FINANCIAL REPORTING COUNCIL

THE UK APPROACH TO CORPORATE GOVERNANCE

NOVEMBER 2006

The key aspects of corporate governance in the UK

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

Checks and balances:

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

Emphasis on objectivity of directors in the interests of the company.

Transparency on appointments and remuneration.

Effective rights for shareholders.

A Code of good practice based on extensive consultation with practitioners, and operating on the basis of the 'comply or explain' principle.

Foreword

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

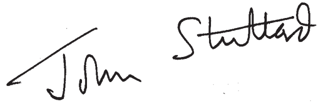
The City of London has a history of encouraging free trade and good corporate governance, based on the application of simple principles to the individual and distinct circumstances of each entity.

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

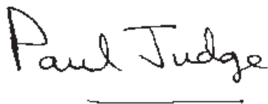
The UK's system of business regulation, which is principles rather than rules based, reduces the cost to global businesses of introducing procedures to comply with detailed regulations, many of which unnecessarily constrain business practice and innovation.

This publication has been produced by the Financial Reporting Council, which is responsible for corporate governance in the UK, as part of the "City of London - City of Learning" initiative.

We welcome this publication which describes the system of corporate governance which we have found to be very advantageous.



John Stuttard, The Rt Hon The Lord Mayor of the City of London



Sir Paul Judge, Chairman, City of London - City of Learning

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Emeritus President, London Metropolitan University

The advantages of the UK approach

The UK approach combines high standards of corporate governance with relatively low associated costs. Comparative studies consistently show that the UK outperforms other countries in terms of governance standards, while compliance costs are estimated to be lower than in other countries with comparable standards.

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

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

The development of corporate governance in the UK

The development of corporate governance in the UK has its roots in a series of corporate collapses and scandals in the late 1980s and early 1990s, including the collapse of the BCCI bank and the Robert Maxwell pension funds scandal, both in 1991.

The UK business community recognised the need to put its house in order. This led to the setting up in 1991 of the Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, which issued a series of recommendations - known as the Cadbury Report - in 1992. The Cadbury Report addressed issues such as the relationship between the chairman and chief executive, the role of non-executive directors and reporting on internal control and on the company's position. A requirement was added to the Listing Rules of the London Stock Exchange that companies should report whether they had followed the recommendations or, if not, explain why they had not done so (this is known as 'comply or explain').

The recommendations in the Cadbury Report have been added to at regular intervals since 1992. In 1995 the Greenbury Report set out recommendations on the remuneration of directors. In 1998 the Cadbury and Greenbury reports were brought together and updated in the Combined Code, and in 1999 the Turnbull guidance was issued to provide directors with guidance on how to develop a sound system of internal control.

Following the Enron and WorldCom scandals in the US, the Combined Code was updated in 2003 to incorporate recommendations from reports on the role of non-executive directors (the Higgs Report) and the role of the audit committee (the Smith Report). At this time the UK Government confirmed that the Financial Reporting Council (FRC) was to have the responsibility for publishing and maintaining the Code. The FRC made further, limited, changes to the Code in 2006. Throughout all of these changes, the 'comply or explain' approach first set out in the Cadbury Report has been retained.

The rationale behind the UK approach

The UK approach starts from the position that good governance is a tool that can improve the board's ability to manage the company effectively as well as provide accountability to shareholders. To quote from the Cadbury Report:

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

A regulatory framework that aims to improve standards of corporate governance is more likely to succeed, and be accepted by those that it regulates, if it recognises that governance should support, not constrain, the entrepreneurial leadership of the company, while ensuring risk is properly managed. Governance must also work to the benefit of the shareholders by improving the long-term value of the company.

This requires a degree of flexibility in the way companies adopt and adapt governance practices. To be effective good governance needs to be implemented in a way that fits the culture and organisation of the individual company. This can vary enormously from company to company depending on factors such as size, ownership structure and the complexity of the business model.

The assessment of whether the company's governance practices are effective should be made by the intended beneficiaries - i.e. the shareholders.

Investors can take a pragmatic approach about how to apply best practice in a way that is in the best interests of the company. This is in contrast to regulators, who find it more difficult to allow exceptions as they must be seen to be applying the rules consistently.

The UK regulatory framework

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

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

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

For the system to work effectively shareholders need to have appropriate and relevant information to enable them to make a judgement on the governance practices of the companies in which they invest. They also

need the rights to enable them to influence the behaviour of the board when they are not content. 'Comply or explain' therefore needs to be underpinned by an appropriate regulatory framework.

Under UK company law, shareholders have comparatively extensive voting rights, including the rights to appoint and dismiss individual directors and, in certain circumstances, to call an Extraordinary General Meeting of the company. Certain requirements relating to the AGM, including the provision of information to shareholders and arrangements for voting on resolutions, are also set out in company law, as are some requirements for information to be disclosed in the annual report and accounts. These include requirements for a Business Review (in which the board sets out, inter alia, a description of the principal risks and uncertainties facing the company) and a report on directors' remuneration, on which shareholders have an advisory vote.

This framework is reinforced by the Listing Rules that must be followed by companies listed on the Main Market of the London Stock Exchange. The Listing Rules provide further rights to shareholders (for example, by requiring that major transactions are put to a vote), and require certain information to be disclosed to the market. This includes the requirement to provide a 'comply or explain' statement in the annual report explaining how the company has applied the Combined Code (or, in the case of companies incorporated outside the UK, to describe how the companies' governance practices differ from those set out in the Code).

Copies of the Combined Code can be obtained from http://www.frc.org.uk/corporate/combinedcode.cfm

The benefits of the UK approach

The UK approach combines high standards of corporate governance with relatively low associated costs.

Studies consistently show that the UK outperforms other countries in terms of governance standards, and that standards within the UK continue to rise. Reports published in 2005 by the FTSE ISS Corporate Governance Index and Governance Metrics International both put the UK at the top of the list of countries by average corporate governance score. A survey carried out by the National Association of Pension Funds in the same year found that 94% of large UK pension funds believed that corporate governance standards in UK companies had improved.

Compliance costs in the UK are considered to be lower than in other countries with comparable standards. A study published in June 2006 by Oxera on behalf of the London Stock Exchange found that the corporate governance requirements were seen by some companies as one of the main factors influencing the choice between a UK and US listing (to the advantage of the UK).

The essential features of UK corporate governance

The role and composition of the board

- A single board with members collectively responsible for leading the company and setting its values and standards.

- A clear division of responsibilities for running the board and running the company with a separate chairman and chief executive.

- A balance of executive and independent non-executive directors - for larger companies at least 50% of the board members should be independent non-executive directors; smaller companies should have at least two independent directors.

- Formal and transparent procedures for appointing directors, with all appointments and re-appointments to be ratified by shareholders.

- Regular evaluation of the effectiveness of the board and its committees.

Remuneration

- Formal and transparent procedures for setting executive remuneration, including a remuneration committee made up of independent directors and an advisory vote for shareholders.

- A significant proportion of remuneration to be linked to performance.

Accountability and Audit

- The board is responsible for presenting a balanced assessment of the company's position (including through the accounts), and maintaining a sound system of internal control.

- Formal and transparent procedures for carrying out these responsibilities, including an audit committee made up of independent directors and with the necessary experience.

Relations with shareholders

- The board must maintain contact with shareholders to understand their opinions and concerns.

- Separate resolutions on all substantial issues at general meetings.

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