higgs report on the role of non-executive directors and the Smith guidance on audit committees.
4. In July 2005 the Financial Reporting Council (FRC) announced a review of the Combined Code, the aim of which was to look at progress in implementing the Code and whether any practical issues had emerged. Most listed companies reported against the 2003 Combined Code for the first time in 2005.
5. Following that review the FRC consulted on a small number of changes to the Combined Code in January 2006 which are summarised in paragraph 10 below. The FRC stated at the outset of the review that amendments to the Code would only be made if they commanded broad support.

### **Business sectors affected**

6. Changes to the Combined Code directly affect those companies incorporated in the UK and fully listed on the Main Market of the London Stock Exchange, as they are required by the Listing Rules to report on how they have applied the Code. As of 31 May 2006 there were 1,326 such companies, operating across all business sectors.

7. Some other sectors such as building societies and mutual insurance companies have voluntarily adopted annotated versions of the Combined Code as the corporate governance standard for that sector. The outcome of the review may therefore indirectly affect those sectors.

## Issues

### Evaluation of the impact of the 2003 Combined Code

8. It was the overwhelming view of respondents to the review that there had been an improvement in the quality of corporate governance among listed companies since the introduction of the revised Combined Code. Most companies were properly adopting the 'comply or explain' approach, and where comparative data was available it showed that an increasing number of companies were choosing to apply the majority of Code provisions. In addition, both companies and investors reported that the dialogue between boards and their main shareholders was more constructive than it had been a couple of years previously and investors considered that the overall quality of disclosure in annual reports had improved.
9. The review found strong support for retaining the existing 'comply or explain' approach rather than introducing more regulation and, while some respondents argued that particular aspects of the Code were either unnecessarily burdensome or insufficiently rigorous, all considered that major changes to the Code were neither necessary nor appropriate. The options of introducing more regulation or making more significant changes to the Code are therefore not addressed in this RIA.

### Proposed amendments to the Combined Code

10. The FRC consulted on the following changes the Combined Code:
  - to amend provision B.2.1 to allow the chairman to sit on the remuneration committee where he or she was considered independent at the time of appointment;
  - to amend section D.2 to provide shareholders voting by proxy with the option of withholding their vote, and to require the publication of details of proxies lodged at the AGM where votes are taken on a show of hands; and

- for those provisions that require companies to “make information available” (provisions A.4.1, B.2.1 and C.3.3), to enable the requirement to be met by placing the information on the company’s website.

11. The options considered for each of these issues, and the associated costs and benefits, are set out in the following sections.

12. It should be noted that the Code provisions will remain subject to the ‘comply or explain’ approach. In principle it would be possible for companies to mitigate any costs associated with the preferred option by choosing to adopt alternative governance arrangements and providing an explanation to their shareholders.

### **Membership of the remuneration committee**

13. Provision B.2.1 of the Combined Code states that: “The board should establish a remuneration committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors”. As the company chairman is not considered to be an independent non-executive director for the purposes of this provision, this means that if a company wishes the chairman to be a member of the committee it needs to provide an explanation to shareholders in the annual report.

- **Option 1:** no change
- **Option 2:** amend the provision to allow the company chairman to be a member of, but not chair, the remuneration committee in addition to the independent non-executive directors, where he or she was considered independent on appointment as company chairman.
- **Option 3:** amend the provision to allow the company chairman to sit on the remuneration committee, without the various qualifications in Option 2.

### Costs and benefits

14. Because the Combined Code operates on a “comply or explain” basis the chairman would be able to sit on the committee under any of the options, but under **Options 2 and 3** there would be no requirement for the company to provide an explanation to shareholders in the annual report. This might result in some marginal cost savings to the company. That apart, the FRC would not expect there to be any impact on administrative costs.

15. Some respondents to the initial consultation argued that the chairman's presence on the remuneration committee could deliver some benefits to shareholders as it should help to ensure that performance incentives and other elements of the company's remuneration policy were properly aligned with its strategic objectives. Some investors were, however, concerned that the presence of the chairman on the committee should not reduce its degree of independence or leave too much power in the hands of the company chairman, and therefore preferred **Option 2** to **Option 3**.
16. The majority of respondents to the consultation on draft amendments to the Code supported **Option 2**. **Option 2** is the recommended option.

### **Votes withheld**

17. Provision D.2.1 of the Combined Code states that: "The company should count all proxy votes and, except where a poll is called, should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution and the number of abstentions, after it has been dealt with on a show of hands. The company should ensure that votes cast are properly received and recorded".
18. In January 2004 a report by Paul Myners to the Shareholding Voting Working Group on impediments to voting UK shares recommended that provision D.2.1 be amended to require companies to include on proxy appointment forms for the AGM a 'vote withheld' box, and to publish details of the total number of votes withheld as well as votes for and against when declaring the results.
- **Option 1:** no change
  - **Option 2:** amend the provision to require companies to include on proxy appointment forms for the AGM a 'vote withheld' box.
  - **Option 3:** as for Option 2, but in addition amend the provision to require companies to publish on their websites details of proxies lodged on resolutions that were dealt with on a show on hands.
  - **Option 4:** extend Option 4 also to cover votes held on a poll.

## Costs and benefits

19. In his January 2004 report Paul Myners argued that the facility to indicate a conscious withholding of votes was a valuable mechanism enabling shareholders to communicate reservations about a particular resolution whilst not going as far as voting against the resolution ('votes withheld' are not counted when calculating the outcome of a vote). This benefit would be delivered by all options apart from Option 1.
20. It is increasingly becoming general practice for companies to provide a 'vote withheld' option. According to RREV, for 92% of company meetings of the FTSE100 in 2005 voting forms included an 'vote withheld' option. For companies already providing this option there should be no additional costs associated with **Option 2**. For other companies, there may be costs resulting from, for example:
- the need to amend proxy appointment forms (although some providers of electronic voting services already includes a 'vote withheld' option in their standard forms);
  - the need to record the votes withheld in addition to votes for and against the resolution; and
  - the possible need to amend the company's Articles of Association.
21. These costs would also be associated with **Option 3 and 4**. In addition, there may be costs associated with publishing results of votes held on a show of hands on the company's website.
22. In his 2004 report, Paul Myners also argued that publication of the results of votes on resolution on company websites would increase transparency for shareholders. The Company Law Reform Bill includes draft clauses that would make it a requirement for listed companies to publish on a website details of the number of votes cast for and against a resolution taken on a poll. **Option 3** would extend this to cover votes held on a show of hands, but would in addition expect companies to publish details of the number of votes withheld. **Option 4** would extend this requirement to cover votes taken on a poll; however, it would also duplicate many of the proposed requirements in the Bill.
23. The majority of respondents to the consultation on draft amendments to the Code supported **Option 3**. **Option 3** is the recommended option.

## **Making information available**

24. The Combined Code contains a number of provisions which state that companies should make certain information available in order to comply with the provision. These include requirements to make available:

- the terms of reference of the nomination, remuneration and audit committees (provisions A.4.1, B.2.1 and C.3.3 respectively); and
- where remuneration consultants are appointed, a statement of whether they have any other connection with the company (provision B.2.1).

25. The footnotes to these three provisions state that the requirement to make the information available would be met by making it available on request and by including the information on the company's website.

- **Option 1:** no change
- **Option 2:** amend the Code so that the requirement to make the information available would be met by including the information on the company's website (with no requirement also to make the information available on request).

## Costs and benefits

26. Data provided by PIRC in its response to the FRC's review suggests that a significant majority of companies – 95% of FTSE100 companies, 82% of FTSE250 companies and 66% of smaller listed companies – currently make the terms of reference of board committees available on their website. It seems reasonable to assume that most shareholders will have Internet access and are therefore able to obtain this information. If there are any shareholders that do not have Internet access and who wish to obtain this information, **Option 1** ensures that they are able to do so. When consulting on the draft amendments to the Code the FRC asked for information from companies about the frequency with which they received requests for this information. Only one company responded on this point, and reported that they had never received such a request.

27. **Option 2** may lead to some limited savings for companies that currently receive requests for this information to be made available by other means, but may reduce the ability of some shareholders to access information. This was not raised as a concern by the UK Shareholders Association, which represents private shareholders, in its response to the consultation on draft amendments to the Code. **Option 2** is the recommended option.

### **Other changes to the Combined Code**

28. In addition to the changes discussed above, the FRC also consulted on a proposal to set out in Schedule C of the Code the disclosure requirements in the Listing Rules in order to ensure companies are able to find details of all relevant requirements in one place. The FRC considers that this amendment would not change the existing requirements of the Combined Code, and would therefore have no impact on the costs and benefits associated with implementing the Code. No concerns were raised by respondents to the consultation.

### **Enforcement and sanctions**

29. Under the UK Listing Authority's Listing Rules, a listed company incorporated in the UK is required to include in its annual report and accounts:

- a statement of how it has applied the principles set out in Section 1 of the Code, providing explanation which enables its shareholders to evaluate how the principles have been applied; and
- a statement as to whether or not it has complied with the Code provisions set out in Section 1 of the Code. The company must specify the Code provisions, if any, with which it has not complied and give reasons for non-compliance.

30. The Financial Services Authority, as Listing Authority, makes no judgement on the accuracy or adequacy of the compliance statements made by listed companies: these are matters for the judgement of directors and shareholders. If a company fails to include a statement in the required form it may, however, use its enforcement powers, including its fining powers, against that company.

## **Consultation**

31. The review of the Combined Code was overseen by the FRC's Corporate Governance Committee, which is drawn from members of the FRC Council and includes representatives of listed companies, investors and other stakeholders.
32. The FRC held two public consultation exercises:
- A consultation inviting views in the impact of the 2003 Combined Code, held between July and October 2005. 59 responses were received from listed companies, institutional investors, representative bodies and other stakeholders.
  - A consultation on draft amendments to the Combined Code, held between January and April 2006. 38 responses were received from listed companies, institutional investors, representative bodies and other stakeholders.
33. A summary of the main issues raised by respondents to the consultations can be found at: [www.frc.org.uk/corporate/reviews.cfm](http://www.frc.org.uk/corporate/reviews.cfm).
34. In addition the Financial Services Authority, as the UK Listing Authority, is obliged by statute to carry out a separate consultation before listed companies can be formally required under the Listing Rules to disclose how they have applied this new version of the Combined Code. This consultation is expected to begin in September 2006 and, subject to views received, the Listing Rules would be expected to apply to the new version of the Combined Code with effect from some time in the second quarter of 2007.

## **Consultation with regulators**

35. A representative from the Department of Trade and Industry sits on the FRC's Corporate Governance Committee. The FRC also consulted the Financial Services Authority and HM Treasury.

## **Monitoring and review**

36. The FRC will continue to monitor implementation of the Combined Code and its related guidance.

## **Summary and recommendations**

37. In view on the strong support received from those who responded to the two consultation exercise, and the limited anticipated costs associated with the proposals, the FRC intends to proceed with all of the amendments to the Combined Code set out in paragraph 10.

## **Contact point**

Chris Hodge  
Financial Reporting Council  
Fifth Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

E-mail: [c.hodge@frc.org.uk](mailto:c.hodge@frc.org.uk)

Telephone: 020 7492 2381