NEW PRINCIPLES IN THE HIGGS II COMBINED CODE

In July, the Financial Reporting Council (FRC) published its redrafted and finalised Combined Code on Corporate Governance to supersede the 1998 Hampel original. The finalised Code includes the bulk of Higgs' recommendations, as well as those of Sir Robert Smith's report, *Audit Committees – Combined Code Guidance*, also published in January. It represents the culmination of extensive consultation by the FRC during the year, in which 181 responses were received.

The Code's overall aim is to enhance board effectiveness and improve investor confidence by raising standards of corporate governance. However, the FRC drafters have been at pains to emphasise that it is not designed to be a tick-box tool for institutional investors. As the preamble to the Code says: "Whilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches. Institutional shareholders and their agents should be careful to respond to the statements from companies in a manner that supports the 'comply or explain' principle."

The revised Combined Code's main features are as follows:

(A) Directors

- The same person should not act as chairman and chief executive
- Chairmen should meet the test of independence at appointment
- A chief executive should not go on to become chairman of the same company, although if "exceptionally" a board decides this is appropriate, major shareholders should be consulted
- In large listed companies, at least half the board should be independent non-exec directors
- The board should appoint one of the independent non-executive directors to be the senior independent director (SID), who should be available to shareholders if they have concerns which contact through the normal channels (chairman, chief executive or finance director) have failed to resolve, or for which such contact is inappropriate
- A nomination committee should lead the process for board appointments, with the majority of its members being independent non-executive directors
- No one should be appointed to a second chairmanship of a FTSE-100 company
- The board should not agree to a full-time executive director taking on more than one non-executive directorship in a FTSE-100 company, nor the chairmanship of such a company
- The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board and all directors should regularly refresh their skills
- The board should undertake a formal and rigorous annual evaluation of its own performance, and that of its committees and individual directors
- All directors should be subject to re-election at intervals of no more than three years
- Non-executive directors should be appointed for specified terms subject to re-election. Any term beyond six years for a non-executive should be subject to particularly rigorous review
- Non-executives may serve longer than nine years, if subject to annual re-election

(B) Remuneration

- Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required, but companies should avoid paying more than necessary
- Performance-related elements should form a significant proportion of the remuneration packages of executive directors
- Executive share options should not be offered at a discount, except as permitted by the Listing Rules
- Remuneration for non-executive directors should not include share options
- Remuneration committees should avoid rewarding poor performance
- Notice or contract periods should be set at one year or less
- The board should establish a remuneration committee of at least three (two for small companies) members – all independent non-executive directors

(C) Accountability and audit

- The board should review the effectiveness of internal controls at least annually
- The board should establish an audit committee of at least three (two for small companies) members – all independent non-executives
- At least one member of the audit committee should have recent relevant financial experience
- The Code sets out a strengthened role for the audit committee in monitoring the integrity of the company's financial reporting, reinforcing the independence of the external auditor and reviewing the management of risks

(D) Shareholder relations

- The chairman should ensure the views of shareholders are communicated to the board
- The senior independent directors should attend sufficient meetings with major shareholders to listen to their views
- The board should use the AGM to communicate with investors and encourage their participation

(E) Institutional shareholders

- Companies and institutional investors should enter into a dialogue based on the mutual understanding of objectives
- Institutional investors should consider carefully the explanations given for departure from the Combined Code, avoiding a box-ticking approach to assessing a company's corporate governance
- Major shareholders should attend AGMs where appropriate and practicable

Additional schedules

(A) Provisions on the design of performance-related remuneration. The schedule addresses annual bonuses for directors, benefits under long-term incentive schemes and other incentive schemes. The remuneration committee should consider the pension implications of remuneration.

(B) Guidance on liability of non-executive directors: care, skill and diligence.
The schedule highlights that the letter of appointment to a

director should set out the expected time commitment, and that the chairman is responsible for ensuring that directors are provided with accurate, timely and clear information. Steps non-executives should take, such as regularly updating their skills, are also included.

(C) Disclosure of corporate governance arrangements. The schedule outlines the disclosures requires in the company's annual report.

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Useful links

● The new Combined Code is available on the FRC website at www.frc.org.uk/combined.cfm

The document includes the Turnbull guidance on internal control, the Smith guidance on audit committees and several pieces of informal best practice guidance from the Higgs report.

● The original Higgs draft of the Code is at www.dti.gov.uk/cld/non_exec_review/pdfs/annexa.pdf

Higgs' draft Combined Code has been revised following an extensive consultation by the FRC. Here are the main areas of difference.

● The finalised Code's structure has been modified to include not only main principles and provisions but also supporting principles, allowing companies greater flexibility in how they implement the Code.

One of the main criticisms of Higgs' draft revised Code was that it was too prescriptive – the number of provisions increased hugely. The number of provisions has been reduced again in the final Code, which now contains 14 main principles for companies and 21 supporting principles.

The provisions should be clearly defined, so companies can report unambiguously whether they have followed them. The supporting principles are cast in more general terms and leave the detailed method of implementation for companies to decide.

In terms of reporting, with provisions, companies must either confirm that they comply with them or provide an explanation to shareholders as to why they do not. In contrast, reporting requirements for principles require companies to describe how they have applied them.

● The board chairman is able to chair the nomination committee. Higgs' draft of the Combined Code required an independent non-executive director to chair the nominations committee, not the board chairman (A.4.1). The finalised Code says the board chairman may do so, except when the successor to the chairmanship is being appointed (A.4.1).

● The redrafted Code has clarified the roles of the chairman and the senior independent director (SID), emphasising the chairman's role in providing leadership to the non-executive directors and in the communication of shareholder views to the board.

Critics suggested that the SID was being promoted as a rival to the chairman, risking splits in the board's unity. The redrafted Code is careful to avoid any such implication. For example, the original draft Code included the principle (C.1.2): "The senior independent director should attend sufficient regular meetings of management with a range of major shareholders to develop a balanced understanding of the themes, issues and concerns of shareholders." In the redraft, provision D.1.1 says the SID should attend "sufficient" meetings with a range of major shareholders.

The redrafted Code (A.1.3) makes clear that non-execs, led by the SID, should meet at least annually, without the chairman present to appraise the chairman's performance.

● For smaller listed companies below the FTSE-350, rules on the number of independent non-execs required on the board are relaxed. The finalised Code (provision A.3.2) says smaller companies, defined as those below the FTSE-350 throughout the year immediately prior to the reporting year, should have at least two independent non-executive directors; other companies are required to have at least half the board, excluding the chairman, being independent non-execs.

● The Code calls for rigorous review when non-exec directors are re-elected beyond six years.

The original draft was specific about how many terms non-execs should serve. A provision (A.7.3) in the draft revised Code said: "Non-executive directors would normally be expected to serve two terms of three years, subject to continued satisfactory performance, but may exceptionally serve longer where this would be in the interests of the company and the reasons are explained to shareholders. Non-executive directors serving nine years or more should be subject to annual re-election."

The finalised Code does not require reasons for long service to be explained to shareholders. Instead, it introduces the concept of a "rigorous review". The relevant provision in the finalised Code (A.7.2) becomes: "Any term beyond six years (eg, two three-year terms) for a non-executive director should be subject to particularly rigorous review and should take into account the need for progressive refreshing of the board. Non-executive directors may serve longer than nine years (eg, three three-year terms), subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1)."

A.3.1 notes that if a director has served on the board for more than nine years, it may be cause to determine whether a director is independent or not.