February 2010

Review

Corporate Strategy & Finance

Combined Code - proposed changes

INTRODUCTION

You will be aware that in December last year the Financial Reporting Council ("FRC") published the final report on its recent review of the Combined Code, together with a consultation paper on the draft version of the, soon to be renamed, "UK Corporate Governance Code".

Comments on the proposals were invited by 5 March 2010 and the revised Code is expected to apply for accounting periods beginning on or after 29 June 2010.

REVIEW RESULTS

There is good news for listed companies as the latest review concludes that the Code continues to meet its objectives and does not require substantial revision. In particular, it was agreed that the flexibility permitted by the Code remains preferable to a more prescriptive framework, and that a single Code should continue to apply to all companies. Accordingly, there are no plans to incorporate any sector-specific provisions.

However, the FRC intends to make a number of structural changes to the Code and to add certain new principles and provisions to refocus attention on specific key issues, including:

- board behaviour, particularly the roles of directors and board composition; and
- improved communication between companies and investors and a board's ability to explain its approach.

BOARD BEHAVIOUR

The FRC emphasises that the quality of corporate governance depends ultimately on behaviour rather than process. The main shortcomings are felt to have arisen from the application of the Code rather than from deficiencies in its content. The FRC is therefore seeking to change the tone of the Code by highlighting the importance of board behaviour and directing attention towards the high level principles.

The Code is to be restructured to encourage a greater focus on board balance, behaviour and responsibility. Notably, the FRC proposes to divide the existing principles and provisions relevant to the board into two new sections on Leadership and Effectiveness. New principles will be added, notably on the need for the board to have an appropriate balance of skills, experience, independence and knowledge of the company. This represents a subtle shift away from the emphasis that was placed on the principle of independence.

Three supporting principles will be upgraded to main principles, so that companies with a Premium Listing will have to report on their application. These cover the chairman's responsibility for leading the board, the responsibility of the non-executive directors to provide constructive challenge and the time commitment expected of all directors. As there will be a main principle requiring directors to allocate sufficient time to the business, boards and shareholders will have to give clearer thought as to what, in each case, is sufficient. Arguably, any increase in their time commitment will lead to non-executive directors being able to take on fewer roles.

Changes to a number of provisions (which for listed companies are subject to the "comply or explain" requirement) are proposed to emphasise that the chairman should agree and regularly review a personalised approach to training and development for each director and that board evaluation should be externally facilitated at least every three years. These changes are designed to promote the ongoing effectiveness of the board.

The FRC suggests amending the Code provisions on the re-election of directors, on the basis that more frequent re-election would increase the accountability of directors to shareholders and

improve the ability of shareholders to signal any concerns that they may have. It is therefore considering two alternative options:

- annual re-election of all directors; or
- annual re-election of the chairman of the board, on the basis that he is ultimately responsible for ensuring that any shareholder concerns are properly addressed.

RISK MANAGEMENT AND ACCOUNTABILITY

The FRC has acknowledged the role of taking risks for a business. A revised principle will now make clear that the board is responsible for defining the company's risk appetite and tolerance. Further, the board must satisfy itself that appropriate systems are in place to identify, assess and manage significant risks.

The Code introduces a new requirement that companies will have to include in their annual report the basis on which they generate revenue and make a profit from their operations and their overall financial strategy. This should enable shareholders to better understand the disclosure on risks and their threat to the business which are included in the business review.

REMUNERATION

Certain changes are also proposed to the provisions on directors' remuneration, including the alignment of executive directors' remuneration with the company's long-term interests and risk policies, the use of non-financial metrics when measuring performance, and arrangements for reclaiming variable components of remuneration in certain circumstances. The Code will also clarify that all forms of performance related remuneration are discouraged for non-executive directors.

COMMUNICATION

The FRC wants to see a further improvement in the quality of communication by companies and engagement between companies and their investors. Boards are encouraged to move away from boilerplate reporting and box ticking and to see such engagement as an opportunity to demonstrate why investors should have confidence in the board. In particular, a board must be able to clearly explain to shareholders why it has taken a particular approach or view, especially where a company chooses to explain, rather than comply with, a Code provision.

Having previously solicited views on the disclosure requirements the FRC is not proposing to remove any of the present disclosure requirements. However, it is now inviting views on whether companies could be given the flexibility to provide full corporate governance disclosure either on their website or in their annual report.

The FRC is also considering the options for developing further good practice guidance on engagement between companies and their investors and will take responsibility for a Stewardship Code on good practices for institutional investors engaging with companies. If satisfactory progress is made with this code, Section E of the Code may be deleted.

CONCLUSION

The revised Code does not herald a major change in the corporate governance obligations of listed companies. However, it arguably signals a greater focus on the high level principles and board behaviour, with more onus on the explanation of board decisions and a move away from what is perceived to have become a box ticking adherence to the more detailed Code provisions.

FURTHER INFORMATION

For more information relating to this article, or for assistance with any of the matters raised, please contact:

Andrew Millar
Senior Associate, Corporate Strategy & Finance (Corporate Finance)
T: +44 (0)161 830 5063
F: +44 (0)870 460 3074
E: andrew.millar@hammonds.com