



**FINANCIAL REPORTING COUNCIL**

**2009 REVIEW OF THE COMBINED CODE: FINAL REPORT**

**DECEMBER 2009**

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## EXECUTIVE SUMMARY

- The purpose of the Code is to promote good governance in the belief that this will support the long-term success of the company. It should not be viewed as a compliance exercise by companies or investors. A prime objective of this review has been to refocus attention on the underlying principles.
- While the Combined Code and its related guidance require some updating, it remains broadly fit for purpose. The flexibility it allows remains preferable to a more prescriptive framework for corporate governance.
- The principles of the Code are intended to encourage appropriate board behaviours. If complying with one of the Code's provisions will make it more difficult for the company to follow one of its principles, it should exercise its right not to comply, but should give a clear explanation to its shareholders of why it has reached that view.
- There is scope for further improvement in the quality of communication by companies and engagement between companies and investors. The FRC is willing to play a role in promoting better communication and more constructive shareholder engagement. This will include taking responsibility for a Stewardship Code for institutional investors as recommended by Sir David Walker, subject to consultation designed to ensure it can be operated effectively.
- The FRC proposes to adopt the recommendations of the Walker Report that it considers, after consultation, are appropriate to all listed companies.
- In particular new Code principles are proposed on the roles of the chairman and non-executive directors, the composition of the board, the commitment expected of directors and the board's responsibility for risk. Strengthened provisions on director development, board evaluation and the frequency of director re-election are also proposed.
- It is important to maintain the integrity of a single Code for companies, so no sector-specific provisions should be added to address the issues that have arisen with respect to the governance of banks and other financial institutions.

## The main actions being taken

### The Combined Code

- A revised introductory section and proposed revisions to the structure of the Code intended to encourage a greater focus on board behaviours.
- Proposed new Code principles on: the roles of the chairman and non-executive directors; the need for the board to have an appropriate mix of skills, experience and independence; the commitment levels expected of directors; and the board's responsibility for defining the company's risk appetite and tolerance.
- Proposed new "comply or explain" provisions including: board evaluation reviews to be externally facilitated at least every three years; the chairman to hold regular development reviews with all directors; and companies to report on their business model and overall financial strategy.
- Consultation on whether to introduce a "comply or explain" provision that either the chairman or all members of the board should stand for annual re-election.
- Changes to the section of the Code dealing with remuneration to emphasise the need for performance-related pay to be aligned with the long-term interest of the company and to the company's risk policies and systems and to enable variable components to be reclaimed in certain circumstances.
- Consultation on whether to allow companies the choice of meeting the disclosure requirements of the Code either in the annual report or on the company's website.
- Section E of the Code (addressed to institutional shareholders) to be removed, subject to sufficient progress being made on the Stewardship Code for institutional investors and its associated governance arrangements.
- The Code to be renamed "The UK Corporate Governance Code" to make clearer its status as the UK's recognised corporate governance standard.
- The revised Code to apply to accounting periods beginning on or after 29 June 2010.

### Other actions

- The FRC to take responsibility for a Stewardship Code for institutional investors as recommended by Sir David Walker, subject to consultation designed to ensure it can be operated effectively.
- The FRC to consider options for producing practical guidance on good practice engagement between companies and investors.
- The FRC to carry out during 2010 a limited review of the Turnbull Guidance on internal control, on which there will be separate consultation.
- The FRC has commissioned the Institute of Chartered Secretaries and Administrators (ICSA) to work with others on its behalf to update the good practice guidance from the 2003 Higgs Report which addresses, for example, the roles of the chairman and non-executive directors.

## 1: THE REVIEW PROCESS

- 1.1. The FRC regularly reviews the content and application of the Combined Code. This has been the third such review since the FRC assumed responsibility for the Code in 2003.
- 1.2. It had originally been the intention to conduct this review in 2010 but in the light of the significant changes in economic conditions since the previous review in 2007, and the Government's decision to commission Sir David Walker to review the governance of banks and other financial institutions, it was decided to bring the review forward. The FRC has worked closely with Sir David and his review team in the intervening period, and would like to express its appreciation for the open and constructive dialogue that has taken place.
- 1.3. The FRC review began in March 2009 with a call for evidence on the impact and effectiveness of the Code. The initial consultation period ended in May and 114 responses were received. Separately, the FRC held a series of meetings with the chairmen of FTSE companies between April and June. In total the chairmen of nearly 100 companies participated.
- 1.4. A progress report was issued in July and further comments invited on the main issues to emerge from the initial consultation, and on the extent to which Sir David Walker's draft recommendations (published earlier that month) might be applicable to non-financial listed companies. This consultation period ended in October and 89 responses were received. The consultation documents, copies of individual responses and other documents associated with the review can be found on the FRC website<sup>1</sup>.

### Next steps

- 1.5. As a result of the review the FRC is proposing a number of changes to the content of the Combined Code as well as a number of other follow-up actions which are summarised in the remainder of this report. A consultation document, including a draft revised Code, has been issued alongside this report and is available from the link below.
- 1.6. Consultation on the draft Code ends on 5 March 2010. The Listing Rules will need to be amended before the revised Code can take effect, and consequential amendments may also be needed to the Disclosure and Transparency Rules. Subject to that, it is intended that the revised Code should apply to accounting periods beginning on or after 29 June 2010.

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<sup>1</sup> <http://www.frc.org.uk/corporate/reviewCombined.cfm>

## 2: MAIN CONCLUSIONS

2.1. The progress report published in July summarised the view of the majority of market participants as follows:

- The Combined Code and its predecessors have contributed to clear improvements in governance since the first code was introduced in 1992.
- There is a recognition that the quality of corporate governance ultimately depends on behaviour not process, with the result that there is a limit to the extent to which any regulatory framework can deliver good governance.
- Market participants have expressed a strong preference for retaining the current approach rather than moving to one more reliant on legislation and regulation. This approach is seen as better able to react to developments in best practice and, because it can take account of the different circumstances in which companies operate, it can set higher standards to which they are encouraged to aspire.

2.2. This view has been reiterated in responses and discussions during the second phase of the review, and is one that the FRC shares. The FRC also shares the view put forward by many respondents that, while some changes need to be made to the Code and its associated guidance to reflect lessons learnt over the last couple of years, the main shortcomings have been in the way that the Code has been applied by some companies, investors and advisers. In particular, the “comply or explain” approach will only work well if there is effective engagement between companies and shareholders.

### The Principles of the Code

2.3. The purpose of the Code is to promote high standards of corporate governance in the belief that good governance should contribute to better long-term performance by helping a board discharge its duties in the best interests of shareholders.

2.4. There is a concern that the Code is too often viewed as a compliance exercise, rather than a means of promoting appropriate behaviour by boards and good communication between boards and shareholders. In particular, there is a concern that too many companies, investors and their respective advisers pay more attention to the detailed provisions of the Code than they do to its high-level principles.

- 2.5. One of the criticisms sometimes levelled at the Code is that its structure obscures this purpose and encourages a focus on detail and process. This focus is also caused by a view amongst many participants that explaining rather than complying means something is necessarily wrong. The FRC accepts there is some truth in these charges. In this review the FRC has therefore sought to change the tone of the Code, including by making changes to signal the importance of board behaviours.
- 2.6. These proposed changes are set out in more detail in the following sections but include restructuring the former Section A (“Directors”) into two sections dealing with board leadership and board effectiveness, and adding new principles on the roles of the chairman and non-executive directors, the need for the board to have an appropriate mix of skills, experience and independence, the commitment levels expected of directors, and the board’s responsibility for setting the company’s risk appetite and tolerance.
- 2.7. The FRC believes that the principles in the draft revised Code, if properly applied, should increase the likelihood that the board will be able to deliver effectively the company’s long-term objectives: by assembling a group of directors with the necessary skills, interest and experience to understand and help to meet the challenges facing the company and sufficient independence to ensure an objective approach; by developing them individually and collectively; by providing leadership and encouraging constructive challenge in the boardroom; and by assessing their ongoing performance.
- 2.8. The FRC would encourage boards to think deeply and thoroughly, now and on an ongoing basis, about how they approach their role and how they can carry it out most effectively. If, as a result, the board considers that following one of the Code’s provisions would adversely affect its ability to apply the related principle it should not feel constrained by that provision. The provisions describe one route by which the principles might be met, but not the only route.

### Communication

- 2.9. Where the board considers that following a provision is not appropriate it should, however, be able to give a clear explanation to its shareholders of why it has reached that view. Current practice remains variable and, in the absence of a clear explanation, it is understandable that shareholders may sometimes be unwilling to give the board the benefit of the doubt.



- 2.10. More generally, there is a need for more boards to embrace confident and persuasive communication with shareholders rather than retreat into boiler-plate. The best already do, as witnessed for example by the high quality of the annual reports short-listed for the inaugural ICOSA/Hermes Transparency in Governance awards held in November 2009. In particular, the FRC would encourage chairmen, and the chairmen of the main board committees, to see the corporate governance statement as an opportunity to demonstrate to current and potential investors why they can have confidence in the board. Not only would this give investors a clearer picture of the steps taken by the board to ensure that it was able to operate effectively but, by providing greater context, it might make investors more willing to accept explanations when a company chose to explain rather than comply with one or more provisions.
- 2.11. There was little enthusiasm among commentators for the FRC or FSA to take on a more formal role in monitoring and enforcing reporting against the Code. There were concerns among both companies and investors that this might have the effect of reducing the flexibility of “comply or explain”, and that regulatory activity might get in the way of, or be seen as an alternative to, engagement between boards and shareholders. The FRC understands these concerns and does not intend to extend its formal activities. However, it will continue informally to monitor standards of disclosure.
- 2.12. The FRC does not propose at this time to remove any of the current disclosure requirements in the Code. However, it is seeking views on whether to amend the Code so that companies can take advantage of the flexibility allowed under the Disclosure and Transparency Rules and make the full corporate governance statement available on their website while including an edited version in the annual report.

### Engagement

- 2.13. Charges of inadequate communication have been levelled by both companies and investors in the FRC’s extensive contacts with them. Satisfactory engagement between company boards and investors is crucial to the health of the UK’s corporate governance regime. There is certainly scope for an increase in trust which might generate a virtuous upward spiral in attitudes to the Code and in its constructive use.
- 2.14. The FRC recognises the constraints under which both companies and investors have to operate, and that there have been considerable advances in engagement in the years that the Code and its predecessors have been in place. Nonetheless, the FRC believes there is room for further improvement in both the quality and quantity of engagement.

2.15. The FRC has accepted the Government's request to take responsibility for a Stewardship Code for institutional investors as recommended by Sir David Walker, subject to consultation designed to ensure it can be operated effectively. If sufficient progress is made on the Stewardship Code, Section E of the Combined Code, which is addressed to institutional investors, will be removed. The FRC is separately considering options for developing good practice guidance on engagement between companies and investors.

#### Changes to the Code and guidance

2.16. In the progress report issued in July the FRC identified three principles against which to judge possible changes to the Code:

- Where there is a demonstrable need for best practice to be clarified or strengthened, this will be addressed either through amendments to the Code or additional, non-binding guidance.
- Where not constrained by regulatory requirements, we will seek to rationalise disclosure requirements in the Code to encourage more informative disclosure on the issues of most importance to investors and to discourage boiler-plate and box-ticking.
- We will seek to avoid an increase in the overall level of prescription in the Code and to preserve its principles-based style.

2.17. Consistent with those principles, and with the view that the priority should be to improve the application of the Code, the FRC is proposing limited but significant changes to the provisions of the Code. It considers that, while not all provisions will be appropriate for all companies, they continue to represent broadly applicable good practice.

2.18. The proposed changes to the provisions are set out in more detail in the following sections but the most significant are: that the chairman should agree and regularly review a development plan with each director; that annual board reviews should be externally facilitated at least every three years; and that companies should describe their business model and overall financial strategy. The FRC is also consulting on whether the Code should recommend that companies should move to annual re-elections either for all directors or for just the chairman of the board.

- 2.19. In addition, the FRC is changing the title of the Code to the UK Corporate Governance Code. The name “Combined Code” was coined by the Hampel Committee in 1998 when it brought together Cadbury and Greenbury Codes and is no longer relevant. The FRC believes that the new title will make the Code’s status as the UK’s recognised corporate governance standard clearer to foreign investors, and to foreign companies listed in the UK which, as a result of changes to the FSA’s Listing Regime, will henceforth need to report against the Code if they have a Premium Listing.
- 2.20. The Code is supported by a number of pieces of guidance intended to help companies apply some of its principles. It is appropriate that this guidance should also be reviewed in the light of developments over the last two years and the proposed changes to the Code. The FRC has therefore commissioned ICSA to lead an exercise on its behalf to update the “Higgs Guidance” (“Good Practice Suggestions from the Higgs Report”, last reissued in 2006). During 2010 the FRC will undertake a limited review of the Turnbull Guidance to address some specific issues identified during the review.

#### The Walker recommendations

- 2.21. In assessing the implications for the Combined Code of the recommendations made by Sir David Walker on the governance of banks and other financial institutions, the FRC has had to consider two issues: to what extent are those recommendations also relevant to non-financial listed companies; and, where they are relevant only to financial companies, whether it is appropriate for them to be incorporated in the Code.
- 2.22. As Sir David notes in his report, there are a number of respects in which banks and other major financial institutions differ from the majority of other listed companies; notably, the systemic nature of their activities (the reason why they are subject to separate regulatory requirements) and the complexity of their operations. It follows that some of the challenges facing the boards of such companies, and the processes required to help the board address them, differ as well.

- 2.23. While the principles underlying the majority of Sir David Walker's recommendations on the governance of banks and financial institutions are also relevant to all listed companies, the FRC believes that not all of the specific processes and structures are of general application. The FRC also shares the view of many respondents to this review that it is important to maintain the integrity of a single Code for listed companies, and that no sector-specific provisions should be added to address the issues that have arisen with respect to the governance of banks and other financial institutions.
- 2.24. The FRC therefore proposes only to amend the Code and its related guidance to adopt the recommendations in the Walker Report that it considers are applicable to all listed companies. This is part of the rationale for some of the proposed changes referred to above and set out in more detail in the following section.

### **3: ANALYSIS AND OUTCOMES**

3.1. In the progress report issued in July, the FRC highlighted a number of topics on which further consideration was required. These were:

- The responsibilities of the chairman and directors
- Board balance and composition
- Frequency of director re-election
- Board information, development and support
- Board evaluation
- Risk management and internal control
- Remuneration
- The quality of disclosure by companies
- Engagement between boards and shareholders

3.2. This section of the report summarises briefly the evidence received on each of these topics and the actions, if any, that the FRC proposes to take as a result of this review.

3.3. A small number of other issues that have arisen during the course of the review are addressed at the end of this section.

## **The responsibilities of the chairman and directors**

- 3.4. In the progress report published in July the FRC sought views on whether the Code should give further clarification of the roles of the chairman and the non-executive directors (including the senior independent directors). The majority of commentators considered that what the Code already said about the roles was sufficient and that, if any further clarification was needed, it should be provided in the form of non-binding guidance.
- 3.5. A number of commentators considered that, while the description of the chairman's role was accurate, it was not given sufficient prominence in the Code considering the leading role the chairman plays in defining the culture of the board – and, by extension, the company – and ensuring that it operates effectively. In the current Code this leadership role is referred to in the supporting principles of Principle A.1 (“The Board”); the only reference to the chairman in the main principles concerns the division of responsibility with the CEO.
- 3.6. The FRC agrees that the crucial role of the chairman should be given more prominence in the Code, and therefore proposes that the existing material in the Code should be brought together under a new main principle stating the chairman's responsibility for leading the board.
- 3.7. Similarly it is proposed that the existing material on the role of the non-executives should be brought together under a new main principle stating their responsibility to provide constructive challenge.
- 3.8. Additional non-binding guidance on these roles, and a number of other issues covered by the Code, is provided in “Good Practice Suggestions from the Higgs Report”, which was last reissued in 2006. The FRC considers that this guidance should be reviewed and updated as necessary in the light of the proposed changes to the Code and economic and other developments since 2006. It has commissioned ICSA to establish a working group to develop updated guidance on the FRC's behalf. It is hoped that this guidance will be available by the time that the revised Code comes into effect in June 2010.
- 3.9. In his report, Sir David Walker makes recommendations on the respective roles of the chairman, senior independent director and the non-executive directors. These recommendations are consistent with the existing principles and provisions of the Code and the FRC considers that they will be reinforced by the proposed structural changes to the Code and the updated guidance. In addition, the provision on the role of the senior independent director has been amended in line with Sir David's recommendation.

- 3.10. Sir David has also proposed indicative minimum time commitments for the chairman and non-executive directors of banks and other financial institutions. The FRC shares the view of the majority of respondents to its review that it would not be appropriate to introduce such indicative levels for the directors of non-financial companies. It was argued strongly that in order for the board to comprise the optimum mix of skills, experience and independence it may be necessary to recruit some non-executive directors whose circumstances may restrict their availability to some extent – for example, if they hold an executive position in another company – but who are, nonetheless, able to make a significant contribution. It was also argued that non-executive directors of smaller and less complex companies may not need to commit the same amount of time as those of large companies in order to carry out their roles satisfactorily.
- 3.11. While the FRC does not propose to introduce indicative minimum time commitments in the Code, it does propose bringing together the existing provisions relating to directors’ availability under a new principle stating that all directors must be able to allocate sufficient time to perform their responsibilities effectively. These changes give the issue of commitment greater prominence in the Code in a manner in which the FRC considers meets the spirit of Sir David’s recommendation.

**Proposed actions:**

- **New principles should be added to the Code on the roles of the chairman and the non-executive directors and on the need for all directors to have sufficient time to perform their responsibilities effectively.**
- **The provision on the role of the senior independent director should be amended to reflect Sir David Walker’s recommendation.**
- **The FRC has commissioned ICSA to work with others on its behalf to update the good practice guidance from the 2003 Higgs Report.**

## **Board balance and composition**

- 3.12. For a board to fulfil its role effectively it needs its members collectively to have the necessary skills, experience and objectivity; it needs to refresh its membership while ensuring continuity; and it needs to do this without the board becoming so large as to make proper debate and decision-making impossible.
- 3.13. There is a perception that Section A.3 of the Code inadvertently may have made it more difficult for boards to achieve this balance by placing too much relative weight on independence. Those who hold this view argue that, as a result, relevant expertise has been lost due to changes in the non-executive element of boards (because the independence criteria in Provision A.3.1 have been interpreted too mechanistically) and that executive directors have been removed from boards in order to keep them to a manageable size (because Provision A.3.2 states that, for FTSE 350 companies, at least 50% of the board excluding the chairman should be made up of independent directors).
- 3.14. The FRC commissioned research from Grant Thornton<sup>2</sup> to compare the relevant experience of non-executives on the current boards of a selection of FTSE 350 companies with the boards of the same companies listed in their 2002-2003 annual reports (i.e. in the financial year before the independence provisions were introduced). The research looked at different types of experience such as experience in the same sector, in related industries and in companies of a similar size. While there were some variations between sectors the research found that, in the sample as a whole, there had been an increase in all types of experience during the period in question; for example, direct sectoral experience has increased from 23% to 30% and directly related industry experience from 53% to 59%.
- 3.15. The Grant Thornton research also showed that in the period since 2003 there had been a slight decrease in the average board size of companies in their sample, as well as a decrease in the number of executive directors and an increase in the number of non-executive directors. This is consistent with data from Deloitte looking at the composition of all FTSE 350 boards over the period<sup>3</sup>. However, both sources also found that the average board (excluding the chairman) already comprised 50% non-executive directors in 2003, while earlier research shows that the decline in the numbers of executive directors pre-dates 2003<sup>4</sup>.

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<sup>2</sup> Grant Thornton; Review of the Experience of Non-Executive Directors; November 2009.

<sup>3</sup> Deloitte & Touche; Board structure, disclosure and non-executive directors' fees; October 2003 and Deloitte; Board structure and non-executive fees; September 2009.

<sup>4</sup> The Chairmen's Forum; The Changing Role of the Chairman; 2005: In 1995 there was an average of 5.2 executive directors on the boards of FTSE 350 companies. This had fallen to 4.7 by 2000 and 3.9



- 3.16. It is not clear that the continuing decline since that date is necessarily a result of the Code provisions. Some respondents to the July progress report speculated that the need to have sufficient non-executive directors to staff increasingly complex board committees may be more of a factor. This might partly explain why Deloitte found that compliance rates in 2009 were much higher among the larger and more complex FTSE 100 companies, of which 93% complied with Provision A.3.2 compared with only 67% of FTSE 250 companies.
- 3.17. The available data does not appear to support the contention that Section A.3 of the Code has resulted in a loss of relevant expertise among non-executives and it is not clear that it has any causal link to the decline in executive directors. Notwithstanding that, the FRC recognises that the drafting of that section may have encouraged the perception among some companies and investors that independence was the primary consideration when assessing the composition of the board and the respective merits of potential directors. This was not the intention. The over-riding consideration should be that the board is fit for purpose.
- 3.18. The FRC proposes to revise the previous Main Principle A.3 to make it clearer that “the board and its committees should consist of directors with the appropriate balance of skills, experience, independence and knowledge of the company to enable it to discharge its duties and responsibilities effectively”. If companies consider that complying with either or both of the related provisions will undermine their ability to meet this principle they should be willing to act accordingly and provide a robust explanation to their shareholders. Anecdotal evidence suggests that most investors will be willing to give fair consideration to explanations in these circumstances. Research conducted by Manifest on behalf of the FRC in 2007 would appear to support this view. The research found that there was only a marginal difference in the outcome of votes on the re-election of non-executive directors who met the independence criteria in the Code and those who did not<sup>5</sup>.

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by 2005. Average board size remained unchanged during this period.

<sup>5</sup> Quoted in Financial Reporting Council; 2007 Review of the Combined Code: Report on the Main Findings of the Review; November 2007.

- 3.19. As in previous reviews, there was considerable comment on the independence criterion related to directors' length of tenure, but no consensus on whether it should be retained. Some respondents considered length of tenure to be irrelevant to an assessment of independence, while others considered that it was an important signal that boards should be regularly refreshed. The FRC does not propose to amend this or other independence criteria, but hopes that the proposed change to the related principle will encourage companies and investors to consider them in the overall context of the need for a properly balanced board.
- 3.20. The broader the pool of talent on which a board is able and willing to draw the easier it should be to achieve the balance of skills, experience, independence and other, more intangible, attributes that will enable the board to operate most effectively. The FRC would therefore encourage nomination committees and their advisers to look beyond the "usual suspects" when refreshing the board, and has proposed some additional wording to this effect in the supporting principles on appointments to the board (new Principle B.2).

**Proposed action:**

- **The principles in the Combined Code should be revised to stress the need for an appropriate balance of skills, experience and independence and for candidates for board appointments to be drawn from a broad talent pool.**

### **Frequency of director re-election**

- 3.21. In the wake of the problems in the financial sector, there have been calls for some or all board directors to be subject to re-election on an annual basis on the grounds that this would increase their accountability to, and the influence of, shareholders. The Combined Code currently recommends that all directors should be subject to re-election at least every three years, except for non-executive directors who have served more than nine years, who should be subject to re-election every year.
- 3.22. Sir David Walker has recommended that the chairman of a bank or other financial institution should be re-elected annually, while the Institutional Shareholders' Committee (ISC) has proposed that the chairmen of the three main board committees should be subject to annual re-election, with the company chairman being put up for re-election the following year should any of them receive less than 75% support. Some companies have already adopted the practice of putting all directors up for re-election every year. The progress report invited views on these different options.
- 3.23. Many commentators argued against the ISC proposal, mainly on two grounds: that it was inequitable and contrary to the concept of the unitary board to encourage investors to hold one or more directors responsible for actions for which the board was collectively responsible; and that doing so would deter people from holding these positions, thus making it more difficult to find quality candidates to fill these key positions. The FRC does not propose to recommend annual election for committee chairmen only.
- 3.24. The FRC considers there is merit in the argument that more frequent re-election of either the company chairman or all directors would provide greater accountability and give shareholders a further opportunity to send a signal to the board if they have concerns. The FRC has heard good arguments for both options, and some suggestions that market practice should be allowed to develop before any changes to the Code are considered.
- 3.25. Some commentators argued for voting on chairmen only as they were ultimately responsible for the governance of the board and company. It was argued that annual election would also empower chairmen in the event that they received a strong mandate, although others considered that it might personalise shareholder concerns and had the potential to undermine a chairman's standing.

- 3.26. On the other hand it was argued that voting on the board as a whole was more consistent with the concept of collective responsibility, but there were concerns that it might have a destabilising effect or encourage short-termism on the part of the board and shareholders. The FRC notes these concerns, although anecdotal evidence suggests that this has not been the experience of those companies that have moved to annual re-election of all directors. In those cases the majority of investors have used their votes responsibly. However, these have generally been large companies with a widely dispersed shareholder base; the concerns may be more understandable for companies with a smaller number of investors with large holdings.
- 3.27. The FRC proposes to consult further on the possible options as part of its consultation on the draft revised Code.
- 3.28. If the option to recommend that all directors should be re-elected annually were adopted it would subsume Sir David Walker's recommendation that the chairman of the remuneration committee be put up for re-election the year after the remuneration report received less than 75% support.
- 3.29. The FRC believes that the annual re-election of the board chairman would also achieve the objective behind Sir David's recommendation, which was to ensure that the advisory nature of the vote should not prevent proper accountability. It is ultimately the responsibility of the chairman of the board to ensure that any concerns raised by shareholders, including on remuneration, are addressed. In most cases to date, the chairman has subsequently acted on those concerns and in future the knowledge that he or she had to face re-election the following year would provide a very strong incentive for them to do so.
- 3.30. There was little support from commentators for the introduction of an advisory vote on the corporate governance statement as a means by which shareholders could raise concerns on governance issues. Most felt that the existing mechanisms, possibly with the addition of more frequent election of some or all directors, were adequate for those purposes.

**Proposed action:**

- **The draft revised Code invites views on two versions of a provision recommending either the annual election of the chairman or of all directors. If the latter option were chosen, the separate provision stating that non-executive directors should be re-elected annually when they served more than nine years would also need to be amended.**

## **Board information, development and support**

- 3.31. As noted in the progress report issued in July, while getting the composition of the board and the culture in the boardroom right is essential if the board is to operate effectively, it is not sufficient. The support provided to the board and the ongoing development of the directors, collectively and individually, are also important components of an effective board.
- 3.32. Some commentators considered that sufficient attention may not have been paid to the section of the Code that addresses these issues, and that companies should be encouraged to give more thought to how they should be applied, but on the whole there was not felt to be a need for significant changes to that section of the Code.
- 3.33. The FRC proposes to split the existing Principle A.5 into two principles on the grounds that development and support, while related, are two separate activities and the Code should therefore treat them as such.
- 3.34. One theme that has emerged from the review is that non-executive directors would be better able to provide constructive challenge in the boardroom if they spent more time in the operational parts of the company in order to gain a better understanding of its activities and the challenges it faces. The FRC agrees and proposes to add a new supporting principle that all directors should have access to the operations and staff of the company in order to improve their knowledge.
- 3.35. The FRC agrees with Sir David Walker that a regular review of development needs between the chairman and each director would ensure that development was given the attention it merits and proposes to add a new provision to this effect to the Code. It may also be appropriate to address director development in the updated guidance that the FRC has asked ICSA to develop on its behalf.
- 3.36. Sir David's report also included recommendations on the support that should be available for non-executive directors and the chairman's responsibility for the flow of information to the board. The FRC considers that the existing principles and provisions in the Code already substantially give effect to these recommendations, and does not propose to make any changes, but this may also be an area where further guidance may be appropriate.

**Proposed actions:**

- **Former Principle A.5 on development, information and support should be divided into two principles.**
- **A new supporting principle should be added on the need for all directors to have knowledge of the company and access to its operations and staff.**
- **A new provision should be added recommending that the chairman should agree and review development requirements with each director.**

## **Board evaluation**

- 3.37. Many companies expressed scepticism about the value of regular formal evaluation of the board's performance at the time the provision was added to the Code in 2003. In discussions with company chairmen as part of this review, however, the FRC found almost universal agreement that regular evaluation can be a beneficial process when taken seriously. The debate now is about the design and frequency of evaluation, and what information should be disclosed to shareholders on the process and outcomes, rather than whether it should be carried out at all.
- 3.38. In his report on the governance of banks and other financial institutions, Sir David Walker recommended that board evaluations should be externally facilitated at least every two or three years.
- 3.39. It is not entirely clear how many listed companies currently undertake externally facilitated evaluation on a rolling basis. Recent research suggests that approximately 20% of the larger companies involve external advisers each year<sup>6</sup>. Anecdotally, the practice appears to be less frequent among smaller listed companies.
- 3.40. Most investors and other commentators, including many companies, considered that external facilitation can add a necessary degree of objectivity to board effectiveness reviews. Many of them supported extending Sir David's recommendation to all listed companies through a new provision in the Code, although some considered that companies should continue to be free to decide whether to involve external advisers without having to comply or explain. Other commentators were concerned at the potential resource implications or were not persuaded that external involvement would add value to the process.
- 3.41. While acknowledging these concerns the FRC considers, on balance, that the potential benefits resulting from the greater objectivity that an external facilitator can bring to the evaluation process are such that a provision should be added to the Code recommending external facilitation of the board review at least every three years. Those companies that consider this to be unnecessary or undesirable will, of course, continue to be able to choose to explain rather than comply. Those companies that choose to comply will be free to decide what form of external involvement would be most beneficial to them.

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<sup>6</sup> ICSA; Board Performance Evaluation; February 2009 found that 21% of the 200 largest UK listed companies undertook externally managed or developed evaluation in 2008, compared to 16% in 2007; while data provided to the FRC by Edis-Bates Associates in November 2009 found that 23% of FTSE 200 companies with December 2008 or June 2009 year ends had undertaken evaluations that had some external input.

- 3.42. In making this recommendation the FRC does not assume that the involvement of external advisers is a panacea. The market in the provision of board evaluation services is still developing and anecdotal evidence from chairmen and other users is that the quality is variable. The FRC also notes Sir David Walker's view that there is a need to articulate appropriate standards for the board evaluation process and provide assurance on the management of potential conflicts of interest. While not favouring one evaluation process or approach over another, the FRC intends to discuss with providers of these services and other interested parties what actions might be taken to address these issues.
- 3.43. In the progress report, the FRC sought views on whether the Code should be amended to recommend that the performance of board committees could be evaluated less frequently. Views were divided between those respondents who considered that annual evaluations were of limited value, particularly where there had been no change in committee membership, and those who considered that the importance of the functions carried out by the main board committees meant that regular evaluation of their performance was desirable. The FRC is not proposing to make any change to the Code.
- 3.44. Current section A.6.1 of the Code requires companies to report on how performance evaluation has been conducted. The FRC does not propose to be more prescriptive in the Code on this issue. Nor does the FRC intend to adopt the proposal floated in the progress report for an "assurance statement", which many respondents were concerned would lead to additional boiler-plate disclosures.
- 3.45. However the FRC would encourage boards, and chairmen in particular, to view the report on the board review as an opportunity to demonstrate to its investors what steps the board has taken to ensure it remains effective. Under the Listing Rules companies are required to report on how they have applied the Main Principles in the Code. In the Preface to the draft revised Code the FRC encourages chairmen to report personally in their annual statements how the principles (in Sections A and B of the new Code) relating to the role and effectiveness of the board have been applied.
- 3.46. The FRC believes that not only would this give investors a clearer picture of the steps taken by the board to ensure that it was able to operate effectively, but, by providing greater context, it might also make investors more willing to accept explanations when a company chose to explain rather than comply with one or more provisions. The FRC believes that reporting in this way, combined with the existing disclosures expected under the Code's provisions, would meet the spirit of Sir David Walker's recommendation for an "evaluation statement".



**Proposed actions:**

- **A new provision should be added to the Code stating that board evaluation reviews should be externally facilitated at least every three years, and that any other connections with the reviewer should be disclosed (as is the case with remuneration consultants).**
- **The FRC will discuss with providers of board evaluation services and other interested parties what actions might be taken to address the quality of such services and concerns about conflicts of interest.**
- **Chairmen are encouraged to report personally in their annual statements how the principles in Sections A and B of the new Code relating to the role and effectiveness of the board have been applied.**

## **Risk management and internal control**

- 3.47. One of the strongest themes to emerge from the review was the need for boards to take responsibility for assessing the major risks facing the company, agreeing the company's risk profile and tolerance of risk, and overseeing the risk management systems. There was a view that not all boards had carried out this role adequately and in discussion with the chairmen of listed companies many agreed that the financial crisis had led their boards to devote more time to consideration of the major risks facing the company. There were differing views about the extent to which risk management systems below board level might need to be reviewed in non-financial companies.
- 3.48. In his report Sir David Walker has recommended some specific processes to ensure the boards of banks and other major financial institutions carry out this role effectively, such as the establishment of a board risk committee.
- 3.49. The majority of commentators on the FRC review considered that the same processes were not necessarily appropriate for all non-financial companies. This view was supported by research carried out by Independent Audit for the ICAEW Foundation, which found "clear differences between financial services organisations and corporates, not only in the nature of their business and risk exposure but also in the role that risk management plays in the organisation. These differences mean that the nature of the problem to be addressed by board governance of risk is different"<sup>7</sup>.
- 3.50. The FRC does not therefore propose to extend all of the recommendations on risk in the Walker report to non-financial listed companies. It does, however, propose to make the board's responsibility for risk more explicit in the Code through a new principle and provision. It also proposes during 2010 to carry out a limited review of the Turnbull Guidance on internal control to ensure that it adequately addresses some of the specific issues raised during the current review, for example, processes for ensuring that emerging risks were brought to the board's attention in a timely manner. The majority of commentators considered that the guidance remained fundamentally sound and that a major overhaul was not required.

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<sup>7</sup> Independent Audit; Getting It Right; October 2009

- 3.51. Many comments were received on risk reporting which is widely seen as being unsatisfactory. This partly reflects what many investors consider to be the limited usefulness of many company disclosures – a recent report by the FRC’s Accounting Standards Board found there were “significant opportunities for improvement in the reporting of principal risks” with only six percent of sampled companies considered to have displayed best practice<sup>8</sup> – and partly the range of different reporting requirements with which companies are required to comply. In his report Sir David Walker stated that further work was needed to improve the reporting of risk.
- 3.52. The FRC may be able to address this to some extent when reviewing the Turnbull Guidance – for example, by encouraging companies to describe in their internal control statements the controls they have in place for the key risks identified in the Business Review – but many of the reporting requirements are outside its remit. The FRC will participate in any further work dealing with wider reporting requirements that is carried out in response to Sir David’s report.
- 3.53. In its report on governance aspects of the banking crisis the House of Commons Treasury Committee commented that “At the moment, financial reports can be used for finding specific bits of information, so are useful for reference, but they do not tell the reader much of a story... A useful approach would be to insist on all listed firms setting out their business model in a short business review, in clear jargon-free English, to detail how the firm has made (or lost) its money and what the main future risks are judged to be”<sup>9</sup>.
- 3.54. The FRC shares the Committee’s view that a short description of the business model and overall financial strategy, linked to the disclosure on risk and uncertainties in the Business Review, would help shareholders and potential investors have a better understanding of what those risks and uncertainties threaten. Preparation of such a statement may also serve to prompt discussion in the boardroom as to the long-term robustness of the business model. The FRC therefore proposes to add a new provision to this effect to Section C of the Code. In addition to views on whether this provision should be included in the Code, views on the wording would be very helpful to ensure that the terminology used will be readily understood.

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<sup>8</sup> Accounting Standards Board; *Rising to the Challenge*; October 2009: the figure quoted relates to disclosures on risk made in the Business Review, not the internal control statement.

<sup>9</sup> House of Commons Treasury Committee; *Banking Crisis: reforming corporate governance and pay in the City*; May 2009

**Proposed actions:**

- **The principle on internal control should be amended to state the board's responsibility for defining the company's risk appetite and tolerance and maintaining a sound risk management system, with a new provision stating that the board should satisfy itself that appropriate systems are in place to enable it to identify, assess and manage key risks.**
- **The FRC will carry out a limited review of the Turnbull Guidance during 2010, on which there will be separate consultation.**
- **A new provision should be added stating that companies should disclose their business model and overall financial strategy.**

## Remuneration

- 3.55. There have been a considerable number of developments in the area of remuneration during the course of the review. For banks and other financial institutions Sir David Walker has made recommendations; the FSA has issued a Code of Practice; the Government has recently brought forward legislation; and significant actions have been taken at European and international level. For all listed companies, the European Commission issued a revised Recommendation in April 2009 and has not ruled out future legislation.
- 3.56. These various initiatives deal collectively with four issues: the design of remuneration packages; disclosure; remuneration committees; and the use of remuneration consultants. The Combined Code does not deal with disclosure - for UK incorporated listed companies the requirements are set out in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 - but it does address the other three subjects.
- 3.57. The FRC does not consider it would be appropriate for the Code to become more prescriptive in this area, particularly if by doing so it might become quickly out of date as thinking on best practice develops further and/or other parts of the regulatory framework are changed. But where there are principles underlying the various recommendations that are applicable to all listed companies, the Code should reflect these where it does not already do so.
- 3.58. For this reason, the FRC proposes a number of changes to the sections of the Code dealing with remuneration (the previous Section B and Schedule A). These include a clearer statement of the need for performance-related elements to be aligned to the long-term interests of the company and new references to alignment with risk policies and systems and consideration of arrangements for reclaiming variable components in certain circumstances.
- 3.59. There are some recommendations that the FRC does not propose to adopt at this time. One such is the European Commission's recommendation that "at least one of the members of the remuneration committee should have knowledge of and experience in the field of remuneration policy". The FRC considers that if companies adhere to the proposed new Code principle that there must be an appropriate balance of skills, experience and independence for the board and its committees to operate effectively, then the intent of this recommendation should be achieved without it needing to be made an explicit requirement.

- 3.60. Sir David Walker has recommended that “the terms of reference of the remuneration committee should include responsibility for setting the principles and parameters of remuneration policy on a firm-wide basis”. The FSA is responsible for addressing this recommendation in respect of banks and other financial institutions.
- 3.61. The Code currently states that the committee should recommend and monitor the level and structure of remuneration for senior management and should be sensitive to pay and employment conditions elsewhere in the group. The FRC shares the view of many respondents that this should be sufficient for most non-financial companies. Sir David’s recommendation is intended to be applied to organisations where there are a large number of high earners below board level whose activities could have a material impact on the company’s risk exposure, and this is not typically the case below senior management level for most companies outside the financial sector.
- 3.62. In his initial report in July Sir David noted that issues had been raised about the independence and quality of the advice provided by remuneration consultants. He reported that a group of remuneration consultants had begun to develop a code of conduct and recommended that a professional body be set up to oversee that code. Since then the Remuneration Consultants Group has been established and a code of practice published<sup>10</sup>, and the Group is developing independent oversight arrangements as recommended by Sir David in his final report.
- 3.63. The FRC welcomes the progress that the industry has already made, encourages wider participation in the Remuneration Consultants Group and notes that the Group intends to carry out a review of the code of practice in late 2010. The FRC will also keep under review whether future changes to the Corporate Governance Code or its associated guidance would be appropriate.

**Proposed actions:**

- **A new Supporting Principle should be added on the need for performance-related remuneration to be aligned to the long-term success of the company, with a similar reference to be added in Schedule A.**
- **The Schedule should also be amended to add references to: the link between remuneration and risk policy; the use of non-financial metrics when measuring performance; and arrangements for reclaiming variable components in certain circumstances.**

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<sup>10</sup> More information is available at [www.remunerationconsultantsgroup.com](http://www.remunerationconsultantsgroup.com)

- **The provisions on remuneration of non-executive directors should be amended to clarify that all forms of performance-related remuneration are discouraged for those directors, not just share options.**
- **The FRC will keep under review whether future changes to the UK Corporate Governance Code or its associated guidance would be appropriate in respect of the code of practice for remuneration consultants.**

## The quality of disclosure by companies

- 3.64. As noted elsewhere in this report, the quality of companies' reporting on corporate governance remains variable. There are many examples of good practice, but there are also many boiler-plate and uninformative reports.
- 3.65. Investors remain concerned in particular about the quality of explanations provided by companies that do not comply with one or more of the Code provisions. While research carried out for the European Commission found that the explanations provided by UK companies compared favourably with those provided in other EU countries<sup>11</sup>, there remains considerable room for improvement.
- 3.66. There was little enthusiasm among commentators for the FRC or FSA to take on a more formal role in monitoring and enforcing reporting against the Code and the "comply or explain" requirement in the Listing Rules. There were concerns among both companies and investors that this might have the effect of reducing the flexibility of "comply or explain", and that regulatory activity might get in the way of, or be seen as an alternative to, engagement between boards and shareholders. The FRC understands these concerns and does not intend to extend its formal activities beyond the Financial Reporting Review Panel's existing role of checking, on behalf of the FSA, that the mandatory disclosure requirements in the Disclosure and Transparency Rules have been met.
- 3.67. The FRC is wary of being prescriptive about what represents best practice, as prescription can rapidly lead to boiler-plate, but there are actions that it can take to encourage companies to give more thought to what they report, for example through the introductory section of the Code - the draft Preface addresses this theme - or by encouraging initiatives such as the ICSA/Hermes Transparency in Governance Awards. The Accounting Standards Board has recently published a report on good and bad practice on other aspects of narrative reporting<sup>12</sup>, and consideration could be given to producing a similar report on the corporate governance statement if this was found to be helpful.
- 3.68. As noted on paragraph 2.10 of this report, FRC would encourage boards, and chairmen in particular, to view the corporate governance statement as an opportunity to demonstrate to its investors what steps the board has taken to ensure it remains effective and fit for purpose.

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<sup>11</sup> RiskMetrics Group; Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States; September 2009.

<sup>12</sup> Accounting Standards Board; Rising to the Challenge; October 2009.



- 3.69. As well as the requirements in the Listing Rules for companies to report on how they have applied the principles in the Code and to explain where they have not complied with its provision, the Code itself contains a number of provisions which require companies to disclose specific information in order to comply with them. The Code specifies where this information is to be made available; in most cases this is in the annual report.
- 3.70. In the progress report issued in July, the FRC invited respondents to identify any such requirements that could be removed on the grounds that the information was of little value. None were identified; all the information provided in accordance with the Code was considered useful by at least some respondents. The scope for removing requirements is also constrained by the fact that some of them are required under European legislation. The FRC does not therefore propose to remove any of the current disclosure requirements in the Code.
- 3.71. However, the FRC invites views on whether the requirements in the Code that certain information must be disclosed in the annual report should be amended to enable companies to take advantage of the flexibility allowed under Section 7.2 of the FSA's Disclosure and Transparency Rules which allow companies a choice of whether to put the corporate governance statement on the website or in the annual report. This might provide an opportunity for companies to make the annual report more focused by placing the full corporate governance statement on the website and an edited version containing the most important information in the annual report. If this proposition was supported, consequential amendments would need to be made to a number of provisions of the Code and further discussions would be needed with the FSA in case changes to the Listing Rules or Disclosure and Transparency Rules were required.

**Proposed actions:**

- **The FRC will consult on whether to allow companies the choice of meeting the disclosure requirements of the Code either in the annual report or on the website. If adopted, consequential amendments would be needed in the relevant provisions.**

## Engagement

3.72. Satisfactory engagement between company boards and investors is crucial to the health of the UK's corporate governance regime. Companies and shareholders both have responsibility for ensuring that "comply or explain" remains an effective alternative to a rules-based system. The FRC seeks to encourage an increase in trust between boards and shareholders.

3.73. There are positive indicators. Regular surveys conducted by organisations such as the National Association of Pension Funds (NAPF) and the Investment Management Association have shown a gradual but consistent increase in the resources devoted to engagement by institutions, and 70% of respondents to the most recent NAPF survey felt that engagement had been at least partly effective<sup>13</sup>. A report on implementation of the UN Principles for Responsible Investment, which include a commitment to active ownership, found that UK asset owners recorded higher scores than peers from other regions and the total number of engagements reported by UK signatories far exceeded the numbers reported in other countries<sup>14</sup>.

3.74. However, during the financial crisis there have been a number of high profile cases where engagement is perceived to have failed, and responses to this review have highlighted two recurring concerns:

- Frustration on the part of companies and investors about the quality of existing engagement, in particular the perceived box-ticking approach to compliance and inconsistent positions of some investors and the perceived lack of transparency and the perceived tendency of some companies to treat consultation as a presentation rather than a dialogue, both of which are perhaps indicative of a lack of trust; and
- A concern that, notwithstanding the improvements made over the years, too many institutional investors are still unwilling or unable to engage actively with investee companies.

3.75. These issues were also highlighted in Sir David Walker's report.

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<sup>13</sup> NAPF; Pension Funds' Engagement with Companies; June 2009

<sup>14</sup> UN PRI; 2009 Report on Progress; July 2009

### Stewardship Code for institutional shareholders

- 3.76. At present, Section E of the Code is addressed to institutional shareholders, while the remainder of the Combined Code applies to companies. In his report, Sir David Walker recommends that investors be subject to a separate code and that the FRC play some role in overseeing this code and facilitating better engagement. The majority of responses to the July progress report supported this recommendation and, partly in response to this recommendation, the Institutional Shareholders Committee<sup>15</sup> published a code in November<sup>15</sup>.
- 3.77. The FRC has accepted the Government's request to take responsibility for a Stewardship Code for institutional investors as recommended by Sir David, subject to separate consultation designed to ensure it can be operated effectively. The FSA has said that it intends to consult upon a rule to introduce a "comply or explain" requirement for relevant investment management firms. Assuming satisfactory progress is made on the Stewardship Code, the FRC proposes to delete the previous Section E of the Combined Code.

### Company relations with shareholders

- 3.78. At meetings held with chairmen of FTSE 100 companies during 2009, the FRC heard that some had succeeded in developing constructive relationships with their major shareholders, and a number of techniques for doing so were identified. Research conducted earlier in the year by the JCA Group<sup>16</sup> on behalf of the FRC also identified potential good practices that could be adopted by boards and investors.
- 3.79. There was a view that guidance that brought together practical suggestions of this nature might be of assistance to boards and investors, and might also help boards to apply the Code principle that there must be a satisfactory dialogue with shareholders and Sir David Walker's recommendation that boards should pay attention to significant changes in the share register. The FRC shares this view and is considering how such guidance could most usefully be developed.

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<sup>15</sup> Institutional Shareholders' Committee; Code on the Responsibilities of Institutional Investors; November 2009.

<sup>16</sup> JCA Group; Corporate Governance and the Effectiveness of Shareholder Engagement– a study of investor, company and adviser perspectives; July 2009

- 3.80. In response to the FRC's consultation, some comments were received to the effect that the provisions in previous Section D of the Code, on the board's dialogue with shareholders, had contributed to the sense of frustration referred to above. These suggest that these provisions have been interpreted in ways that were not intended and the FRC proposes to make a number of minor changes to this section of the Code.
- 3.81. These include proposed amendments to clarify that engagement with private shareholders - who might also form a significant part of the share register in some companies - is encouraged, and that it is not necessary to set up separate meetings in order for non-executive directors to develop a better understanding of shareholder concerns when attendance at regular meetings could achieve the same end.

**Proposed Actions:**

- **The FRC will take responsibility for a Stewardship Code for institutional investors, subject to consultation designed to ensure it can be operated effectively.**
- **Section E of the Combined Code should be deleted, subject to satisfactory progress on the Stewardship Code.**
- **The FRC is considering options for producing practical guidance on good practice engagement between companies and investors.**
- **The wording in the previous Section D of the Code should be clarified where necessary.**

## Other issues

3.82. This section summarises briefly other issues that have arisen during the course of the review in relation to which follow-up action has been considered.

### Title and coverage of the Code

3.83. The FRC will change the title of the Code from the Combined Code to the UK Corporate Governance Code. The FRC believes that the new title would make the Code's status as the UK's recognised corporate governance standard clearer to foreign investors, and to foreign companies listed in the UK which, as a result of changes to the FSA's Listing Regime announced in October 2009, will henceforth need to report against the Code if they have a Premium Listing.

3.84. With effect from April 2010 all companies on regulated markets in the UK will have the choice of a Premium or Standard listing. As a result all companies with a Premium listing will be required to meet the requirements in the Listing Rules to report on how they have applied the principles of the Code and to explain where they have not complied with its provisions. This will extend the requirement to report against the Code to all foreign incorporated companies with a Premium listing.

3.85. The FRC does not consider that any substantive changes need to be made to the Code to reflect these developments, although cross-references to statutory requirements will need to be amended to clarify that they only apply to UK incorporated companies, but would particularly welcome comments on the draft revised Code from companies that will be required to report against it for the first time.

### Other changes to the Code

3.86. The FRC has proposed structural changes to what was Section A of the Code. These are largely a consequence of the proposal to create a number of new Main Principles intended to give greater prominence to issues such as the roles of the chairman and non-executive directors and the commitment expected of all directors, but they are also a response to the view expressed by some commentators that those parts of the Code could be set out more clearly.

3.87. The FRC therefore proposes to split the material previously in Section A into two sections, one dealing with the role of the board and its members and the other with the composition, development, support and evaluation of the board. This is reflected in the proposed titles of these new Sections: "Leadership" and "Effectiveness".

- 3.88. Other proposed structural changes include updating the structure and content of the Preamble to the Code to form a new introductory section, adding a list of all the Code principles after that introductory section to remind users of the primacy of the principles, and reversing the order of the sections dealing with remuneration and accountability.
- 3.89. Finally, the FRC proposes to delete Schedule B to the Code. This addresses directors' liability and summarises those Code provisions that may be relevant to an assessment of whether non-executive directors have met their duty of care. It is not considered that the Schedule is necessary given the availability of other guidance on this topic but, if there is a demand, it would be more appropriate for it to be incorporated in the updated Higgs Guidance being developed on behalf of the FRC by ICSA and others.

"Apply or explain"

- 3.90. As in previous reviews, a number of commentators have argued that the term "comply or explain" should be changed to "apply or explain" (which is used, for example, in the Netherlands). It is argued that this would be a more accurate description of what companies are actually being asked to do, and that the term "comply or explain" has contributed to box-ticking by some investors and voting advisory services and, as a consequence, encouraged a compliance mindset in some companies.
- 3.91. While the FRC has a degree of sympathy for these comments, having discussed the subject with the Monitoring Commission that is responsible for the Netherlands Corporate Governance Code amongst others, it is not persuaded that a change of terminology would result in a change of behaviour. In addition, the term "comply or explain" is widely recognised and has been adopted in European legislation.
- 3.92. For these reasons, the FRC does not propose to ask the FSA to amend the Listing Rules to refer to "apply or explain". Instead as part of its focus on engagement, it will make renewed efforts to encourage both companies and investors to judge the case for complying or explaining with the provisions of the Code on the basis of a company's ability to meet the Code's principles.

## Other changes to related guidance

- 3.93. The FRC Guidance on Audit Committees was last revised in October 2008. Accordingly the FRC does not consider there is a need for a full review of the Guidance at present. However it is possible that the FRC may wish to propose limited changes to the Guidance depending on the outcome of work being undertaken by the FRC's Auditing Practices Board (APB).
- 3.94. The APB is currently consulting on issues relating to the provision by audit firms of non-audit services to their audit clients. Responses have yet to be received but one possibility is that there will be support for the US approach that audit committees should pre-approve the provision of all non-audit services or, perhaps, above a certain value or for particular services. Separately, the APB has amended the ethical standards for auditors to allow the rotation period of the audit engagement partner to be extended from five to seven years where the audit committee is satisfied that the extension is necessary to safeguard audit quality. It may be helpful for there to be further guidance on the disclosures and arguments that might be given in such cases.
- 3.95. If any changes are proposed to the FRC Guidance on Audit Committees as a result of these deliberations they will be subject to separate consultation.

## **Proposed actions**

- **The Code will be renamed "The UK Corporate Governance Code".**
- **Structural changes should be made to the Code to reinforce its principles and the importance of board behaviours.**
- **Schedule B on non-executive directors' liability should be removed.**



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