

Mr Jeroen Hooijer
Head of Unit
DG Justice and Consumers
European Commission

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Dear Jeroen,

The Financial Reporting Council (FRC) welcomes the opportunity to update the Commission on the United Kingdom's 'comply or explain' system in the context of the Recommendation on the quality of corporate governance reporting ('comply or explain') 2014/208/EU. The FRC has been asked to respond by the Department for Business, Innovation and Skills on the UK's behalf.

The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC sets the framework of codes and standards for the corporate reporting, accounting, auditing, actuarial and investor communities, including the UK Corporate Governance and Stewardship Codes. We monitor their application and oversee and enforce the conduct of the professionals involved.

The UK Corporate Governance Code ('the Code') was introduced in 1992, and since then has become an important element of the UK regulatory environment. Companies with a premium listing on the London Stock Exchange are required to comply or explain against the Code by the Listing Rules, as enforced by the UK Listing Authority, which sits within the Financial Conduct Authority (FCA).

The Code consists of principles (main and supporting) and provisions covering the key areas of governance best practice, including board responsibilities, board evaluation, remuneration, succession planning and strategy. The Listing Rules require companies to publish a statement of how they have applied the Main Principles. The principles are the core of the Code and the way in which they are applied is the central question for a board as it determines how it is to operate according to the Code. Companies must also comply or explain against the relevant provisions and, where they have not complied, must explain the reasons for non-compliance.

The Code provides important information to investors to assist them to make more informed decisions about the companies in which they invest. It also highlights the role of investors in monitoring corporate governance statements, including explanations, to assess whether they are content with the governance arrangements of the company. An investor should pay due regard to a company's individual circumstances when assessing explanations and may challenge companies where explanations are insufficient. Oversight by investors is the most important form of monitoring of company statements, as this is the group for which the information is provided.

The FRC monitors the application of, and compliance with, the Code through an annual report, the most recent of which was titled 'Developments in Corporate Governance and Stewardship 2014' and is available on the FRC website at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewardsh.pdf>. This report provides an overview of changes in stewardship and governance

over the past twelve months. The FRC's monitoring includes sampling company reports to assess levels of compliance and commenting on the quality of explanations.

FRC also uses analysis undertaken by third parties, for example consultancy and accountancy firms. The FRC regularly communicates with other regulators including the Financial Conduct Authority, Prudential Regulation Authority and the Department for Business, Innovation and Skills about the framework for company law and corporate governance in the UK. Monitoring of the Code forms part of the oversight undertaken by the FRC in pursuit of the mission to promote better corporate governance and reporting to foster investment.

The FRC welcomes the Commission's focus on explanations in the Recommendation. In 2012, the FRC strengthened the Code to outline the elements of an informative and effective explanation. These criteria are given in paragraph 3 of the 'Comply or Explain' section, upon which we judge the effectiveness of explanations.

'In providing an explanation, the company should aim to illustrate how its actual practices are consistent with the principle to which the particular provision relates, contribute to good governance and promote delivery of business objectives. It should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken to address any additional risk and maintain conformity with the relevant principle. Where deviation from a particular provision is intended to be limited in time, the explanation should indicate when the company expects to conform with the provision.'

The FRC considers that the Code meets the provisions of the Recommendation. The board agrees the Corporate Governance Statement (which is situated within the Directors' Report in the Annual Report and Accounts) and therefore must approve any divergence from the Code and the relevant explanation.

The 'comply or explain' method of adherence has given companies flexibility and made it possible to set more demanding standards than can be done through hard rules. Experience has shown that the vast majority of companies attain these standards – in 2014 the Grant Thornton survey of compliance by FTSE 350 companies found that 94 per cent of companies complied with all, or all but one or two, of the 54 provisions in the Code. And by requiring companies to report to shareholders rather than regulators means that the decision on whether a company's governance is adequate is taken by those in whose interest the board is meant to act.

The FRC has commenced a communications exercise to raise standards and promote the flexibility of 'comply or explain'. Through this we will be reminding both companies and investors that simply complying without giving due consideration to what is appropriate and relevant reduces the flexibility that this approach aims to achieve. To this end, further work will be conducted during the rest of this year to monitor reporting by companies on explanations given when they are not compliant with the Code. The FRC will also continue to discuss with the FCA the best way to achieve better quality explanations.

Yours sincerely



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