



FINANCIAL REPORTING COUNCIL

THE UK APPROACH TO CORPORATE GOVERNANCE

OCTOBER 2010

The key aspects of corporate governance in the UK

A single board collectively responsible for the sustainable success of the company.

Checks and balances including:

- **Separate Chairman and Chief Executive.**
- **A balance of executive and independent non-executive directors.**
- **Strong, independent audit and remuneration committees.**
- **Annual evaluation by the board of its performance.**

Transparency on appointments and remuneration.

Effective rights for shareholders, who are encouraged to engage with the companies in which they invest.

The UK Corporate Governance Code operates on the basis of the ‘comply or explain’ principle and is regularly reviewed in consultation with companies and investors.

Foreword

Good corporate governance is essential to the effective operation of a free market, which facilitates wealth creation and freedom from poverty.

The City of London has a history of encouraging free trade and good corporate governance, based on the application of simple principles to the individual and distinct circumstances of each entity. The events of 2007-09 have shown that such principles and the practices that go with them should be strengthened.

The more ingrained the system of corporate governance in a business community, the less the need for detailed regulation to ensure effective compliance with good standards of business behaviour.

The UK's system of business regulation, which is principles rather than rules based, also reduces the cost to global businesses of introducing procedures to comply with detailed regulations, many of which unnecessarily constrain business practice and innovation.

Of course, there continues to be public and political pressure for better regulation of the City and this must be accepted and acted upon. However, better regulation should be part of the framework for economic growth, directed at the next crisis rather than the last. Excessive regulation could damage the spirit of innovation that the UK economy needs.

Regulation should begin with strong corporate governance. It is the role of shareholders and boards to scrutinise and ensure that their companies are being led in the right direction over the long term. Encouraging transparency, accountability and long-term stability will promote healthy long term growth and help the UK financial services industry to regain public trust.

This publication has been produced by the Financial Reporting Council, which is responsible for corporate governance in the UK. I welcome this publication and commend it to the government, to companies, and to business academics, here and internationally. Increasingly, business does not recognise borders. It is in everybody's interests that governance standards are similarly international.

A handwritten signature in black ink, reading "Nick Anstee". The signature is written in a cursive style and is positioned above a horizontal line.

Nick Anstee, The Rt Hon Lord Mayor of the City of London

The advantages of the UK approach

The UK approach combines high standards of corporate governance with relatively low associated costs. In a September 2009 report by Governance Metrics International, the UK ranked second in a table showing average governance performance by companies in different countries.

It is proportionate and capable of dealing with a wide variety of circumstances. There is a relative lack of prescription as to how a company's board organises itself and exercises its responsibilities. The UK Corporate Governance Code identifies good governance practices, but companies can choose to adopt a different approach if that is more appropriate to their circumstances.

The key relationship is between the company and its shareholders, not between the company and the securities regulator or stock exchange. Boards and shareholders are encouraged to engage in dialogue on corporate governance matters. Shareholders have voting rights and rights to information, set out in company law and the Listing Rules, which enable them to hold the board to account.

The development of corporate governance in the UK

The development of corporate governance in the UK has its roots in a series of corporate collapses and scandals in the late 1980s and early 1990s.

The UK business community recognised the need to put its house in order. This led to the setting up in 1991 of a committee chaired by Sir Adrian Cadbury which issued a series of recommendations - known as the Cadbury Report – in 1992. The Cadbury Report addressed issues such as the relationship between the chairman and chief executive, the role of non-executive directors and reporting on internal control and on the company's position.

A requirement was added to the Listing Rules of the London Stock Exchange that companies should report whether they had followed the recommendations or, if not, explain why they had not done so (this is known as 'comply or explain').

The recommendations in the Cadbury Report have been added to at regular intervals since 1992. In 1995 a separate report set out recommendations on the remuneration of directors, and in 1998 the two reports were brought together in a single code (known initially as the Combined Code and now as the UK Corporate Governance Code). In 1999 separate guidance was issued to directors on how to develop risk management and internal control systems, which has subsequently been updated.

In 2003 the Code was updated to incorporate recommendations from reports on the role of non-executive directors and the role of the audit committee. At this time the UK Government decided that the Financial Reporting Council (FRC), the independent regulator responsible for corporate governance and reporting, was to take responsibility for publishing and maintaining the

Code. The FRC has updated the Code at regular intervals, most recently and most substantially in 2010 to reflect lessons learnt from the problems in the UK's financial services sector.

Throughout all of these changes, the 'comply or explain' approach first set out in the Cadbury Report has been retained. In 2010 it was reinforced by the UK Stewardship Code, under which institutional investors report on their policies for monitoring and engaging with the companies in which they invest.

The rationale behind the UK approach

In the UK, the Companies Act 2006 requires directors to focus on enlightened shareholder value. This means that boards must ensure that the business is sustainable and take account of long-term consequences in setting its business model and strategies.

Good governance can improve the board's ability to manage the company effectively to deliver long-term success as well as provide accountability to shareholders. To quote from the Cadbury Report:

“The effectiveness with which boards discharge their responsibilities determines Britain's competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance.”

A regulatory framework that aims to improve standards of corporate governance is more likely to succeed if it recognises that governance should support, not constrain, the entrepreneurial leadership of the company, while ensuring risk is properly managed.

This requires a degree of flexibility in the way companies adopt and adapt governance practices. Boards must see good governance as a means to improve their performance, not just a compliance exercise. To be effective it needs to be implemented in a way that fits the culture and organisation of the individual company. This can vary enormously from company to company depending on factors such as size, ownership structure and the complexity of its activities.

The assessment of whether the company's governance practices are effective in underpinning the sustainable success of the company should be made by the intended beneficiaries - i.e. the shareholders. Well-informed and engaged investors are able to take a pragmatic approach about how to apply best practice in a way that is in the best long-term interests of the company. The FRC's role as regulator is to ensure investors have the information they need to make that assessment.

The UK regulatory framework

The UK has developed a market-based approach that enables the board to retain flexibility in the way in which it organises itself and exercises its responsibilities, while ensuring that it is properly accountable to its shareholders.

This is done primarily through the UK Corporate Governance Code which is maintained by the FRC. The Code operates on the basis of 'comply or explain'. It identifies good governance practices relating to, for example, the board and its committees and risk management and internal control, but companies can choose to adopt a different approach if that is more appropriate to their circumstances. Where they do so, however, they are required to explain the reason to their shareholders who must decide whether they are content with the approach that has been taken.

This 'comply or explain' approach enables judgements about, for example, the composition and performance of the board to be made on a case by case basis. It is supported by companies, investors and regulators in the UK, and has increasingly been adopted as a model in other markets.

For the system to work effectively shareholders need to have appropriate and relevant information to enable them to make a judgement on the governance practices of the companies in which they invest. They also need the rights to enable them to influence the behaviour of the board when they are not content, and the willingness to use them. 'Comply or explain' therefore needs to be underpinned by an appropriate regulatory framework.

Under UK law, shareholders have comparatively extensive voting rights, including the rights to appoint and dismiss individual directors and, in certain circumstances, to call a general meeting of the company. Certain requirements relating to general meetings, including the provision of information to shareholders and arrangements for voting on resolutions, are

also set out in law, as are some requirements for information to be disclosed in the annual report and accounts. These include requirements for a Business Review (in which the board sets out its assessment of the company's future prospects) and a report on directors' remuneration, on which shareholders have an advisory vote.

There are also additional regulatory requirements for some specific sectors, such as financial services.

This framework is reinforced by the rules that must be followed by companies listed on the London Stock Exchange. The rules provide further rights to shareholders (for example, by requiring that major transactions are put to a vote), and require certain information to be disclosed to the market. For companies with a Premium Listing, this includes the requirement to provide a 'comply or explain' statement in the annual report explaining how the company has applied the UK Corporate Governance Code.

Copies of the UK Corporate Governance Code can be obtained from

<http://www.frc.org.uk/corporate/ukcgcode.cfm>

For their part, institutional investors are encouraged to report on the extent to which they have applied the UK Stewardship Code. The Code sets out good practice principles for monitoring and engagement with the companies in which they invest including, for example, disclosure of their voting policy and how any potential conflicts of interest are managed.

Copies of the UK Stewardship Code can be obtained from:

<http://www.frc.org.uk/corporate/investorgovernance.cfm>

The essential features of UK corporate governance

An effective board to provide leadership

- A single board with members collectively responsible for the long term success of the company.
- A clear division of responsibilities for running the board and running the company with a separate chairman and chief executive.
- An appropriate balance of skills, experience and independence on the board and its committees.
- Formal and transparent procedures for appointing directors, with all appointments and re-appointments to be ratified by shareholders.
- Regular evaluation of the effectiveness of the board, its committees and individual directors.

Accountability

- The board must present a balanced assessment of the company's position.
- The board must determine the nature and extent of the significant risks it is willing to take, and oversee sound risk management and internal control systems.
- Formal and transparent procedures for carrying out these responsibilities, including an audit committee made up of independent directors and with the necessary experience.

Remuneration

- Formal and transparent procedures for setting executive remuneration, including a remuneration committee made up of independent directors and an advisory vote for shareholders.
- A significant proportion of remuneration to be linked to performance conditions designed to promote the long-term success of the company.

Relations with shareholders

- Regular contact with shareholders to understand their opinions and concerns.
- Separate resolutions on all substantial issues at general meetings.
- Shareholders to monitor and engage with the companies in which they invest.

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