

FINANCIAL REPORTING COUNCIL

CONSULTATION ON REVIEW OF IMPACT OF THE COMBINED CODE

CBI RESPONSE

July 2007

INTRODUCTION AND SUMMARY OF CBI POSITION

1. The proposed review of the Combined Code was referred to by the FRC in their consultation on Strategy, Budget and Work Plan for 2007 / 08. We responded that CBI members did not see the need at this time for a full scale review of the Combined Code, given that the latest version of the Code had only taken effect from November 2006. However we acknowledge that it is nonetheless useful to consider the impact of the Code and whether there are particular matters worth highlighting given the extensive changes to the Code resulting from the Higgs Review. We are very grateful for Sir Christopher Hogg's attendance at recent meetings of the CBI President's Committee and CBI Companies Committee to discuss the FRC Review.
2. CBI members are substantially content with the present Code, and the Comply or Explain approach. The issue is whether Comply or Explain is being sustained in practice. The Code is not seen as a major burden on larger listed companies albeit that it has become more prescriptive as a result of the most recent changes. But there has to be a question as the burden on smaller listed companies, and we make some remarks below which will be appropriate to take into account as part of a future review of the Code. The main burden on listed companies generally comes, not so much from the Code, but from the large bulk of compulsory regulation, including such as the move to IFRS, and EU company law and financial markets Directives including the Transparency Directive, and now the most recent UK Companies Act. Even de-regulatory and other beneficial changes come at a cost to implement.
3. As a result company annual reports and annual accounts are becoming ever longer and more complex. With the changes introduced by the Companies Act 2006 to facilitate the use of electronic communications with shareholders, including by means of company websites, consideration should be given to the possibility of permitting the use of the company website to publish a company's corporate governance statement required by the Listing Rules in place of in the annual report.
4. Following the Higgs review the Code is now much longer and more detailed, and any changes should not make the Code any longer or more complex, and possible simplification looked for. On the wording of the current Code, CBI members support a relaxation of Code provision A.4.3 to permit an individual to serve as chair of two FTSE 100 companies at the same time. This amendment is also supported by CBI investor members.



5. Apart from this change, which is essentially a point of detail, CBI members do not seek major changes or a significant re-write of the Code at this point in time. Rather CBI members seek a period of stability, and for a more detailed review of the Code left to be undertaken at the time of the next review in say 2009 /10 when experience of the new Companies Act and implementation of the new requirements of the 4th 7th and 8th Directives, Transparency Directive, and Shareholder Rights Directive has been gained, and their impact on the Combined Code.
6. Our comments in response to the specific consultation questions are set out below.

COMMENTS ON CONSULTATION QUESTIONS

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

7. A lot of factors affect board performance, but we would say that appropriate governance arrangements as laid down by the Code give a very strong underpinning to seeking to achieve effective board performance. Despite this opinion we have seen no hard evidence that it has any impact on board performance.
8. The Listing Rule requirement that companies should state how they apply the Main and Supporting Principles is often interpreted as a requirement to explain how all 60 + elements of the Main and Supporting Principles are applied. This can generate excessive boilerplate in the corporate governance statement. The emphasis should be on why certain processes are in place, not just that they exist. With the assistance of the FRC, perhaps the FSA could be asked to issue some guidance on this to accompany the Listing Rule.

Q.2. Is the Comply or Explain approach working effectively ?

9. This is certainly a fundamental principle of the Code, and not to be jettisoned. Some in companies believe that certain of the investor community treat the Code as “comply or else”, but CBI dialogue between companies and investors has shown a mutual commitment to this principle. Companies are free not to comply with individual provisions, as long as they identify them, and explain why not. It is then for individual investors to decide on the merits of the explanation, and whether to take up with the company. Many CBI members consider that compliance departments of institutional shareholders do adopt a box ticking approach and are disconnected from those who make their investment decisions, who often take a more positive and practical stance.
10. We support the efforts of Sir Christopher Hogg in his meetings with stakeholders to emphasise the key role of the explanation in addressing any areas of non –compliance, and a point the FRC may wish to make when announcing the outcome of their Review in due course. This should also include engagement with the voting service agencies to encourage them to provide companies with enough time to comment on their compliance reports., and to ensure that they understand that explanations should be given proper consideration , and is not non-compliance.
11. At the time of the next major review of the Code, it might aid understanding of the comply or explain philosophy, if consideration was given to a change in the terminology to “Apply or Explain”.

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

12. If the Code is burdensome on business then this is most likely to be the case for smaller companies. The Code broadly applies in a similar way to smaller listed companies, as for larger ones, although they can have fewer independent NEDs on the board.
13. Investors consider that smaller listed companies can address any particular issues and possible additional areas of non - compliance through disclosure and explanation under the Comply or Explain mechanism. However some smaller listed companies will say that they do not like to have to keep justifying and explaining why they do not comply.
14. Particularly as an aid to smaller listed companies, consideration should be given as to whether the non-executive chairman can continue to be to be considered independent following appointment, and not just on appointment (Code provision A.2.2 and footnote 2 to Code provision A.3.1). The non-executive chairman could then be regarded as an independent director when considering committee membership. It will also reduce the explanations about non-compliance with the Code provisions concerning number of independent directors on the board and its committees.

Q.4. Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies ?

15. Yes we would say so overall. It is in other areas of mandatory regulation and accounting standards that cause most cost and burden to companies.
16. CBI members are concerned at the burgeoning size of annual reports, but this does not derive from Combined Code compliance statements, but rather from the volume of disclosures required by IFRS and other regulatory requirements, as mentioned above.
17. Accordingly, CBI members support initiatives to simplify the financial statements and to make the accounts more relevant and useful to investors, and the CBI is in discussions with investor groups about this.
18. Company annual reports and annual accounts are becoming ever longer and more complex. With the changes introduced by the Companies Act 2006 to facilitate the use of electronic communications with shareholders, including by means of company websites, consideration should be given to the possibility of permitting the use of the company website to publish a company's corporate governance statement required by the Listing Rules in place of in the annual report.
19. With the ever changing shareholder base, shareholders may continue to need help in understanding UK corporate governance best practice, as evidenced by the Combined Code and the comply or explain regime. Accordingly, companies' statements and explanation of their policies were as important as ever.
20. On particular issues on the wording of the current Code, CBI members support a relaxation of Code provision A.4.3 to permit an individual to serve as chair of two FTSE 100 companies at the same time. This amendment is also supported by CBI investor members.