



**FINANCIAL REPORTING COUNCIL**

**THE COMBINED CODE ON CORPORATE GOVERNANCE**

**JUNE 2008**



# **THE COMBINED CODE ON CORPORATE GOVERNANCE**

**June 2008**



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## **The Combined Code on Corporate Governance**

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# CODE ON CORPORATE GOVERNANCE

## PREAMBLE

1. Good corporate governance should contribute to better company performance by helping a board discharge its duties in the best interests of shareholders; if it is ignored, the consequence may well be vulnerability or poor performance. Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term. The Combined Code on Corporate Governance ('the Code') is published by the FRC to support these outcomes and promote confidence in corporate reporting and governance.
2. The Code is not a rigid set of rules. Rather, it is a guide to the components of good board practice distilled from consultation and widespread experience over many years. While it is expected that companies will comply wholly or substantially with its provisions, it is recognised that non-compliance may be justified in particular circumstances if good governance can be achieved by other means. A condition of non-compliance is that the reasons for it should be explained to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result. This 'comply or explain' approach has been in operation since the Code's beginnings in 1992 and the flexibility it offers is valued by company boards and by investors in pursuing better corporate governance.
3. The Listing Rules require UK companies listed on the Main Market of the London Stock Exchange to describe in the annual report and accounts their corporate governance from two points of view, the first dealing generally with their adherence to the Code's main principles, and the second dealing specifically with non-compliance with any of the Code's provisions. The descriptions together should give shareholders a clear and comprehensive picture of a company's governance arrangements in relation to the Code as a criterion of good practice.
4. In relation to the requirement to state how it has applied the Code's main principles, where a company has done so by complying with the associated provisions it should be sufficient simply to report that this is the case; copying out the principles in the annual report adds to its length without adding to its value. But where a company has taken additional actions to apply the principles or otherwise improve its governance, it would be helpful to shareholders to describe these in the annual report.

5. If a company chooses not to comply with one or more provisions of the Code, it must give shareholders a careful and clear explanation which shareholders should evaluate on its merits. 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 and contribute to good governance.
6. Smaller listed companies, in particular those new to listing, may judge that some of the provisions are disproportionate or less relevant in their case. Some of the provisions do not apply to companies below the FTSE 350. Such companies may nonetheless consider that it would be appropriate to adopt the approach in the Code and they are encouraged to do so. Externally managed investment companies typically have a different board structure, which may affect the relevance of particular provisions; the Association of Investment Companies's Corporate Governance Code and Guide can assist them in meeting their obligations under the Code.
7. In their turn, shareholders should pay due regard to companies' individual circumstances and bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces. Whilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches. Institutional shareholders should be careful to respond to the statements from companies in a manner that supports the 'comply or explain' principle and bearing in mind the purpose of good corporate governance. They should put their views to the company and be prepared to enter a dialogue if they do not accept the company's position. Institutional shareholders should be prepared to put such views in writing where appropriate.
8. Companies and shareholders have a shared responsibility for ensuring that 'comply or explain' remains an effective alternative to a rules-based system. Satisfactory engagement between company boards and investors is therefore crucial to the health of the UK's corporate governance regime. Although engagement has been improving slowly but steadily for many years, practical obstacles necessitate a constant effort to keep the improvement going.
9. Companies can make a major contribution by spreading governance discussion with shareholders outside the two peak annual reporting periods around 31<sup>st</sup> December and 31<sup>st</sup> March and by raising further the general standard of their explanations justifying non-compliance. Shareholders for their part can still do more to satisfy companies that they devote adequate resources and scrutiny to engagement.

10. References to shareholders in this Preamble also apply to intermediaries and agents employed to assist shareholders in scrutinising governance arrangements.
11. This edition of the Code applies to accounting periods beginning on or after 29 June 2008, and takes effect at the same time as new FSA Corporate Governance Rules implementing European requirements relating to audit committees and corporate governance statements. The relevant sections of these Rules are summarised in Schedule C. There is some overlap between the content of the Code and the Rules, and the Rules state that in these areas compliance with the Code will be deemed sufficient also to comply with the Rules. However, where a company chooses to explain rather than comply with the Code it will need to demonstrate that it nonetheless meets the minimum requirements set out in the Rules.
12. The Code itself is subject to periodic reviews by the FRC, the latest of which was conducted in 2007 and was generally reassuring about the Code's content and impact. In the normal course of events the next review will take place in 2010.

Financial Reporting Council  
June 2008



# CODE OF BEST PRACTICE

## SECTION 1 COMPANIES

### A. DIRECTORS

#### A.1 The Board

##### Main Principle

**Every company should be headed by an effective board, which is collectively responsible for the success of the company.**

##### Supporting Principles

The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

All directors must take decisions objectively in the interests of the company.

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

## Code Provisions

- A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.
- A.1.2 The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees. It should also set out the number of meetings of the board and those committees and individual attendance by directors<sup>1</sup>.
- A.1.3 The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance (as described in A.6.1) and on such other occasions as are deemed appropriate.
- A.1.4 Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.
- A.1.5 The company should arrange appropriate insurance cover in respect of legal action against its directors.

## A.2 Chairman and chief executive

### Main Principle

**There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.**

### Supporting Principle

The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The

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<sup>1</sup> Provisions A.1.1 and A.1.2 overlap with FSA Rule DTR 7.2.7 R; Provision A.1.2 also overlaps with DTR 7.1.5 R (see Schedule C).

chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman should also facilitate the effective contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors.

### Code Provisions

- A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.
- A.2.2 The chairman should on appointment meet the independence criteria set out in A.3.1 below. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report<sup>2</sup>.

### A.3 Board balance and independence

#### Main Principle

**The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.**

#### Supporting Principles

The board should not be so large as to be unwieldy. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business and that changes to the board's composition can be managed without undue disruption.

To ensure that power and information are not concentrated in one or two individuals, there should be a strong presence on the board of both executive and non-executive directors.

The value of ensuring that committee membership is refreshed and that undue reliance is not placed on particular individuals should be taken into account in deciding chairmanship and membership of committees.

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<sup>2</sup> Compliance or otherwise with this provision need only be reported for the year in which the appointment is made

No one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee.

### Code provisions

A.3.1 The board should identify in the annual report each non-executive director it considers to be independent<sup>3</sup>. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- has been an employee of the company or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

A.3.2 Except for smaller companies<sup>4</sup>, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.

A.3.3 The board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have

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<sup>3</sup> A.2.2 states that the chairman should, on appointment, meet the independence criteria set out in this provision, but thereafter the test of independence is not appropriate in relation to the chairman.

<sup>4</sup> A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate.

## **A.4 Appointments to the Board**

### **Main Principle**

**There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.**

### **Supporting Principles**

Appointments to the board should be made on merit and against objective criteria. Care should be taken to ensure that appointees have enough time available to devote to the job. This is particularly important in the case of chairmanships.

The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board.

### **Code Provisions**

- A.4.1 There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. The nomination committee should make available<sup>5</sup> its terms of reference, explaining its role and the authority delegated to it by the board.
- A.4.2 The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.
- 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

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<sup>5</sup> The requirement to make the information available would be met by including the information on a website that is maintained by or on behalf of the company.

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 their impact explained in the next annual report.

- A.4.4 The terms and conditions of appointment of non-executive directors should be made available for inspection<sup>6</sup>. The letter of appointment should set out the expected time commitment. Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and the board should be informed of subsequent changes.
- A.4.5 The board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company.
- A.4.6 A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments<sup>7</sup>. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director.

## A.5 Information and professional development

### Main Principle

**The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.**

### Supporting Principles

The chairman is responsible for ensuring that the directors receive accurate, timely and clear information. Management has an obligation to provide such information but directors should seek clarification or amplification where necessary.

The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company

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<sup>6</sup> The terms and conditions of appointment of non-executive directors should be made available for inspection by any person at the company's registered office during normal business hours and at the AGM (for 15 minutes prior to the meeting and during the meeting).

<sup>7</sup> This provision overlaps with FSA Rule DTR 7.2.7 R (see Schedule C).

should provide the necessary resources for developing and updating its directors' knowledge and capabilities.

Under the direction of the chairman, the company secretary's responsibilities include ensuring good information flows within the board and its committees and between senior management and non-executive directors, as well as facilitating induction and assisting with professional development as required.

The company secretary should be responsible for advising the board through the chairman on all governance matters.

## **Code Provisions**

A.5.1 The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, the company should offer to major shareholders the opportunity to meet a new non-executive director.

A.5.2 The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should be provided with sufficient resources to undertake their duties.

A.5.3 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole.

## **A.6 Performance evaluation**

### **Main Principle**

**The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.**

### **Supporting Principle**

Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

## Code Provision

A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

## A.7 Re-election

### Main Principle

**All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.**

### Code Provisions

A.7.1 All directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election.

A.7.2 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Acts provisions relating to the removal of a director. The board should set out to shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual should be elected. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role. Any term beyond six years (e.g. two three-year terms) for a non-executive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board. Non-executive directors may serve longer than nine years (e.g. three three-year terms), subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

## **B. REMUNERATION**

### **B.1 The Level and Make-up of Remuneration**

#### **Main Principles**

**Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.**

#### **Supporting Principle**

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

#### **Code Provisions**

##### **Remuneration policy**

- B.1.1** The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels. In designing schemes of performance-related remuneration, the remuneration committee should follow the provisions in Schedule A to this Code.
- B.1.2** Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.
- B.1.3** Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

B.1.4 Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report<sup>8</sup> should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

### **Service Contracts and Compensation**

B.1.5 The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

B.1.6 Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

## **B.2 Procedure**

### **Main Principle**

**There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.**

### **Supporting Principles**

The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.

The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

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<sup>8</sup> As required under the Directors' Remuneration Report Regulations 2002.

## Code Provisions

- B.2.1 The board should establish a remuneration committee of at least three, or in the case of smaller companies<sup>9</sup> two, independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available<sup>10</sup> its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, a statement should be made available<sup>11</sup> of whether they have any other connection with the company.
- B.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.
- B.2.3 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.
- B.2.4 Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

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<sup>9</sup> See footnote 4.

<sup>10</sup> This provision overlaps with FSA Rule DTR 7.2.7 R (see Schedule C).

<sup>11</sup> See footnote 5.

## C. ACCOUNTABILITY AND AUDIT

### C.1 Financial Reporting

#### Main Principle

**The board should present a balanced and understandable assessment of the company's position and prospects.**

#### Supporting Principle

The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

#### Code Provisions

C.1.1 The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.

C.1.2 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

### C.2 Internal Control<sup>12</sup>

#### Main Principle

**The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.**

#### Code Provision

C.2.1 The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so<sup>13</sup>. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

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<sup>12</sup> The Turnbull guidance suggests means of applying this part of the Code. Copies are available at [www.frc.org.uk/corporate/internalcontrol.cfm](http://www.frc.org.uk/corporate/internalcontrol.cfm)

<sup>13</sup> In addition FSA Rule DTR 7.2.5 R requires companies to describe the main features of the internal control and risk management systems in relation to the financial reporting process (see Schedule C).

### C.3 Audit Committee and Auditors<sup>14</sup>

#### Main Principle

**The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.**

#### Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies<sup>15</sup> two, 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<sup>16</sup>.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include<sup>17</sup>:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;

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<sup>14</sup> The Smith guidance suggests means of applying this part of the Code. Copies are available at [www.frc.org.uk/corporate/auditcommittees.cfm](http://www.frc.org.uk/corporate/auditcommittees.cfm)

<sup>15</sup> See footnote 4.

<sup>16</sup> This provision overlaps with FSA Rule DTR 7.1.1 R (see Schedule C).

<sup>17</sup> This provision overlaps with FSA Rules DTR 7.1.3 R (see Schedule C).

- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.
- C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available<sup>18</sup>. A separate section of the annual report should describe the work of the committee in discharging those responsibilities<sup>19</sup>.
- C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.
- C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.
- C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.
- C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

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<sup>18</sup> See footnote 5.

<sup>19</sup> This provision overlaps with FSA Rules DTR 7.1.5 R and 7.2.7 R (see Schedule C).

## D. RELATIONS WITH SHAREHOLDERS

### D.1 Dialogue with Institutional Shareholders

#### Main Principle

**There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place<sup>20</sup>.**

#### Supporting Principles

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman (and the senior independent director and other directors as appropriate) should maintain sufficient contact with major shareholders to understand their issues and concerns.

The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

#### Code Provisions

- D.1.1 The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.
- D.1.2 The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion.

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<sup>20</sup> Nothing in these principles or provisions should be taken to override the general requirements of law to treat shareholders equally in access to information.

## **D.2 Constructive Use of the AGM**

### **Main Principle**

**The board should use the AGM to communicate with investors and to encourage their participation.**

### **Code Provisions**

- D.2.1 At any general meeting, the company should propose a separate resolution on each substantially separate issue, and should in particular propose a resolution at the AGM relating to the report and accounts. For each resolution, proxy appointment forms should provide shareholders with the option to direct their proxy to vote either for or against the resolution or to withhold their vote. The proxy form and any announcement of the results of a vote should make it clear that a 'vote withheld' is not a vote in law and will not be counted in the calculation of the proportion of the votes for and against the resolution.
- D.2.2 The company should ensure that all valid proxy appointments received for general meetings are properly recorded and counted. For each resolution, after a vote has been taken, except where taken on a poll, the company should ensure that the following information is given at the meeting and made available as soon as reasonably practicable on a website which is maintained by or on behalf of the company:
- the number of shares in respect of which proxy appointments have been validly made;
  - the number of votes for the resolution;
  - the number of votes against the resolution; and
  - the number of shares in respect of which the vote was directed to be withheld.
- D.2.3 The chairman should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend.
- D.2.4 The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

## SECTION 2 INSTITUTIONAL SHAREHOLDERS

### E. INSTITUTIONAL SHAREHOLDERS<sup>21</sup>

#### E.1 Dialogue with companies

##### Main Principle

**Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.**

##### Supporting Principles

Institutional shareholders should apply the principles set out in the Institutional Shareholders' Committee's "The Responsibilities of Institutional Shareholders and Agents – Statement of Principles"<sup>22</sup>, which should be reflected in fund manager contracts.

#### E.2 Evaluation of Governance Disclosures

##### Main Principle

When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.

##### Supporting Principle

Institutional shareholders should consider carefully explanations given for departure from this Code and make reasoned judgements in each case. They should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position. They should avoid a box-ticking approach to assessing a company's corporate governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces.

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<sup>21</sup> Agents such as investment managers, or voting services, are frequently appointed by institutional shareholders to act on their behalf and these principles should accordingly be read as applying where appropriate to the agents of institutional shareholders.

<sup>22</sup> Available at [www.institutionalshareholderscommittee.co.uk](http://www.institutionalshareholderscommittee.co.uk).

### **E.3 Shareholder Voting**

#### **Main Principle**

**Institutional shareholders have a responsibility to make considered use of their votes.**

#### **Supporting Principles**

Institutional shareholders should take steps to ensure their voting intentions are being translated into practice.

Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.

Major shareholders should attend AGMs where appropriate and practicable. Companies and registrars should facilitate this.

## **Schedule A: Provisions on the design of performance related remuneration**

1. The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to enhance shareholder value. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period.
2. The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities.
3. Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or at least form part of a well considered overall plan, incorporating existing schemes. The total rewards potentially available should not be excessive.
4. Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return.
5. Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.
6. In general, only basic salary should be pensionable.
7. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

## **Schedule B: Guidance on liability of non-executive directors: care, skill and diligence**

1. Although non-executive directors and executive directors have as board members the same legal duties and objectives, the time devoted to the company's affairs is likely to be significantly less for a non-executive director than for an executive director and the detailed knowledge and experience of a company's affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director. These matters may be relevant in assessing the knowledge, skill and experience which may reasonably be expected of a non-executive director and therefore the care, skill and diligence that a non-executive director may be expected to exercise.
2. In this context, the following elements of the Code may also be particularly relevant.
  - (i) In order to enable directors to fulfil their duties, the Code states that:
    - The letter of appointment of the director should set out the expected time commitment (Code provision A.4.4); and
    - The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. The chairman is responsible for ensuring that the directors are provided by management with accurate, timely and clear information. (Code principle A.5).
  - (ii) Non-executive directors should themselves:
    - Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company (Code principle A.5 and provision A.5.1)
    - Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice. (Code principle A.5 and provision A.5.2)
    - Where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the board and, to the extent that they are not resolved, ensure that they are recorded in the board minutes (Code provision A.1.4).
    - Give a statement to the board if they have such unresolved concerns on resignation (Code provision A.1.4)
3. It is up to each non-executive director to reach a view as to what is necessary in particular circumstances to comply with the duty of care, skill and diligence they owe as a director to the company. In considering whether or not a person is in breach of that duty, a court would take into account all relevant circumstances. These may include having regard to the above where relevant to the issue of liability of a non-executive director.

## **Schedule C: Disclosure of Corporate Governance Arrangements**

Corporate governance disclosure requirements are set out in three places:

- FSA Listing Rule 9.8.6 (which includes the ‘comply or explain’ requirement);
- FSA Disclosure and Transparency Rules Sections 7.1 and 7.2 (which set out certain mandatory disclosures); and
- The Combined Code (in addition to providing an explanation where they choose not to comply with a provision, companies must disclose specified information in order to comply with certain provisions).

These requirements are summarised below. The full text of Listing Rule 9.8.6 and Disclosure and Transparency Rules 7.1 and 7.2 are contained in the Listing, Prospectus and Disclosure section of the FSA Handbook, which can be found at <http://fsahandbook.info/FSA/html/handbook/>.

There is some overlap between the mandatory disclosures required under the Disclosure and Transparency Rules and those expected under the Combined Code. Areas of overlap are summarised in the Appendix to this Schedule. In respect of disclosures relating to the audit committee and the composition and operation of the board and its committees, compliance with the relevant provisions of the Code will result in compliance with the relevant Rules.

### **Listing Rules**

Paragraph 9.8.6 R of the Listing Rules states that in the case of a listed company incorporated in the United Kingdom, the following items must be included in its annual report and accounts:

- a statement of how the listed company has applied the Main Principles set out in Section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied;
- a statement as to whether the listed company has:
  - complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code; or
  - not complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code and if so, setting out:
    - (i) those provisions, if any, it has not complied with;

- (ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and
- (iii) the company's reasons for non-compliance.

### **Disclosure and Transparency Rules**

Section 7.1 of the Disclosure and Transparency Rules concerns audit committees or bodies carrying out equivalent functions.

DTR 7.1.1 R to 7.1.3 R sets out requirements relating to the composition and functions of the committee or equivalent body:

- DTR 7.1.1 R states that an issuer must have a body which is responsible for performing the functions set out in DTR 7.1.3 R, and that at least one member of that body must be independent and at least one member must have competence in accounting and/or auditing.
- DTR 7.1.2 G states that the requirements for independence and competence in accounting and/or auditing may be satisfied by the same member or by different members of the relevant body.
- DTR 7.1.3 R states that an issuer must ensure that, as a minimum, the relevant body must:
  - (1) monitor the financial reporting process;
  - (2) monitor the effectiveness of the issuer's internal control, internal audit where applicable, and risk management systems;
  - (3) monitor the statutory audit of the annual and consolidated accounts;
  - (4) review and monitor the independence of the statutory auditor, and in particular the provision of additional services to the issuer.

DTR 7.1.5 R to 7.1.7 R explain what disclosure is required:

- DTR 7.1.5 R states that the issuer must make a statement available to the public disclosing which body carries out the functions required by DTR 7.1.3 R and how it is composed.
- DTR 7.1.6 G states that this can be included in the corporate governance statement required under DTR 7.2 (see below).
- DTR 7.1.7 R states that compliance with the relevant provisions of the Combined Code (as set out in the Appendix to this Schedule) will result in compliance with DTR 7.1.1 R to 7.1.5 R.

Section 7.2 concerns corporate governance statements. Issuers are required to produce a corporate governance statement that must be either included in the directors' report (DTR 7.2.1 R); or in a separate report published together with the annual report; or on the issuer's website, in which case there must be a cross-reference in the directors' report (DTR 7.2.9 R).

DTR 7.2.2 R requires that the corporate governance statements must contain a reference to the corporate governance code to which the company is subject (for listed companies incorporated in the UK this is the Combined Code). DTR 7.2.3 R requires that, to the extent that it departs from that code, the company must explain which parts of the code it departs from and the reasons for doing so. DTR 7.2.4 G states that compliance with LR 9.8.6R (6) (the 'comply or explain' rule in relation to the Combined Code) will also satisfy these requirements.

DTR 7.2.5 R to 7.2.7 R and DTR 7.2.10 R set out certain information that must be disclosed in the corporate governance statement:

- DTR 7.2.5 R states that the corporate governance statement must contain a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process. DTR 7.2.10 R states that an issuer which is required to prepare a group directors' report within the meaning of Section 415(2) of the Companies Act 2006 must include in that report a description of the main features of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts.
- DTR 7.2.6 R states that the corporate governance statement must contain the information required by paragraph 13(2)(c), (d), (f), (h) and (i) of Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) where the issuer is subject to the requirements of that paragraph.
- DTR 7.2.7 R states that the corporate governance statement must contain a description of the composition and operation of the issuer's administrative, management and supervisory bodies and their committees. DTR 7.2.8 G states that compliance with the relevant provisions of the Combined Code (as set out in the Appendix to this Schedule) will satisfy the requirements of DTR 7.2.7 R.

## The Combined Code

In addition the Code includes specific requirements for disclosure which are set out below:

The annual report should record:

- a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management (A.1.1);
- the names of the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees (A.1.2);
- the number of meetings of the board and those committees and individual attendance by directors (A.1.2);
- the names of the non-executive directors whom the board determines to be independent, with reasons where necessary (A.3.1);
- the other significant commitments of the chairman and any changes to them during the year (A.4.3);
- how performance evaluation of the board, its committees and its directors has been conducted (A.6.1);
- the steps the board has taken to ensure that members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company (D.1.2).

The annual report should also include:

- a separate section describing the work of the nomination committee, including the process it has used in relation to board appointments and an explanation if neither external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director (A.4.6);
- a description of the work of the remuneration committee as required under the Directors' Remuneration Report Regulations 2002, and including, where an executive director serves as a non-executive director elsewhere, whether or not the director will retain such earnings and, if so, what the remuneration is (B.1.4);
- an explanation from the directors of their responsibility for preparing the accounts and a statement by the auditors about their reporting responsibilities (C.1.1);

- a statement from the directors that the business is a going concern, with supporting assumptions or qualifications as necessary (C.1.2);
- a report that the board has conducted a review of the effectiveness of the group's system of internal controls (C.2.1);
- a separate section describing the work of the audit committee in discharging its responsibilities (C.3.3);
- where there is no internal audit function, the reasons for the absence of such a function (C.3.5);
- where the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, a statement from the audit committee explaining the recommendation and the reasons why the board has taken a different position (C.3.6); and
- an explanation of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded (C.3.7).

The following information should be made available (which may be met by placing the information on a website that is maintained by or on behalf of the company):

- the terms of reference of the nomination, remuneration and audit committees, explaining their role and the authority delegated to them by the board (A.4.1, B.2.1 and C.3.3);
- the terms and conditions of appointment of non-executive directors (A.4.4) (see footnote 8 on page 10); and
- where remuneration consultants are appointed, a statement of whether they have any other connection with the company (B.2.1).

The board should set out to shareholders in the papers accompanying a resolution to elect or re-elect directors:

- sufficient biographical details to enable shareholders to take an informed decision on their election or re-election (A.7.1);
- why they believe an individual should be elected to a non-executive role (A.7.2); and
- on re-election of a non-executive director, confirmation from the chairman that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role, including commitment of time for board and committee meetings and any other duties (A.7.2).

The board should set out to shareholders in the papers recommending appointment or reappointment of an external auditor:

- if the board does not accept the audit committee's recommendation, a statement from the audit committee explaining the recommendation and from the board setting out reasons why they have taken a different position (C.3.6).

### **Additional guidance**

The Turnbull Guidance and Smith Guidance contain further suggestions as to information that might usefully be disclosed in the internal control statement and the report of the audit committee respectively. Both sets of guidance are available on the FRC website at <http://www.frc.org.uk/corporate/>.

## APPENDIX

## OVERLAP BETWEEN THE DISCLOSURE AND TRANSPARENCY RULES AND THE COMBINED CODE

DISCLOSURE AND TRANSPARENCY RULES	COMBINED CODE
<p><b>D.T.R 7.1.1 R</b></p> <p>Sets out minimum requirements on composition of the audit committee or equivalent body.</p>	<p><b>Provision C.3.1</b></p> <p>Sets out recommended composition of the audit committee.</p>
<p><b>D.T.R 7.1.3 R</b></p> <p>Sets out minimum functions of the audit committee or equivalent body.</p>	<p><b>Provision C.3.2</b></p> <p>Sets out the recommended minimum terms of reference for the committee.</p>
<p><b>D.T.R 7.1.5 R</b></p> <p>The composition and function of the audit committee or equivalent body must be disclosed in the annual report</p> <p><i>DTR 7.1.7 R states that compliance with Code provisions A.1.2, C.3.1, C.3.2 and C.3.3 will result in compliance with DTR 7.1.1 R to DTR 7.1.5 R.</i></p>	<p><b>Provision A.1.2:</b></p> <p>The annual report should identify members of the board committees.</p> <p><b>Provision C.3.3</b></p> <p>The annual report should describe the work of the audit committee. Further recommendations on the content of the audit committee report are set out in the Smith Guidance</p>
<p><b>D.T.R 7.2.5 R</b></p> <p>The corporate governance statement must 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><i>While this requirement differs from the requirement in the Combined Code, it is envisaged that both could be met by a single internal control statement.</i></p>	<p><b>Provision C.2.1</b></p> <p>The Board must report that a review of the effectiveness of the internal control system has been carried out. Further recommendations on the content of the internal control statement are set out in the Turnbull Guidance.</p>

<p><b>DTR 7.2.7 R</b></p> <p>The corporate governance statement must include a description of the composition and operation of the administrative, management and supervisory bodies and their committees.</p> <p><i>DTR 7.2.8 R states that compliance with Code provisions A.1.1, A.1.2, A.4.6, B.2.1 and C.3.3 with result in compliance with DTR 7.2.7 R.</i></p>	<p>This requirement overlaps with a number of different provisions of the Code:</p> <p><b>A.1.1:</b> the annual report should include a statement of how the board operates.</p> <p><b>A.1.2:</b> the annual report should identify members of the board and board committees.</p> <p><b>A.4.6:</b> the annual report should describe the work of the nomination committee.</p> <p><b>B.2.1:</b> a description of the work of the remuneration committee should be made available. [Note: in order to comply with DTR 7.2.7 R this information will need to be included in the corporate governance statement].</p> <p><b>C.3.3:</b> the annual report should describe the work of the audit committee.</p>
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