



FINANCIAL REPORTING COUNCIL

**2007 REVIEW OF THE COMBINED CODE:
CONSULTATION ON PROPOSED CHANGES TO THE CODE**

DECEMBER 2007

INTRODUCTION

1. During the course of 2007 the Financial Reporting Council has carried out a review of the impact and implementation of the Combined Code, the results of which were published in November.
2. The review found that the Code continues to have a broadly beneficial impact, and is seen as having contributed to higher overall standards of governance among UK listed companies and to more professional boards. It was considered that the FRC should focus its efforts on improving the practical application of the Code as this would be of greater benefit than a major overhaul of the content of the Code, which enjoys broad support.
3. In the light of these findings the FRC is consulting on only two possible changes to the Code:
 - removing the restriction in provision A.4.3 on an individual chairing more than one FTSE 100 company; and
 - for listed companies outside the FTSE 350, amending provision C.3.1 to allow the company chairman to be a member of, but not chair, the audit committee provided he or she was considered independent on appointment.
4. Draft changes to the Code are set out in this consultation document. The document also explains other amendments which the FRC intends to make to the Preamble and Schedules to the Code as a result of the FRC review and EU legislation.

TIMING

5. Consultation on the proposed amendments is being carried out in parallel with an FSA consultation on the draft new FSA Rules needed to implement the corporate governance requirements in the 4th and 8th Company Law Directives (which respectively require listed companies to produce a corporate governance statement and to have an audit committee). It is also the intention that the new Rules and any changes to the Code should take effect at the same time; it is provisionally intended that both will apply to financial years beginning on or after 29 June 2008.

HOW TO COMMENT

6. Comments on the proposed changes set out in this consultation document are requested by 14 March 2008. Responses should be sent by e-mail to codereview@frc.org.uk, or in writing to:

Chris Hodge
Financial Reporting Council
5th Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

7. If the proposed changes to the Combined Code are implemented following this consultation, the FRC will publish a regulatory impact assessment when issuing the revised Code. The FRC does not believe either of the proposed changes would introduce new regulatory burdens, but would welcome views from respondents on the likely costs and benefits of the proposals.

Note: Unless otherwise stated, responses will be regarded as being on the public record. Respondents should indicate specifically whether their responses should be treated as confidential (standard disclaimers in responses received by e-mail will be disregarded for this purpose).

PROPOSED AMENDMENTS TO THE COMBINED CODE

Chairing more than one FTSE 100 company

8. A significant number of respondents to the FRC review argued that the recommendation that one individual should not chair more than one FTSE 100 company should be removed. It was argued that it was unnecessarily prescriptive and might have the effect of restricting the supply of skilled and experienced people willing and able to serve as Chairman of large listed companies. In addition, some investors argued that by focusing narrowly on FTSE 100 companies the recommendation ignored the impact of the Chairman's time commitments outside the corporate sector and/or outside the UK, which might be very significant.
9. Provision A.4.3 already includes other recommendations relating to the availability of the Chairman. These include disclosing his or her other commitments before appointment and disclosing any changes to these commitments in the annual report. In addition Supporting Principle A.4 states that it is important to ensure that all directors, and in particular the Chairman, are able to devote sufficient time to the company. Views are invited on whether these existing measures are sufficient to meet the objective of ensuring that the Chairman has enough time available to do the job properly, or whether additional safeguards should be incorporated in a revised provision A.4.3.

Current wording of provision A.4.3

For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and included in the next annual report. No individual should be appointed to a second chairmanship of a FTSE 100 company.

Proposed changes

For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and included in the next annual report. ~~No individual should be appointed to a second chairmanship of a FTSE 100 company.~~

Company chairman sitting on audit committee for smaller companies

10. A number of respondents to the consultation argued that it should be possible for smaller companies to continue to classify the chairman as independent if they were so considered on appointment. It was argued, inter alia, that this would help these companies cope with the Code's recommendations on the composition of the board committees, and that in the particular case of the audit committee the chairman would often be the board member best qualified to sit on the committee.
11. The FRC has rejected that proposal. It is difficult to argue that the status of the company chairman is determined by the size of the company; and it might inadvertently send a signal to smaller companies that it was no longer considered best practice to have at least two independent non-executive directors on the board. However an amendment to allow the chairman to sit on the audit committee might deliver the same benefits without raising these issues. Views are invited on whether this change would be appropriate.
12. If the amendment were to be adopted, it is proposed that the chairman of the company should not also be able to chair the audit committee, and that if they were to sit on the committee they would do so in addition to the minimum two independent non-executive directors, rather than taking the place of one of those directors.

Current wording of provision C.3.1

The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

Proposed changes

The board should establish an audit committee of at least three, or in the case of smaller companies two, ~~members, who should all be~~ independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

OTHER REVISIONS TO THE COMBINED CODE

Revised Preamble

13. Many respondents to the review of the impact and implementation of the Code raised points that cannot easily be reflected in detailed 'comply or explain' provisions; these included, for example, the need to emphasise that good governance should support wealth creation and entrepreneurship as well as protect shareholder value, and to encourage companies to make relevant and company-specific disclosures. The Preamble to the Code, which has no formal status, provides an opportunity to reinforce important messages about the way in which the Code should be viewed and implemented. When publishing the revised Code the FRC therefore intends to update the Preamble to reflect some of the main points to come out of its recent review.

Overlap with FSA Corporate Governance Rules

14. It is the intention that the revised Combined Code should come into effect at the same time as the new FSA Rules needed to implement the corporate governance requirements in the 4th and 8th Company Law Directives. There are some areas of overlap between the Code and the draft Rules, which are summarised in the Appendix.
15. In most cases the relevant provisions of the Code are more detailed or more onerous than the equivalent draft Rules; for example, the Code sets out in more detail than the Rules what information should be disclosed about the operation of the Board and its committees, and the Code recommends greater independent representation on the audit committee than is required in order to comply with the draft Rules. In these cases, while companies will remain free to choose whether to comply or explain with the relevant provision of the Code, if they do choose to explain they will still need to ensure that they comply with the minimum requirements in the FSA Rules.

16. When publishing the updated Combined Code, the FRC proposes to:

- Add footnotes to those provisions of the Code that overlap with the Rules, drawing this to companies' attention. This should ensure companies do not overlook the need to comply with the Rules when considering whether to comply or explain against the Code.
- Update Schedule C so that it lists all corporate governance disclosure requirements (i.e. those required by the Rules as well as those that companies are required to make in order to comply with specific provisions of the Code). This should enable companies and investors to find all the information they need about the content of the corporate governance statement in one place.

17. Views are invited on whether these updates would be helpful.

Financial Reporting Council
December 2007

APPENDIX

OVERLAP BETWEEN THE DRAFT FSA CORPORATE GOVERNANCE RULES AND THE COMBINED CODE

DRAFT FSA RULES	COMBINED CODE
<p>Draft D.T.R 7.1.1</p> <p>Sets out minimum requirements on composition of the audit committee: at least one committee member to be independent and at least one to have competence in accounting and/or auditing.</p>	<p>Provision C.3.1</p> <p>Sets out recommended composition of the audit committee: all members to be independent (subject to the proposed change for smaller listed companies), and at least one member to have recent and relevant financial experience.</p>
<p>Draft D.T.R 7.1.3</p> <p>Sets out minimum functions of the audit committee.</p>	<p>Provision C.3.2</p> <p>Sets out the recommended minimum terms of reference for the committee (which include all of those functions in D.T.R 7.1.4).</p>
<p>Draft D.T.R 7.2.5</p> <p>Requirement for the corporate governance statement to include a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process.</p>	<p>Provision C.2.1 [and the Turnbull Guidance]</p> <p>Address all internal controls, not just those relating to financial reporting. Although the scope of the Code is broader than that of the Rules, it is envisaged that it should be possible to cover both requirements in the same internal control statement.</p>

<p>Draft DTR 7.2.7</p> <p>Requirement for the corporate governance statement to include a description of the composition and operation of the administrative, management and supervisory bodies and their committees.</p>	<p>The requirement in the Rules overlaps with a number of different provisions of the Code:</p> <p>A.1.1: the annual report should include a statement of how the board operates.</p> <p>A.1.2: the annual report should identify members of the board and board committees.</p> <p>A.4.6: the annual report should describe the work of the nomination committee.</p> <p>B.1.4: the description of the work of the remuneration committee should be made available. The Directors Remuneration Report Regulations 2002 also require companies to report on the work of the remuneration committee.</p> <p>C.3.3 [and the Smith Guidance]: the annual report should describe the work of the audit committee.</p> <p>The Code provisions and associated guidance generally go into more detail than the draft Rules about the information to be disclosed.</p>
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