Financial Reporting Council

Review of the implementation of the 2006 Combined Code

Regulatory Impact Assessment

May 2008

REGULATORY IMPACT ASSESSMENT
REVIEW OF THE IMPLEMENTATION OF THE 2006 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 FSA 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 last significant revisions to the Combined Code were made in 2003 when it was updated to incorporate recommendations from the Higgs report on the role of non-executive directors and the Smith guidance on audit committees. Further limited amendments were made in 2006 following a Financial Reporting Council (FRC) review of the implementation of the 2003 Code.

4. In April 2007 the FRC announced a further review of the Combined Code, the aim of which was to look at the impact and implementation of the Code. Following that review the FRC consulted on a small number of changes to the Combined Code in December 2007 which are summarised in paragraph 10 below.

Business sectors affected

5. 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 30 April 2008 there were 1,200 such companies, operating across all business sectors.

6. 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 2006 Combined Code

7. The FRC review found that 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. 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.

8. 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.

9. 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.

Proposed amendments to the Combined Code

10. The FRC consulted on the following changes the Combined Code:

- removing the restriction on an individual chairing more than one FTSE 100 company; and

- for listed companies outside the FTSE 350, allowing the company chairman to be a member of, but not chair, the audit committee provided he or she was considered independent on appointment.

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.

Chairing more than one FTSE 100 company

13. Provision A.4.3 of the Combined Code states that "For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and included in the next annual report. No individual should be appointed to a second chairmanship of a FTSE 100 company".

14. In the consultation document the FRC proposed removing the restriction on an individual chairing more than one FTSE 100 company. The main benefit of this change is that it removes a restriction on the supply of skilled people willing and able to serve as Chairman of large listed companies, which will be beneficial. There are not expected to be any direct costs associated with the change, which should not have any impact on the level of remuneration for company chairmen. The main risk is that an individual might become over-committed and be unable to devote sufficient time to the role. The other requirements of provision A.4.3 – which will be retained – are designed to reduce the risk of this happening.

Audit Committee membership

15. Provision C.3.1 of the Code states that "the board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent nonexecutive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience".

16. In the consultation document the FRC proposed loosening the requirements on audit committees for smaller listed companies (i.e. those outside the FTSE 350) to allow the company chairman to be a member of, but not chair, the committee where he or she was considered independent on appointment. The main benefit expected as a result of this change is more effective performance of the audit committee; this benefit cannot be quantified.

17. If the chairman were to join the committee it would be in addition to, rather than instead of, the two independent members. This is in order to reduce the risk that the independence of the committee might be compromised. It means that there are unlikely to be any direct cost savings arising from a reduction in the number of non-executive directors on the board, although for some companies it may mean that they do not need to incur further costs by recruiting additional non-executives to serve on the committee.

Enforcement and sanctions

18. 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.

19. 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

20. The review of the Combined Code was overseen by the FRC's Corporate Governance Committee, which includes representatives of listed companies, investors and other stakeholders.

21. The FRC held two public consultation exercises:

    - A consultation inviting views in the impact of the 2006 Combined Code, held between April and July 2007. 107 responses were received from listed companies, institutional investors, representative bodies and other stakeholders.

    - A consultation on draft amendments to the Combined Code, held between December 2007 and March 2008. 36 responses were received from listed companies, institutional investors, representative bodies and other stakeholders.

22. A summary of the main issues raised by respondents to the consultations can be found at http://www.frc.org.uk/corporate/2007review.cfm.

Consultation with regulators

23. The FRC consulted the Financial Services Authority, the Department for Business, Enterprise and Regulatory Reform and HM Treasury.

Monitoring and review

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

Summary and recommendations

25. In view on the strong support received from those who responded to the two consultation exercise, and the absence of any direct costs associated with the proposals, the FRC intends to proceed with both 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

Telephone: 020 7492 2381

Financial Reporting Council
May 2008

FINANCIAL REPORTING COUNCIL
5TH FLOOR
ALDWYCH HOUSE
71-91 ALDWYCH
LONDON WC2B 4HN
TEL: +44 (0)20 7492 2300
FAX: +44 (0)20 7492 2301
WEBSITE: www.frc.org.uk