FRC

Financial Reporting Council

Review of the effectiveness of The Combined Code

Progress Report and Second Consultation

July 2009

INTRODUCTION

Background

Since the last major revisions to the Combined Code on Corporate Governance in 2003, following the Higgs and Smith reports on non-executive directors and audit committees respectively, the FRC has reviewed the impact and implementation of the Combined Code every two years. This is the third such review.

The current review began in March 2009 with a call for evidence on the impact and effectiveness of the Code. The FRC would like to thank all those who have taken the time to input to this review.

When announcing this review the FRC stated that, in the light of the significant change in the economic conditions since the previous review in 2007, it was appropriate to look at all aspects of the content and application of the Code to ensure that it remained effective.

The initial consultation period ended on 29 May, and 114 responses were received. Separately the FRC held a series of meetings with the chairmen of FTSE companies between April and June. In total the chairmen of nearly 100 companies participated. Summaries of the main points raised by respondents to the consultation and in the meetings with chairmen are being published alongside this report, and copies of individual responses are available on the FRC website[1]. We have also considered the findings from various research publications and surveys. We are particularly grateful to the JCA Group for interviewing investors, companies and advisers on the FRC's behalf to obtain their views on the effectiveness of shareholder engagement[2].

There are a number of other recent developments that need to be considered alongside the evidence from this review. Particularly important is the Walker Review. Sir David Walker issued his first consultation paper on 16 July[3], the relevant recommendations of which are summarised in this document. While Sir David has made it clear that his principal focus is on the governance practices of banks and other financial institutions, the FRC will need to consider the extent to which any of his recommendations should also be considered best practice for all listed companies, or for a clearly definable sub-set of listed companies such as the FTSE 100 or FTSE 350; and, with the FSA, how best to implement these recommendations.

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[1] These documents are available at http://www.frc.org.uk/corporate/reviewCombined.cfm

[2] The JCA Group's report "Corporate Governance and the Effectiveness of Shareholder Engagement" is available at http://www.jcagroup.net/publications.html

[3] The report is available at http://www.hm-treasury.gov.uk/walker_review_information.htm

Sir David Walker's consultation paper recommends extensions to the FRC and FSA's remit to encourage and monitor active engagement by institutional investors, and a possible role for the FRC in relation to remuneration consultants. The FRC is willing to consider taking on an enhanced role and will be discussing the implications of these proposals with Sir David, the FSA and others. These issues are discussed in more detail in Section 2 of this report.

Other developments include the European Commission's Recommendation on the remuneration of executive directors of listed companies[4], published in April, and the recommendations on remuneration and the provision of non-audit services by a company's auditors contained in the report by the House of Commons Treasury Select Committee published in May[5]. The implications of these recommendations for the Combined Code will need to be assessed.

Summary of feedback to date

The FRC believes that the strength of the response means that what we have heard can reasonably be assumed to be representative of the view of market participants as a whole. That view can be summarised as:

- The Combined Code and its predecessors have contributed to clear improvements in governance standards since the first code was introduced in 1992;

- While there are differing views about the extent to which the perceived shortcomings in governance in the banking sector are replicated in the listed sector as a whole, many consider at least some of them to be specific to that sector;

- There is a recognition that the quality of corporate governance ultimately depends on behaviour not process, with the result that there is a limit to the extent to which any regulatory framework can deliver good governance; and

- Market participants have expressed a strong preference for retaining the current approach of 'soft law' underpinned by some regulation, rather than moving to one more reliant on legislation and regulation. It is seen as better able to react to developments in best practice, and because it can take account of the different circumstances in which companies operate it can set higher standards to which they are encouraged to aspire.

[4] The Recommendation is available at http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm
[5] The Report is available at http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf

While the view of a large majority of respondents was that there is no need for a complete overhaul of the content of the Combined Code, there are a number of parts of the Code which need further review and possibly revision. These are addressed in Section 1 of this report.

Both companies and investors have expressed reservations about the way in which "comply or explain" works in practice, and it is clear that more needs to be done to encourage all parties to apply it in the intended manner. These issues are addressed in Section 2 of the report.

The FRC shares the market's view that the flexible 'soft law' approach remains the most appropriate way of raising standards of corporate governance in listed companies, as does Sir David Walker in his recent consultation paper. But the continuing credibility of this approach depends on there being consensus that the contents of the Code are conducive to best practice, and on companies and investors acting in the spirit, not just the letter, of the Code and "comply or explain".

In particular it is of critical importance that there are sufficient institutional investors willing and able to engage actively with the companies in which they invest. This cannot be taken for granted – dispersed ownership, the declining market share of UK insurance companies and pension funds and resource constraints are all potential obstacles to achieving this objective. In their turn, companies must be willing to welcome communication with their shareholders as an opportunity to obtain an informed external perspective on their performance.

Next steps

The FRC is not making any specific proposals to amend the Code or enhance "comply or explain" at this stage. If it is concluded that any such changes would be appropriate, these will be subject to separate consultation later in the year.

The FRC aims to publish its final report, and begin consultation on whatever changes may be proposed to the Combined Code, before the end of the year. Subject to the outcome of that consultation, a revised Code would take effect in mid-2010.

Submitting views

The FRC would welcome any additional comments or other evidence on the issues identified in this document. **If you have already given your views on these issues as part of the initial consultation, there is no need to do so again as those comments will be taken into account when assessing the overall evidence gathered as part of the review.**

Any further comments should be submitted by 9 October 2009:

by e-mail to codereview@frc.org.uk

or by post to:

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

It is the FRC's policy to publish on its website all responses to formal consultations issued by the FRC and/or any of its Operating Bodies unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

SECTION 1: THE CONTENT OF THE COMBINED CODE

Introduction

Many commentators on the review have identified parts of the Combined Code which they consider may need to be amended. The main issues identified are set out in this report and the accompanying summaries of responses to the consultation exercise and the meetings held with the chairmen of FTSE companies.

Almost all commentators also said that they continue strongly to support the principles-based approach of the Code and the flexibility provided by "comply or explain", and that they would not want the perceived advantages of this approach to be lost.

For this reason the FRC intends to adopt three guiding principles when assessing the lessons to be learnt from the financial crisis and the case for changes to the Code and its accompanying guidance during the next phase of the review. These are:

- Where there is a demonstrable need for best practice to be clarified or strengthened, this will be addressed either through amendments to the Code or additional, non-binding guidance;

- Where not constrained by regulatory requirements, we will seek to rationalise disclosure requirements in the Code to encourage more informative disclosure on the issues of most importance to investors and to discourage boiler-plating and box-ticking; and

- We will seek to avoid an increase in the overall level of prescription in the Code and to preserve its principles-based style.

In addition, if there is evidence that the Code may inadvertently have made it more difficult for boards and committees to operate effectively, changes to the relevant sections of the Code will be considered.

The FRC would welcome views on these guiding principles.

Under each of the issues in this section we have included a summary of the relevant recommendations in the Walker Review's consultation paper issued on 16 July. These recommendations are directed to banks and other financial institutions (BOFIs), and in his consultation paper Sir David Walker noted that it "leaves for separate consideration how far Combined Code changes that are proposed in respect of BOFIs should be extended to provisions in respect of non-financial institutions".

This consultation is part of that separate consideration and views are invited. The FRC has reached no conclusions at this stage on whether Sir David's recommendations – which are still subject to consultation – should be extended to all non-financial listed companies, or to a sub-set of such companies, for example FTSE 100 or FTSE 350 companies or companies in specific sectors.

The responsibilities of the chairman and the non-executive directors

Current position

The statutory duties of all directors are set out in Sections 170 to 177 of the Companies Act 2006. They include the duties to promote the success of the company, to exercise independent judgement, and to exercise reasonable care, skill and diligence.

The Combined Code does not attempt to define the role and responsibilities of the chairman and non-executive directors in full. The main responsibilities of the chairman are set out in the supporting principle to Section A.2, and of the non-executive directors in their capacity as members of the board in the supporting principles to Section A.1. Further, non-binding, guidance is set out in "Good Practice Suggestions From The Higgs Report"[6].

In addition, specific responsibilities are identified in other parts of the Code, for example in relation to the composition and operation of board committees and, in relation to the chairman, communication with the shareholders. The Code also identifies some responsibilities of the Senior Independent Director (SID). Section A.4 of the Code discusses the time commitment needed from the chairman and the non-executive directors, without being prescriptive.

Issues for consideration

Many commentators on the review believed the performance of company chairmen to be crucial to good governance, as they are primarily responsible for the culture of the board, and by extension the organisation as a whole, and for ensuring that the board operates effectively. Some felt that further clarification of the chairman's role might be helpful, for example in relation to assessing the executive management and ensuring the board was aware of shareholder views, although there was also a concern that greater prescription should not limit the chairman's ability to exercise his or her own judgement.

Some commentators considered it would be helpful to provide further clarification of the responsibilities of the non-executive directors, in particular the importance of providing constructive challenge to improve the development of the company's strategy. Some of those who held this view considered this would be helpful for non-executive directors; others considered that a clearer explanation of their role and its limits may help to manage what might otherwise be unrealistic expectations of non-executive directors. Other commentators considered that the Code paid insufficient attention to the role of the executive directors.

[6] The guidance is available at http://www.frc.org.uk/corporate/combinedcode.cfm

Summary of the Walker Review recommendations

Recommendation 3: Non-executive directors (NEDs) should be expected to give greater time commitment, with a minimum expected time commitment of 30 to 36 days.

Recommendation 6: NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive.

Recommendation 7: The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity.

Recommendation 8: The chairman should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position.

Recommendation 9: The chairman should encourage and expect the informed and critical contribution of the directors and promote effective communication between executive and non-executive directors.

Recommendation 11: The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.

Specific issues for further consideration include:

- Whether it would be helpful to give further clarification of the role, key responsibilities and expected behaviours of the chairman, the senior independent director and/ or the non-executive directors, either in the Code or in non-binding guidance.

- ·Whether it would be helpful to provide further guidance on the time commitment expected of the chairman, senior independent director and / or non-executive directors.

In considering these issues it will be necessary to balance the benefits that might be derived from a clearer exposition of the role and responsibilities of these board members with the risk that over-specification of either the qualities needed or time commitment expected might unnecessarily reduce the pool of people qualified and available to carry out these roles.

Board balance and composition

Current position

Section A.3 of the Combined Code addresses board balance, composition and independence. Its recommendations include that there should be a strong presence on the board of both executive and non-executive directors, with a minimum level of independent non-executive representation (50% of the board in FTSE 350 companies and at least two independent non-executives in smaller listed companies). It also sets out some criteria against which the independence of non-executive directors should be assessed, although it is open to companies to conclude that an individual remains independent even when one or more of these criteria is relevant.

Section A.3 also states that undue reliance should not be placed on particular individuals when deciding the membership of board committees. Elsewhere, the Code recommends that the three main board committees – nomination, audit and remuneration – should consist entirely or mainly of independent non-executive directors.

Issues for consideration

For a board to fulfil its role effectively it needs its members collectively to have both directly relevant experience and a broad range of skills and expertise; it needs to refresh its membership while ensuring continuity; and it needs to do all this without the board becoming so large as to make proper debate and decision-making impossible.

This is a very difficult balance to achieve and there is a perception among some commentators on the review that not all boards have managed to do so. There is also a perception that Section A.3 of the Code may inadvertently have made it more difficult for boards to achieve this balance by placing too much relative weight on one or other factor, or by being applied in an overly mechanistic way by some boards and investors. The issues that have been raised include:

- How to get the balance between the need for independence and the need for experience;

- The extent to which boards of non-financial companies need non-executive directors;

- Whether all the independence criteria identified in the Code remain relevant; and

- The appropriate balance between executive and non-executive directors.

For this reason the FRC will be looking at Section A.3 in its entirety to consider whether there is evidence to support this perception and, if so, how this section might be amended to help chairmen and nomination committees strike a better balance when considering the composition of the board.

Summary of the Walker Review recommendations

Recommendation 4: The FSA's supervisory process should give closer attention to the overall balance of the board and take into account the relevant experience and other qualities of individual directors

Recommendation 5: The FSA's interview process for NEDs should involve questioning and assessment by one or more senior advisers with relevant industry experience at or close to board level of a large or complex entity.

Specific issues for further consideration include:

- Whether the Combined Code gives sufficient emphasis to the need for relevant experience among the non-executive directors collectively.

- Whether the independence criteria and the way they have been applied by boards of companies and investors have unnecessarily restricted the pool of potential non-executive directors, and in particular whether the so-called "nine year rule" has resulted in a loss of continuity and valuable experience.

- Whether the recommendation that the boards of FTSE 350 companies should comprise at least 50% independent non-executive directors has resulted in fewer executive directors sitting on boards and/or boards becoming larger.

- Whether more guidance is needed, in the Code or elsewhere, on succession planning and the need to ensure that board composition is aligned with the present and future needs of the business.

Frequency of director re-election

Current position

Section A.7 of the Combined Code recommends that all directors should be subject to re-election at least every three years, except for non-executive directors who have served more that nine years who should be subject to re-election every year. There is no statutory restriction on the length of terms that can be served by directors, meaning that there is nothing to prevent companies from putting some or all directors up for re-election more frequently than recommended by the Code.

Issues for consideration

In the wake of the problems in the financial sector there have been calls for some or all board directors to be subject to re-election on an annual basis on the grounds that this would increase their accountability to shareholders. For example, the Institutional Shareholders' Committee has proposed that the chairmen of the three main board committees should be subject to annual re-election, with the chairman of the board being put up for re-election the following year should any of them receive less than 75% support. Some commentators on the review supported this position, with some arguing that the company chairman should also be subject to annual re-election.

A small number of companies already put the entire board up for re-election annually. Some commentators have argued that this would be more equitable than singling out individual directors, which might also exacerbate existing difficulties in finding chairmen for the audit and remuneration committees; others felt that re-election of the entire board – or of individual directors - would risk greater uncertainty and might encourage "gaming" on the part of some investors, particularly in relation to smaller companies with less dispersed shareholder bases.

A number of commentators on the review have suggested that, rather than focusing on the performance of individual board members, there may be other ways in which voting could be used to increase the accountability of the board, for example through an advisory or binding vote on the risk report or the corporate governance statement.

Summary of the Walker Review recommendations

Recommendation 10: The chairman of the board should be proposed for election on an annual basis.

Recommendation 36: If the non-binding resolution on a remuneration committee report attracts less than 75 percent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

Views are invited from companies and investors on whether changes to voting would increase accountability to shareholders and which, if any, of the following options they would support as recommendations for possible inclusion in the Code:

- Annual re-election of the company chairman.
- Annual re-election of the chairs of the main board committees.
- Annual re-election of all directors.
- Binding or advisory votes on specific issues, or on the corporate governance statement as a whole.

Board information, development and support

Current position

Section A.5 of the Combined Code states that the board should be supplied in a timely manner with information that will enable it to discharge its duties, and that all directors should receive induction on joining the board and regularly update and refresh their skills and knowledge. It recommends that all directors should have access to the advice and services of the company secretary, and to independent professional advice at the company's expense where they deem it necessary.

Issues for consideration

Many commentators on the review highlighted the need for the non-executive directors individually and collectively to have sufficient knowledge of, and information about, the business to be able effectively and constructively to challenge the executive. This could be obtained in a number of ways:

- Through prior relevant experience, which the sections of the Code dealing with board balance and composition should facilitate;

- Through the information they received, whether from the executive or from independent sources. Some commentators felt that the Code could encourage non-executive directors to make more use of independent sources of advice;

- Through greater contact with the operational activities of the company. Some commentators felt non-executive directors could be more proactive in this respect, and that it was the responsibility of the chairman and CEO to facilitate these contacts, while recognising the implications in terms of the overall time commitment required of non-executive directors; and

- Through induction and ongoing professional development.

The role of the company secretary was considered important to the effective functioning of the board. Various proposals were put forward for increasing its effectiveness, for example through greater resource, more clearly defined responsibilities or a change of reporting lines. There was not a great deal of support for the proposition that the secretariat should be completely divorced from the executive, with the majority of those who commented taking the view that this would reduce rather than increase effectiveness and might undermine the unitary board.

Summary of the Walker Review recommendations

Recommendation 1: The board should provide thematic business awareness sessions for NEDs on a regular basis. The induction, training and development programme for each NED should be reviewed annually with the chairman

Recommendation 2: The board should provide dedicated support for NEDs on any matter on which they require advice separate from that available in the normal board process.

Recommendation 9: The chairman should be responsible for ensuring that the directors receive accurate and timely information.

Views are invited on whether it would be helpful to provide more guidance on some or all of these issues, either in the Combined Code or in non-binding guidance.

Board evaluation

Current position

Section A.6 of the Combined Code states that the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors, and state in the annual report how it has been conducted. The Code does not specify how the evaluation should be conducted.

Issues for consideration

The recommendation for an annual evaluation of board performance was added to the Code in 2003. While many companies expressed scepticism about the value of such an exercise at the time, in discussions with company chairmen as part of this review, the FRC found almost universal agreement that regular evaluation is a beneficial process. The debate now is about the design and frequency of evaluation, not whether it should be carried out at all.

Many investors and other commentators considered that external facilitation can add a necessary degree of objectivity and evaluation experience to board effectiveness reviews. Many larger companies already undertake external reviews, either annually or intermittently; anecdotally the practice appears to be less frequent among smaller listed companies.

Investors and other commentators would like to see more informative disclosure from companies about the process followed and any actions that have been taken as a result. One respondent to the consultation proposed that the board should include an "assurance statement", which would report on the board evaluation review but might also comment on other aspects of board effectiveness, such as the working methods of the board, how its composition served the business needs of the organisation and succession planning.

Summary of the Walker Review recommendations

Recommendation 12: The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report. Where an external facilitator is used, this should be indicated in the statement, together with an indication whether there is any other business relationship with the company.

Recommendation 13: The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders understanding of the main features of the evaluation process. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.

Specific issues for further consideration include:

- Whether the Code should be amended to recommend that board evaluations should be externally facilitated at least every two or three years for some or all companies.

- Whether the recommendation that the effectiveness of all the main board committees should be evaluated every year should be relaxed in some way, for example to recommend a rolling cycle of committee reviews. Some commentators considered that after the initial evaluation there was limited value in subsequent annual reviews.

- How disclosures in the annual report might be made more informative, either in relation to the process that was followed and/ or the outcomes of the effectiveness review.

On the last issue, the FRC believes that the proposal for an "assurance statement" merits further consideration as it may provide a means of enabling investors to obtain more relevant information while allowing some other disclosure requirements in the Code to be rationalised, and would welcome views on what might be covered by such a statement.

Risk management and internal control

Current position

Section C.2 of the Combined Code states that companies should maintain a sound system of internal control, the effectiveness of which should be reviewed at least annually with the review being reported on in the annual report. Further guidance on this subject, including recommendations on disclosure, is set out in the Turnbull Guidance, which was last revised in 2005.

Listed companies are also required under the Companies Act 2006 to include in the Business Review a description of the principal risks and uncertainties facing the company, and under the FSA's Disclosure and Transparency Rules to describe the main features of the internal control system as it relates to financial reporting. In addition, IFRS 7 requires companies to set out in their audited accounts how they manage financial risks and a summary of the information that key operating decision makers use to manage those risks. All of these disclosures are monitored by the Financial Reporting Review Panel (FRRP), which is part of the FRC.

Issues for consideration

Many commentators on the review distinguished between the management of operational risks, for which the majority considered existing processes and guidance to be sufficient (at least for non-financial companies), and the management of strategic risks, in particular "high impact, low probability" risks. In the latter case the board's responsibility for setting the risk appetite and profile of the company was of particular importance.

There was a view that not all boards had carried out this role adequately, and in discussion with the chairmen of listed companies many agreed that the financial crisis had led their boards to devote more time to consideration of the major risks facing the company. There were differing views about the extent to which risk management systems below board level may need to be reviewed in non-financial companies.

Some commentators on the review were critical of companies' reporting on risk, which investors felt was often uninformative. In its most recent annual review, published in October 2008[7], the FRRP also identified some common failings in business reviews including lack of clarity about the business model and specific risks and uncertainties, and the use of boiler-plate descriptions.

[7] The Annual Review is available at http://www.frc.org.uk/frrp/press/pub1717.html

As noted above there are various overlapping disclosure requirements relating to risk management and internal controls, and this complexity adds to the difficulty for both companies and readers of annual reports. It may be possible to rationalise these requirements, although the scope for doing so is constrained by the fact that many of them are required by statute or FSA Rules.

Summary of the Walker Review recommendations

Recommendation 23: The board should establish a risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy.

Recommendation 24: The board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units.

Recommendation 25: The board risk committee should have access to and, in the normal course, expect to draw on external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

Recommendation 26: The board risk committee should oversee a due diligence appraisal of proposed acquisitions or disposals.

Recommendation 27: The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.

Specific issues for further consideration include:

- Whether the board's responsibility for strategic risks and setting risk appetite – as set out in the Turnbull Guidance - should be made more explicit in the Code, and whether the current balance between the Code and the Guidance is the right one.

- Whether there is a need for all or parts of the Turnbull Guidance to be reviewed.

- To what extent the particular mechanisms recommended for banks and financial institutions would also be appropriate for other listed companies. For example, there were mixed views among commentators about whether separate risk committees were necessary for companies with less complex business models.

- How reporting on risk might be improved, for example by rationalising existing disclosure requirements or providing guidance on good communications tools.

Remuneration

Current position

Section B.1 and Schedule A of the Combined Code contain recommendations on the level and make-up of remuneration; Section B.2 sets out the procedures to be followed when setting remuneration for executive directors, including the composition and remit of the remuneration committee.

Listed companies are also subject to the Directors' Remuneration Reporting Regulations 2002 ("the 2002 Regulations"), which require disclosure of the remuneration of individual directors and the company's remuneration policy, on which shareholders are given an advisory vote at the annual general meeting.

Issues for consideration

Respondents to the review commented on many different issues including:

- The link between risk and remuneration;
- The need to ensure remuneration policies promote the long-term interests of the company;
- The design of remuneration packages;
- The remit, composition and effectiveness of the remuneration committee;
- The role of shareholders in setting remuneration of directors;
- The remuneration of employees below board level;
- The use of remuneration consultants; and
- The need for further guidance or disclosure on different aspects of remuneration.

During the course of this review a number of other reports have been issued recommending action on remuneration. Many of these developments relate specifically to banks and other financial institutions. In addition to the recommendations of the Walker Review summarised below, the FSA has consulted on a proposed code of remuneration practice which is expected to take effect in January 2010[8], and the European Commission issued a non-binding Recommendation on the same subject in April 2009[9]. The Commission has stated that it will bring forward legislation later in the year.

While the detailed practices contained in these documents are specifically intended for banks and other financial institutions, some of the principles they set out may also be applicable to non-financial listed companies, for example that remuneration policies should be consistent with effective risk management.

The European Commission also issued in April a revised version of the Recommendation on the remuneration of directors of listed companies originally issued in 2004[10]. While many of the practices recommended have already been implemented in the UK through either the Code or the 2002 Regulations, there are some new elements. Some of these relate to areas that are addressed in the Code, for example the composition of the remuneration committee and the use of remuneration consultants.

In its report on reforming corporate governance and pay in the City, the House of Commons Treasury Select Committee[11] reported on the role of shareholders in setting remuneration and commented that "the time is now ripe for a review of how institutional investors with holdings in the financial services sector have exercised these rights [for an advisory vote]". A few respondents to the review considered that shareholders might be given a more direct role in setting directors' remuneration, for example through a vote on individual remuneration packages.

[8] The consultation draft of the code is available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf
[9] The Recommendation is available at http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm
[10] See previous footnote for details of availability
[11] Available at http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf

Summary of the Walker Review recommendations

Recommendation 28: The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on risk.

Recommendations 29 and 30: The remuneration committee should oversee remuneration of all executives for whom total remuneration exceeds or might exceed the median compensation of executive board members. The remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group, and disclose total remuneration, in bands, indicating numbers of executives in each band.

Recommendation 31: The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed.

Recommendation 33: At least half the variable remuneration offered should be in the form of a long-term incentive scheme with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used.

Recommendation 34: Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards. Vesting of stock for this group should not normally be accelerated on cessation of employment.

Recommendation 35: The remuneration committee should seek advice from the board risk committee on specific risk adjustments to be applied to performance objectives set in the context of incentive packages.

Recommendation 37: The remuneration committee report should state whether any executive board member has the right to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance benefits.

Recommendations 38 and 39: The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the code. The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.

Specific issues for further consideration include:

- Whether to revise the Code to ensure consistency with the European Commission's Recommendations and, where appropriate, the FSA's proposed code of remuneration practice for financial institutions and the recommendations of the Walker Review.

- Whether any other changes to the Code, or additional guidance, are required to reflect developments in best practice.

- Whether shareholders should be given a more direct role in setting remuneration and, if so, how this might be achieved.

SECTION 2: THE IMPLEMENTATION OF THE COMBINED CODE

Introduction

The Combined Code operates on the basis of "comply or explain". To be fully effective "comply or explain" requires companies to provide their shareholders with the information they need to judge the adequacy of the company's governance arrangements, and it requires investors to consider those arrangements on their merits, even where they deviate from the Code.

There are three primary reasons why this approach is perceived to be more appropriate than regulatory monitoring and enforcement for the sort of issues that the Code addresses:

- While it encourages companies to follow accepted best practice, it recognises that in certain circumstances it may be appropriate for them to achieve good governance by other means;

- By allowing a degree of flexibility it enables the Code to set more demanding standards than would be appropriate in regulation. It can also be more easily adapted to take account of developments in best practice; and

- It leaves decisions about the appropriateness of a company's governance arrangements in the hands of its board and owners.

A number of commentators have called for a change of terminology, arguing that the term "comply or explain" should be replaced by "apply or explain". It is argued that this change might encourage companies to be more willing to explain where it was appropriate to do so, rather than feeling compelled to comply in all circumstances, and encourage investors and proxy voting services to take less of a box-ticking approach. It is not self-evident that this would be the effect but the FRC will give further consideration to the proposal. In doing so we will look at the experience in those countries such as the Netherlands that have adopted the term "apply or explain". Any change would need to be agreed with the FSA as it would require a change to be made to the Listing Rules and Disclosure and Transparency Rules.

To be fully effective "comply or explain" also requires both sides to be willing to engage when necessary. Discussions with company chairmen identified a number of potential benefits from engagement, including developing a relationship which might encourage investors to take a long term view, and getting an investor's view on the strategy and the quality of the management team.

While some companies reported that they had been able to develop constructive relationships with their major shareholders, there was also a lot of frustration with how engagement worked in practice. This frustration was shared by many active investors, some of whom also commented on the variable quality of reporting on corporate governance matters.

Ultimately, responsibility for the effectiveness of "comply or explain" rests with companies and investors, but there may be actions that the FRC could take to encourage more informative disclosure and more effective engagement. These are discussed in the next sections.

The quality of disclosure by companies

Current position

UK listed companies are required under the FSA's Listing Rules and Disclosure and Transparency Rules to disclose:

- How they have applied the principles of the Combined Code;
- Whether they have complied with the provisions of the Code and, if not, to explain why not. Some provisions of the Code are complied with by disclosing further information; and
- Certain mandatory requirements under the Disclosure and Transparency Rules.

In addition UK incorporated and listed companies are subject to other requirements under the Companies Act 2006 to disclose information that is relevant to an assessment of their corporate governance, for example disclosing their principal risks as part of the Business Review.

The Financial Reporting and Review Panel (FRRP) has statutory responsibility for monitoring and enforcing the Business Review. From July 2009 onwards the FRRP will also monitor on behalf of the FSA a small number of mandatory corporate governance disclosures required under the Disclosure and Transparency Rules. If it appears on the basis of its annual report that a company may not have met these requirements, the FRRP will refer the matter to the FSA to decide whether to take follow-up action.

Issues for consideration

As with previous reviews of the Combined Code, many respondents commented on the usefulness or otherwise of disclosures made by companies reporting against the Code. The majority view was that, while there were some good examples of informative corporate governance statements and the overall standard had shown some improvement, there continued to be a tendency towards boiler-plate reporting.

There are particular concerns about the amount of information provided when companies choose to explain rather than comply with a provision of the Code, or in some cases about failure to disclose information required in order to comply. Grant Thornton's most recent survey of the corporate governance statements of FTSE 350 companies found that 5% of companies failed to give an explanation for one or more instance of non-compliance[12].

[12] 'Harmony from Discord: emerging trends in governance in the FTSE 350'; Grant Thornton; 2009

Ultimately, the usefulness of disclosures will be determined by the mindset of the company. Those companies that see corporate governance, and the Combined Code in particular, as a compliance exercise are more likely to produce defensive and boiler-plate disclosures than those who see it as an aid to better management of the company, and disclosure as an opportunity to communicate with their shareholders.

There is only so much that pressure and encouragement from investors and regulators can achieve among the first group, but there may be steps that can be taken by the FRC or other regulators to assist those companies seeking to communicate to do so more effectively and/or to ensure that the minimum requirements of the Listing and Disclosure and Transparency Rules are being met. The role that investors can play is discussed in the next section.

Some commentators on the review were of the opinion that the Combined Code itself encourages boiler-plate reporting, identifying as it does nineteen separate pieces of information that must be disclosed in order to comply, and suggested that the corporate governance reporting model - of which the Code is just a part - should be overhauled in order to encourage more informative reporting. This might be done either by reducing the number of different disclosure requirements, retaining only those on which investors placed most importance, and/or recasting them so that companies report on outcomes rather than processes.

This objective is consistent with that of the FRC's project to reduce complexity in corporate reporting, a discussion paper on which was issued in June[13]. While there are some constraints on the ability to change the existing disclosure requirements, not least that some derive from UK or EU legislation, the FRC will look at the scope for rationalisation.

There were mixed views among respondents on whether it would be useful for the FRC and/or the FSA to undertake formal monitoring and enforcement of the "comply or explain" element of the corporate governance statement to ensure that companies were meeting the requirements in the Listing and Disclosure and Transparency Rules. Some felt this could help ensure that a greater degree of information was provided when a company chose to explain; others were concerned that regulatory intervention could reduce the valued flexibility of the current system.

[13] The discussion paper is available at http://www.frc.org.uk/press/pub1994.html

If the FRC were to undertake a formal monitoring role of some sort it would be limited to checking whether an explanation had been provided, not whether that explanation was appropriate. The latter judgement rightly rests with the company's shareholders. The potential costs for the FRC, FSA and listed companies would also need to be considered alongside the likely benefits. If the FRC were to undertake such a role we would issue an annual report on the results of our scrutiny.

Summary of the Walker Review recommendations

There were no recommendations on this issue, but the report noted that it was for separate consideration "whether, in respect of amended provisions for BOFIs, an explicit and dedicated Combined Code review and monitoring process should be put in place beyond that currently undertaken by the FRC".

Specific issues for further consideration include:

- The extent to which it would be possible and desirable to rationalise the disclosure requirements set out in the Code. We would particularly welcome the views of investors on what information is of most value to them, and the views of companies on what information is most costly to produce.

- Whether it would be appropriate for the FRC or the FSA to undertake greater monitoring and enforcement of "comply or explain" statements, and if so what form this might take.

Views are invited on these issues, and on whether there are any other actions that the FRC might take to encourage more informative disclosure.

<u>Engagement between boards and shareholders</u>

<u>Current position</u>

Section D.1 of the Combined Code states that the board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place, and places particular responsibility on the chairman, and to a lesser extent the senior independent director, for ensuring that this happens. Companies are expected to disclose what steps have been taken to ensure that the board understands the views of major shareholders. The Code also identifies particular circumstances in which dialogue with shareholders is encouraged, for example if considering appointing the CEO to be chairman (Section A.2.2).

Section E of the Code is directed to institutional shareholders and their agents and sets out a number of principles, such as the need to enter a dialogue with companies based on a mutual understanding of objectives, to make reasoned judgements when a company chooses to depart from the Code, and to make considered use of their votes. Unlike companies, investors are currently under no obligation to disclose how they have applied the Code as the Listing Rule requirements described in the previous section do not apply to them.

More detailed best practice on engagement for investors is set out in the Statement of Principles issued by the Institutional Shareholders' Committee (ISC)[14], which is endorsed in Section E.

Many leading institutions have chosen to engage actively, in the belief that doing so can add to the value of their investment. For a variety of reasons - such as their choice of investment strategy, constraints on resources or scepticism about the value of engagement and governance – others have not. In addition the market share of those institutions that have traditionally taken the lead in engagement - UK insurance companies and pension funds - has declined in recent years as they have diversified their investments and other UK and foreign investors have increased their holdings.

Given the highly dispersed ownership of many listed companies, it is understandable that some investors may have concluded that resource devoted to engagement may have little return in terms of direct influence on the board. But it also seems likely that, looking at the cumulative impact of investor engagement, the whole may be greater than the sum of the parts by making specific interventions more effective, and because of the message this then sends to the market as a whole.

[14] The Statement of Principles is available at http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCStatementofPrinciplesJun07.pdf

Issues for consideration

As with previous reviews, commentators reported differing experiences of engagement. There were many positive comments, with some listed companies reporting that they had succeeded in developing constructive relationships with their major shareholders, but two related concerns came through consistently:

- Frustration on the part of companies and investors about the quality of existing engagement. Some familiar criticisms were raised, for example the perceived box-ticking approach to compliance on the part of some investors and some proxy voting services; inconsistent positions being taken by corporate governance departments and fund managers within the same institution; and lack of openness and transparency on the part of some companies.

- A concern that too many institutional investors were unwilling or unable actively to engage with investee companies. Some companies who contributed to the review were frustrated because, as they saw it, the Code and Listing Rules obliged them to attempt to engage with investors who were under no obligation to reciprocate. Other commentators, including some investors, considered this was a derogation of their responsibilities as owners.

For these reasons, some respondents to the consultation suggested that Section E of the Code should be expanded and perhaps made subject to "comply or explain". Others proposed that there should be a separate, stand-alone "comply or explain" code for investors. There were mixed views about the extent to which it would be appropriate for the FRC or other regulators to be involved in the monitoring and enforcement of any such code.

There have been a number of important developments on this issue since the review of the Combined Code began in March. In June the ISC announced its intention to upgrade its Statement of Principles to a code and that those investors that chose to sign up to that code would be expected to disclose how it had been applied. More recently, the Walker Review has recommended that the FRC should sponsor the ISC Statement of Principles and, with the ISC, review them annually. Sir David also envisages a role for the FSA in encouraging fund managers and other institutions that it authorizes to commit to the Statement of Principles and to disclose against them on a "comply or explain" basis.

Any decisions on how to proceed cannot be taken by the FRC in isolation, and further discussions will be held with the Walker Review team, the ISC, the FSA and other interested parties over the next few months

Sir David Walker has also made recommendations intended to encourage co-operation between investors on engagement. The FRC welcomes these proposals and agrees with Sir David that any specific mechanisms for arranging collective engagement are best developed by investors themselves. But the FRC would be willing to play a supporting role to encourage broader participation if that was felt helpful and an appropriate role could be defined. However, under no circumstances would the FRC intervene in discussions between investors and individual companies.

While these initiatives will hopefully contribute to an increased level of engagement, they will not address all of the frustrations and barriers to engagement identified by respondents to the review. Some of these are structural barriers that will take time to address if they can be addressed at all – such as changes to ownership structures and the bunching of annual general meetings – but others are behavioural and there may be actions that can be taken by companies and investors to make the relevant aspects of engagement easier. For example, the research conducted by the JCA Group[15] identified potential best practices that could be adopted by boards and investors, and other good practices were identified by respondents to the review.

Some commentators from companies considered that some of the existing recommendations in the Code - such as encouraging non-executive directors to meet major shareholders when there appeared to be little demand on the part of the shareholders for such contacts - contribute to the sense of frustration and might be amended.

Summary of the Walker Review recommendations

Recommendation 14: Boards should ensure they are made aware of any material changes in the share register and take steps to respond if any are required.

Recommendations 16 to 18: The remit of the FRC should be extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. They should do so by sponsoring Principles of Stewardship based on the ISC Statement of Principles. The ISC and FRC should review these Principles annually.

[15] The report is available at http://www.jcagroup.net/publications.html

Recommendation 19 and 20: Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship, and the FSA should require disclosure of such commitment on a comply or explain basis.

Recommendation 21: To facilitate effective collective engagement, a Memorandum of Understanding should be prepared among major long only UK investors.

Recommendation 21: The FRC and major UK fund managers and institutional investors should encourage major foreign institutional investors to commit to the Principles of Stewardship and Memorandum of Understanding.

Recommendation 22: Fund managers and other institutional investors should disclose their voting record and their policies in respect of voting.

Specific issues for further consideration include:

- The framework proposed by Sir David Walker, and the appropriate role for the FRC.
- What role, if any, it would be appropriate for the FRC to play in encouraging collective engagement.
- Whether further guidance on best practice for companies, investors or proxy voting services would be helpful, either in the Combined Code or elsewhere, and whether the practices currently recommended in Sections D and E of the Code continue to represent best practice.
- What other steps might be taken, by the FRC or others, to encourage both companies and investors to be more proactive about regular engagement and with a longer term focus than the annual results presentations.

Views are invited on all of these issues.

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