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By email: codereview@frc.org.uk

Dear Chris

REVIEW OF THE IMPACT OF THE COMBINED CODE

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to comment on this consultation issued by the Financial Reporting Council (FRC) in April, 2007.

The ICAEW has consistently participated in consultations regarding the Combined Code (Code) and plays an active role in the development of corporate governance in the UK and internationally. This includes the publication of the Turnbull Guidance on Internal Control in 1999 and the *Beyond the myth of Anglo-American corporate governance* initiative.

This response has been drafted after consultation with the ICAEW Corporate Governance Committee which includes representatives from the business and investment communities. We have highlighted some general observations below and provide detailed comments on the consultation questions in the Appendix.

Corporate governance evolves over time and requires regular review

The Code sets out good practice which evolves over time. It is acknowledged as being flexible and amendments are at times necessary to address changing expectations, potential conflicts or unforeseen circumstances. It is therefore appropriate for the FRC to conduct regular reviews of the impact and effectiveness of the Code. Market participants indicate that the current application of the Code, via the 'comply or explain' approach, is useful and effective. We therefore do not envisage that this review will lead to the need for any major changes.

'Comply or explain' is threatened by regulatory creep

The success of the UK 'comply or explain' approach is largely based on the pragmatism of business in practising good corporate governance and reliance on shareholders to oversee such practice. The sustainability of this approach is threatened by regulatory creep, particularly from the European Commission and the extra-territorial effects of US regulation. This can lead to a number of adverse consequences to the current flexible nature of the UK corporate governance system. In this regard, UK regulators should be cautious about how to implement, monitor and enforce new mandatory requirements.

The nature of share ownership is changing

There is currently international debate around how innovative financial products (e.g. contracts for difference) and market practice (e.g. stock lending) impact on the traditional alignment of management and shareowner interests through share voting. Such innovation separates legal ownership and economic interests and can lead to a greater diversity of competing objectives in the long and short term. In this regard, it is appropriate to acknowledge and monitor over time the impact that changes in share ownership may have on the Code.

We hope that our suggestions are useful. Please do not hesitate to contact me or my colleague Kerrie Waring (Corporate Governance Manager) if you wish to discuss this response in more detail.

Yours sincerely



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APPENDIX

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

Yes, we believe that the Code supports better board performance over time. The Code has led to positive developments in UK corporate governance and is widely acknowledged and endorsed by market participants. Code recommendations have helped to clarify the roles, responsibilities and powers of boards and investors in relation to corporate direction and control. It sets out recommendations for good practice over and above minimum legal or regulatory requirements. As a result, UK companies adhere to some of the highest standards of corporate governance in the world.

By identifying accepted good practice, the Code provides a tool by which boards can compare their practices relative to peers and by which shareholders can evaluate the appropriateness of Code disclosures. However, it is important to consider how to continue encouraging good governance and yet avoid it becoming a charter for boards to avoid risk to the detriment of shareholder returns.

Good corporate governance is reliant on the quality of the people on the board and their effectiveness in collectively leading the success of the company. The Code provides guidance around the practices and processes that enable boards to achieve this success. However, excessive governance requirements will be ignored by crooks and may discourage appropriate risk-taking by good management.

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

Yes, we believe that the 'comply or explain' approach is working effectively but that there are potential threats to its sustainability. The 'comply or explain' approach is integral to building trust and communication between boards and shareholders in the UK. However, there are potential threats to its sustainability which are characterised as follows:

Consequences of regulatory creep

Application of the Code is a Listing Rule requirement and therefore has regulatory status but without legal redress for non-compliance. This approach allows for a degree of flexibility that traditional law, which imposes the same rules on all companies, does not. Thus, the Code recognises the diversity of individual companies and the need for shareholders to take a considered approach to evaluating disclosure of non-compliance.

The Code is threatened by regulatory creep, particularly with the on-going implementation of European Directives and influences from US regulation. New measures are often legally binding and threaten the flexibility of the 'comply or explain' approach. The consequences of moving to a more statutory footing are as yet undetermined but could lead to:

- a reliance on lawyers and other intermediaries to advise on the application of concepts such as 'independence' in the event a complaint is made to relevant regulators. Under the 'comply or explain' approach, judgements around such concepts are most appropriately made by boards and shareholders, not regulators;
- more time being required for legal and regulatory compliance issues, possibly at the expense of other board matters;
- a reduction in the number of willing candidates to take up non-executive director positions with a particular reluctance to sit on audit committees;

- increases in pay for board members; and
- increases in the cost of directors' and officers' liability insurance.

Quality of disclosures and evaluation of explanations

Under the 'comply or explain' approach, companies disclose that they comply with Code provisions or explain any deviations to shareholders. This involves not simply producing boilerplate explanations of non-compliance, which can be another symptom of regulatory creep and liability avoidance, but justifying the board's position on a particular issue.

Companies are encouraged to communicate directly with shareholders when contentious issues arise and shareholders are encouraged to be receptive to meeting with board representatives. However, the large size and complexity of many investment funds can make effective evaluation of statements of non-compliance difficult and result in box-ticking. There should be appropriate allocation of resources by both companies and shareholders to facilitate engagement if the 'comply or explain' approach is to remain effective.

Increasingly, the evaluation of corporate governance statements is outsourced to voting advisory services. Whilst recognising the valuable contribution of such intermediaries, there is a need for greater confidence that Code disclosures are considered on the merits of each individual case. Ultimately, evaluation of Code disclosures informs voting decisions and should therefore be properly considered and not reduced to box-ticking.

Changing nature of share ownership

There is currently international debate around how innovative financial products (e.g. contracts for difference) and market practice (e.g. stock lending) impact on the traditional alignment of management and shareowner interests through share voting. Such innovation separates legal ownership and economic interests and can lead to a greater diversity of competing objectives in the long and short term.

The Code helps investors to form opinions on the stewardship of their investment and provides guidance on good practice to help decision-making around how votes are cast. Shareholders will not always unanimously agree with explanations for non-compliance as there will always be different points of view. This reflects differing objectives among shareholders and the changing nature of share ownership. Currently, the majority of share ownership in UK public companies continues to be held by institutional investors but it is appropriate to acknowledge and monitor over time the impact that changes in share ownership may have on the Code.

The size of the public market is also decreasing with an increase of public to private buy-outs by private equity firms. This is encouraged by a desire to generate healthier returns outside public markets and to avoid the degree of regulatory compliance expected of public companies. There can be a sense of frustration from the business community with the burden of regulatory compliance, which can inadvertently add to the attractiveness of alternatives to public company status.

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

Companies that wish to benefit from the advantages of capital market participation must accept the wider obligations imposed upon public companies. AIM listed companies which aspire to float on the London Stock Exchange's Main Market benefit from the guidance of the Code and are encouraged to follow good corporate governance practice. As such, the points made relating to questions 1 and 2 above are also relevant to smaller companies. However, the practical application of specific recommendations should be balanced with costs and benefits of compliance.

The Code takes into consideration the different challenges faced by smaller listed companies (those below the FTSE 350) in upholding standards of good corporate governance, for example by taking into account the need for fewer independent non-executive directors. In this respect, it is important to acknowledge common sense application of the Code by smaller companies. Whilst the 'spirit' of the Code is often followed, full compliance is not always practical due to cost constraints.

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

The Code provides a useful tool for communication between boards and shareholders. This is reliant upon transparency and high standards of information disclosed by boards and high quality interpretations and evaluations of such disclosures by shareholders.

It is difficult to quantify the costs of applying the Code and explaining departures from a company perspective. However, anecdotal evidence suggests that this is not considered to be an issue of concern and UK companies accept the requirement for Code disclosures.

Anecdotal evidence from the shareholder community indicates general satisfaction with the quality of explanations provided for non-compliance with Code provisions. Explaining deviations, rather than simply complying, is often more informative and helps to mitigate contentious issues.

As a final observation, it may be worthwhile for the FRC to conduct research into the extent to which companies comply with recommendations which were in the past the subject of frequent non-compliance and explanation. This may give an indication over time of recommendations which are difficult to implement in practice (e.g. limiting length of tenure to maintain independence) and those which have become accepted practice.