



FINANCIAL REPORTING COUNCIL

REVIEW OF THE 2003 COMBINED CODE

SUMMARY OF RESPONSES TO THE REVIEW

JANUARY 2006

SUMMARY OF RESPONSES

1. This document is a summary of the responses received by the FRC to the call for evidence on the review of the implementation of the 2003 Combined Code. Where a representative body has commented on an issue the organisation concerned is named, but comments from individual companies and other stakeholders have been anonymised. In all 59 responses were received. Respondents are listed in the annex to this summary, and copies of individual responses are available on request from codereview@frc.org.uk.
2. Most respondents considered that the 2003 Code appeared to be bedding down well and was having a positive impact on the quality of corporate governance among listed companies. It was also the view of almost all respondents that major changes to the Code were not required.
3. The FRC asked for comments on any aspect of implementation, but views were sought on a number of key questions. The main comments on each question are summarised below, as are some of the suggestions put forward by respondents for amending the Code.

Has the Code begun to have an impact on the overall quality of corporate governance in UK listed companies? Are there any areas in which practice has notably improved?

4. It was the overwhelming view of respondents to the consultation that there has been an improvement in the quality of corporate governance among listed companies since the revised Code came into force. The ABI responded “*We consider that the Code is working well. Its introduction has led to a considerable improvement in the dialogue between companies and shareholders*”. Respondents noted improvements in many areas, for example one investor noted “*Specific improvements concerning board structure both in terms of independence of the board and the splitting of CEO/Chairman role*”.
5. The response on the subject of board evaluation, which was added to the Code in 2003, was broadly positive. The ABI noted that “*Before the Higgs Review, only a tiny proportion of companies reported having such a process, whereas in this first full year of the new Code the majority of FTSE All-Share companies report having one and in some cases provide detailed descriptions of the process used.*” A FTSE 100 company also considered that the Code had “*led to a general improvement in practice*”. However, another FTSE 100 company felt that “*the current code is overly prescriptive. We would suggest that the requirement for an annual evaluation of the performance of the board, its committees and individual directors should be altered to allow a process to cover these matters over a cycle of at least two years rather than one*”.

Have companies come up against any practical barriers to implementing the Code?

6. Few companies stated they had experienced practical difficulties, but there was some comment on the amount of the board's time needed to implement some provisions of the Code. This was particularly an issue for smaller listed companies.

7. The Code states that the board's role is to provide "entrepreneurial leadership of the company within a framework of prudent and effective controls". Some companies felt that this was being compromised, with one commenting that there was an *"excessive level of concern about the framework of prudent and effective controls. Any rebalancing that can be promoted would be welcomed"*. One smaller listed company commented: *"The boards focus should be the performance and strategic development of the business, good corporate governance as put down by the Code should underpin that never become an alternative agenda"*.

8. Two FTSE 100 companies mentioned difficulties in recruiting sufficient independent non-executive directors to meet the recommendations in the Code, with one commenting: *"The search to identify a sufficient number of high-quality independent non-executive directors with the appropriate skills, experience, knowledge and time to serve on the Board of a UK listed company (and also without an existing conflicting appointment) remains challenging"*. The GC 100 observed that *"some companies are also encountering difficulties in recruiting sufficient non-executive directors of the right calibre and in particular with regard to the non-executive director with "recent and relevant financial experience" to sit on the Audit Committee"*.

How informative are the corporate governance statements in the annual reports, and has there been a change in the overall quality of disclosure?

9. All investors that responded considered that the overall quality of disclosure in annual reports has improved since the introduction of the 2003 Code. One investor commented that *"Disclosure overall has improved significantly... [and] has therefore already added value, and will continue to do so into the future"*, while another noted that *"The best disclosure includes web-based information on committees and terms of reference in addition to that shown in the annual report"*.

10. Notwithstanding the overall improvement, some investors responded that quality was varied. One institutional investor noted there was a *"marked difference between large and smaller companies, [with] smaller companies much more inclined to report in formulaic manner"*.

11. Some investors commented on what they saw as the ‘boiler-plate’ nature of many disclosures, and said that they would welcome more discursive corporate governance statements. The NAPF commented that the *“quality of disclosure is not uniformly high and boilerplate statements remain a problem in some annual reports, especially smaller companies and those that are closely held, but on the whole there has been a welcome trend towards better explanations”*.

12. Investors also considered that corporate governance statements could be made more informative in other respects, for example by including more company-specific information on how the principles of the Combined Code have been applied, and when the company chooses to explain rather than follow the provisions of the Code. The ABI commented that investors *“need to understand boards’ reasons for non-application of specific provisions and their overall approach to implementation.”*

13. Companies also considered there had been a general improvement in disclosure, with one FTSE 100 company commenting that *“there has been an improvement in the quality of reporting. Rather than a sudden step change we see the Code, in combination with other factors, as encouraging ongoing improvements in reporting which are continuing.”* Another FTSE 100 company said *“The quantity of disclosure has certainly increased following the more detailed requirements of the Code, but whether this has led to an increase in the quality of disclosure is debatable and, inevitably, this will vary from company to company”*.

14. Business organisations expressed similar views. For example the IoD responded that *“Companies are more aware of the need for quality reporting and explanations where appropriate, but many (particularly smaller companies) are still feeling their way towards striking the appropriate balance”*.

Where companies are choosing to explain rather than comply with a particular provision, how informative are those explanations and are they being accepted by shareholders?

15. The review found strong support from companies and investors for retaining the ‘comply or explain’ approach to implementing the Combined Code. A FTSE 100 company considered ‘comply or explain’ to be *“a particular strength of the Code. This allows for a level of flexibility which is critical in allowing companies to conduct their business in ways which are in the best interests of their shareholders. There may be circumstances where non-compliance with certain aspects of the Code on some occasions may be sensible for a particular company. Through ensuring transparency, the Code provides the company with an opportunity to justify any non-compliance and therefore allowing shareholders to determine whether or not it accepts the explanation”*.

16. Most investors reported that they were willing to consider explanations on a case by case basis. One investor said that the important issue was *“how persuasive the explanation is when a contentious issue is identified”*.

17. For companies, experience appears to be that an explanation is more likely to be accepted when it is informative and company-specific and, when appropriate, has been discussed in advance with shareholders. One FTSE 100 company shared its experience that *“most shareholders do accept explanations for non-compliance where they are full and clear (and particularly where there is a commitment to comply in the future). Inevitably, the sensitivity of the issue being “explained” will, to a large extent, dictate whether or not shareholders are willing to accept the explanation for non-compliance”*.

18. Some companies were critical of some ratings agencies and investors for a perceived ‘box-ticking’ approach. One FTSE 100 company was concerned that *“an excessive reliance on “box ticking” by investors, and some of those who advise them, makes the “explain” option less attractive than it should be”*. In addition, the CBI warned of companies with *“a tendency to default to compliance even although that may not be wholly consistent with the best interests of the company and its shareholders”*.

19. A FTSE 100 company felt that *“the Code should do more to encourage the “explain” option and emphasise that there may be alternative ways of achieving good corporate governance which are different from the means specified in the Code”*, and one investor indicated they would *“welcome more companies – particularly smaller companies – having the confidence not to comply fully with the Code but to explain why their particular circumstances justify non-compliance”*.

20. Some companies raised concerns that some investors and rating agencies appeared to apply criteria that are different to those set out in the Code when assessing a company’s corporate governance practices. One FTSE 100 company noted the *“plethora of conflicting guidelines”*, another added *“some major institutional shareholders have their own in-house corporate governance codes which can differ from the Code. This can lead to inconsistent interpretation and, sometimes, voting actions. We believe it would be beneficial for both shareholders and companies if the FRC encouraged all major institutional shareholders to adopt the Code”*. One investor said that they had already done so, commenting that *“we were supportive of the introduction of the revised Code and have set aside our own corporate governance guidelines in favour of unequivocal support for the Code”*.

Has the Code had an impact on the level and quality of dialogue between boards and their shareholders?

21. The general view was that dialogue between boards and their main shareholders was in the main more constructive than it had been before the implementation of the 2003 Code. A FTSE 100 company said the Combined Code had *“encouraged dialogue with our shareholders”* and one institutional investor commented that *“We believe that the dialogue between companies and their shareholders has improved very considerably, and that this is in significant measure due to the new Code”*.

22. The IMA responded that it *“believes that in recent years the level and quality of dialogue between boards and their shareholders has improved and that the Combined Code has contributed to this. Explanations for non-compliance are rarely accepted without question and evaluating the persuasiveness of the arguments raises the quality of the dialogue on both sides. Furthermore, company chairmen tend to be more proactive in meeting institutional investors”*.

23. One investor noted that *“We have noticed a significant increase in the willingness of directors to engage in these discussions since the new Code came into effect, and we have found the discussions themselves to be more productive. We believe that this greater dialogue is the most significant achievement from the new Combined Code”*, while another identified examples of good practice on the part of some companies, such as *“shareholder forums and ‘meet the non-executives’ days”*.

24. Some medium-sized shareholders said they came together to pool resources regarding engagement with companies, with one investor commenting that they *“generally have to be proactive themselves to ensure dialogue with the company. For this reason (we) collaborate with other investors”*.

25. There remains a perception among some companies that the fund managers and corporate governance specialists within some institutions do not always take a consistent position. The QCA responded that *“where shareholders have outsourced voting to an agency other than the institutional fund manager, engagement with voting agencies is even less satisfactory”*.

26. The QCA also commented that *“There has been a continued feeling that companies are devoting substantially more effort to complying with provisions of the new Code which are seen as having limited if any value to the company than investors are in engaging to discuss explanations. Further companies continue to perceive that in their engagement with institutional investors, corporate governance is not a matter of significant interest to the fund managers they meet... It continues to be vital that institutional investors pay regular and thoughtful attention to companies’ governance if companies’ commitment is to be maintained”*.

What impact has the Code had on smaller listed companies, in particular those outside the FTSE350?

27. In its response to the review the QCA commented that *“overall, it is our impression that there have not been any very major insurmountable difficulties in implementing the new Code”*. There was a view that some of the issues identified elsewhere in this summary can be more pronounced for smaller listed companies. For example, on the issue of NED recruitment, an accountancy body responded *“Smaller companies outside the FTSE 350 face more of a challenge in finding the necessary minimum number of non-executive directors”*.

28. On disclosure, one investor commented that the *“quality of disclosure has been noteworthy with regards to some smaller companies where, previously, disclosure had been of limited value”* although others felt that the standard of disclosure was not uniformly high (see paragraphs 10 and 11 above).

29. The IoD suggested some small companies may choose to default to compliance on some issues, rather than use the option of explaining: *“Because of the publicity surrounding the Code smaller companies have often felt themselves to be under some pressure to comply (rather than to explain) or to adopt practices more appropriate to larger companies in circumstances that can cause them considerable difficulty”*.

30. An institutional investor commented that *“as [small companies] do not necessarily have the resources to fully engage with institutional shareholders, we take this into account when evaluating how the Combined Code has been implemented”*. However, an independent research consultancy considered that *“corporate governance should not be a matter of size. We believe that lower levels of compliance are, paradoxically, a result of smaller companies taking a narrow view that the Code is an issue of compliance rather than considering the underlying principles and how good governance can add value to their companies and for their shareholders.”* One investor said that small companies are *“not always as proactive as larger companies in engaging investors”*.

Suggested amendments to the Combined Code

31. Almost all respondents said that they did not consider significant changes to the Code were necessary at this stage, and shared the view of the FTSE 100 company that commented: *“A period of stability, without further significant change to the Code, would be sensible... this would allow the Code to bed down and enable judgements to be made on its overall effect in the context of other changes to regulation and disclosure”*.

32. Notwithstanding that, many respondents also suggested changes that they considered could be made to the Code. The proposals that were put forward most frequently are listed below.

Provision A.2.2: The Chairman

33. It was suggested by some respondents that the footnote to this provision, which 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”* needed to be clarified. A FTSE 100 respondent said *“At present it is not clear whether this is meant to be interpreted as stating that the chairman is NOT independent once he has been appointed. If that is what is meant the statement could be made more explicit. On the other hand we would question the view that independence is lost on the day after appointment”*.

Provision A.3.1: Board balance and independence

34. Provision A.3.1 lists factors that may appear relevant to the determination of director independence. Some respondents called for the provision relating to a director that has served for more than nine years to be removed. One FTSE 100 company responded that they would “*rebut the presumption that tenure affects independence and therefore believe that either the specific reference to nine years is removed... or it is made more explicit that tenure does not automatically jeopardise independence*”.

35. The ABI responded “*some companies describe this as a rule and have urged that it be removed. However, voting records show that the overwhelming majority of investors do not apply the provision as a rule and routinely re-elect directors who have served more than nine years... While adopting a flexible approach, our members see value in retaining this provision as it provides a reference point beyond which there is a need to check whether independence is maintained. We therefore believe the code would be weakened by its removal. Nor would it be appropriate to extend the time horizon*”.

36. On this subject, the QCA noted “*It is important that the FRC and other bodies (including ourselves) emphasise that a non-executive director ceasing to be independent is not a cause for the end of his directorship – if he is still contributing valuably he should be encouraged to remain a director although he is unlikely to be considered independent*”.

Provision A.4.3: Appointments to the Board

37. Some respondents called for the provision relating to the chairmanship of two FTSE100 companies to be amended, including the CBI who commented that “*the feeling is that this has moved the Code away from its traditional emphasis on principles rather than rules, which does not sit well within the UK Code and its reliance upon judgment. Rather the focus should be on the principle that an individual should disclose the nature and extent of all other appointments, leaving the board and ultimately investors to judge whether the individual has sufficient time for the job*”. One FTSE 100 company argued that “*the principle that no individual should be appointed to a second chairmanship of a FTSE 100 company may have made it more difficult to find chairmen for FTSE companies and almost certainly has caused FTSE companies’ chairmen’s fees to increase significantly*”.

38. The ABI's view was that *“a second chairmanship of a FTSE 100 company may not be the only reason for a chairmen being overstretched. For example, an individual may be significantly stretched by chairing a second large company outside the FTSE or by involvement in a private equity venture... Consideration could therefore be given to amending this provision to provide for full justification and consultation of shareholders in advance when chairmen are considering taking up significant additional responsibilities, including the chair of a second large company”*.

Principle A.6: Performance evaluation

39. Some investors and accountancy bodies suggested companies should disclose the general outcomes of board evaluations and any resulting actions.

40. Some companies suggested that the annual evaluation of the performance of the board, its committees and individual directors should be altered to allow a process to cover these matters over a cycle of at least two years rather than one.

Provision B.2.1: The Remuneration Committee

41. Some respondents suggested the Code should be changed to allow the Chairman to sit on the remuneration committee. One institutional investor responded *“The Chairman may often be invited to attend remuneration committee meetings without being a member. This reflects the contribution that the Chairman can bring to remuneration issues. A change to the Code to permit membership of the Chairman would be appropriate if the standard of independence was met on appointment. This would be particularly relevant for smaller companies where the number of non-executive directors is more limited.”* However, the NAPF responded *“we do not consider it appropriate for the chairman to be a member of the audit or remuneration committees”*.

Provision C.3.1: Audit Committee

42. It was reported that many companies had decided to state that the committee as a whole had *“recent and relevant financial experience”*, rather than saying that one individual had such expertise, as recommended by the Code. Some respondents suggested the Code should be changed to reflect this position.

Audit engagement letters

43. As part of the review, views were sought on the proposal from the Audit Quality Forum that companies should be required to publish the terms of the audit engagement letter on their websites. Views were divided on the issue. 10 respondents were in favour of the proposal, while 24 were against. The IMA responded that it *“supports engagement letters being made available to shareholders. Any information that can help them understand the relationship between a company and its auditors is to be welcomed”*. The CBI responded *“We are not in favour of the audit engagement letter being disclosed on the company website. If there are particular issues which need to be addressed, these would be better dealt with by means of a summary in the annual report itself. We do not believe that this would add value for investors”*.

Provision D.2.1: Proxy voting and ‘votes withheld’

44. As part of the review, views were sought on the proposal from the Shareholding Voting Working Group to enable shareholders consciously to withhold their vote when voting by proxy. 24 respondents were in favour and four against adding a ‘vote withheld’ option. The NAPF responded that they would *“strongly support such a change. This would allow shareholders to register unease over a matter requiring attention, but which does not merit a possibly confrontational vote against”*. The IoD responded that the inclusion of a vote withheld option would *“enable companies to demonstrate levels of interest or lack of interest in proposals. Those who did not tick any of the boxes could more clearly be seen to not participate in the democratic process”*. The Association of Investment Trust Companies responded that it *“believes the option to include a ‘votes withheld’ box should be open to companies where shareholders request this approach is taken. It is unconvinced that this should be a requirement of the Combined Code”*.

45. Some investor bodies suggested that full poll or proxy vote results should be disclosed via company websites and/or regulatory information services. Other investors suggested the Code should be explicit in providing that the chairman should call a poll if the result on the show of hands contradicts the results recorded in the proxy count, or that the chairman should call a poll as a matter of course.

Schedule C and disclosure

46. One respondent suggested that Schedule C of the Code should repeat the Listing Rules requirement for companies to report how they apply both the main and supporting principles of the Code.

47. The QCA suggested that *“the FRC should consider enabling the bulk parts of the reports which are in large part static year on year to be disclosed on the company’s website with a cross reference within the annual report... This would, as well as reducing the bulk of the annual report publication, enable companies to update the report at an appropriate time when there is an update required rather than a once a year retrospective update in the annual report package”*. One respondent identified those schedule C disclosures that they considered should be required to be made available on companies’ websites, while another suggested it would be helpful for all directors’ information to be formalised so all relevant details are in one place.

ANNEX

RESPONDENTS TO THE CONSULTATION EXERCISE

Note: this list excludes those respondents that requested their comments remain confidential.

Association of British Insurers
Association of Chartered Certified Accountants
Association of Investment Trust Companies
Aviva plc
Balfour Beatty plc
Barclays Global Investors Ltd
Better Regulation Task Force
Boardroom Review
The BOC Group plc
British Airways plc
British American Tobacco plc
BT Group plc
Building Societies Association
CBI
Chartered Institute of Management Accountants
Co-operative Insurance Society Limited
Deloitte & Touche LLP
Diageo plc
David Evans
F&C Asset Management plc
Gartmore Investment Management plc
GC100
Patrick Gerard
GKN plc
Hermes Pensions Management Ltd
Independent Audit Ltd
Independent Remuneration Solutions
Informa plc
Institute of Chartered Accountants in England & Wales
Institute of Chartered Accountants in Ireland
Institute of Chartered Accountants of Scotland
Institute of Chartered Secretaries and Administrators
Institute of Directors
International Power plc
Investment Management Association
Investor Relations Society
Jupiter Asset Management Ltd
KBC Advanced Technologies plc
KPMG LLP

Law Society Company Law Committee
Legal & General Investment Management
London Stock Exchange
National Association of Pension Funds [joint response with RREV]
Pearson plc
Pensions & Investment Research Consultants Ltd
PricewaterhouseCoopers LLP
Provident Financial plc
Quoted Companies Alliance
Reuters Group plc
RSM Robson Rhodes LLP
Shareholder Voting Working Group
Standard Life Investments
Tate & Lyle plc
Tesco plc
3i Investments plc
Vodafone Group Plc