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BRIEFING

New Combined Code – implementation of the Higgs Report

Employment, pensions and benefits: briefing 95

Executive summary

The revised Combined Code implements most of the recommendations made in the *Higgs Review of the Role and Effectiveness of Non-Executive Directors*. Some of the more controversial Higgs recommendations have been dropped and others have been diluted. The revised Code comes into effect for listed companies with reporting years beginning on or after 1 November 2003. This briefing explains the changes which have been made to the Code.

The Financial Reporting Council has published the revised Combined Code (Code), which comes into effect for listed companies with reporting years beginning on or after 1 November 2003. This implements most of the recommendations made in the *Higgs Review of the Role and Effectiveness of Non-Executive Directors* (the Higgs Report). Some of its more controversial recommendations have been diluted and a few have been dropped.

This briefing explains the changes made to the Code as a result of these revisions and assumes the reader is broadly familiar with the existing requirements of the Code. The revised Code is available at www.frc.org.uk/publications/content/combined.pdf.

Structure of the Code

The Code comprises *principles*, which are now divided into main principles and supporting principles, and *provisions*. The Listing Rules require companies to make a two-part statement regarding the Code in their annual reports. In the first part companies must explain their governance policies 'in light of the principles' of the Code (which now includes both main and supporting principles) and can give details of any special circumstances which resulted in a particular approach being adopted. The second part of the statement requires companies to confirm they comply with the Code provisions or explain any non-compliance.

The main principles of the Code have not been materially changed, although there has been one addition and one removal. The new main principle requires the board to undertake an annual evaluation of its performance and the performance of its committees. The old principle providing that the annual report should contain a statement of the company's remuneration policy and details of each director's remuneration (along with a related schedule) has been removed. This is as a result of the introduction of the Directors' Remuneration Report Regulations 2002.

Supporting principles

The main criticism of the draft of the Code annexed to the Higgs Report (the Higgs draft Code) was that it was too prescriptive. Most of the Higgs recommendations were included as provisions, with which companies would have had to 'comply or explain'. The fear was that the so-called box tickers – corporate governance specialists at institutional shareholders – would treat non-compliance with a provision of the Code as a 'cross', however valid the supporting explanation. Many companies would have had difficulty complying with the Higgs recommendations if these had been implemented as provisions. Thus, they might have been criticised as having poor governance, even where an adequate explanation for non-compliance was given.

The compromise position has been to include many of the Higgs recommendations as a new set of supporting principles. These are drafted in more general terms than the Code provisions so that companies can decide themselves on their method of implementation. This is a more flexible approach and should help to avoid the box ticking problem described above.

Provisions of the Code (subject to the 'comply or explain' requirement)

Set out below are the Higgs Report recommendations which have been included in the Code as provisions (ie subject to the 'comply or explain' requirement).

Non-executive directors

Test of independence (A.3.1)

The Code continues to require the board to identify in its annual report each non-executive director (NED) which it considers to be independent. The Higgs test for independence has been included. This provides that 'the board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination'.

Factors relevant to independence include if the director:

- has been an employee of the company or group within the last five years;
- has had a material business relationship with the company within the last three years;
- receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of first election – this period is one year shorter than the Higgs recommendation of ten years so as to tie in with the provision that directors should serve no more than three terms of three years each.

Board composition (A.3.2)

The revised Code provides that at least half the board, excluding the chairman, should comprise independent NEDs – except for smaller companies, which should have at least two NEDs on the board. (A smaller company is defined as one that falls below the FTSE 350 throughout the year immediately prior to the reporting year).

This requirement will be unwelcome to many companies. The Higgs Report acknowledged it would take companies some time to comply with this recommendation but no transition period has been included in the Code. Instead, companies will be required to explain the reasons for their non-compliance with this provision from 1 November 2003. It should be noted that a non-independent NED (for example, a NED who was previously an employee of the company or one of its advisers) is regarded in the same category as an executive director (rather than as neutral, like the chairman). The Higgs Report stated that its recommendation that at least half the board comprise independent NEDs should not be interpreted as meaning that non-independent NEDs had no place on company boards. But, for many companies, the presence of non-independent NEDs will make compliance with this recommendation significantly more difficult.

This provision is also likely to result in a shift in the overall power of the board in favour of independent NEDs, and away from executive management. This is perhaps likely to be the most important long-term effect of the Higgs Report.

The Tyson Report – *Recruitment and Development of Non-Executive Directors* – published shortly after the Higgs Report, provided suggestions on how companies might draw on a wider pool of talent when selecting NEDs. The Higgs Report had suggested that a list of qualified persons from the non-commercial sector who could be considered for NED positions be drawn up. The Tyson Report did not recommend this and instead set out general considerations to be borne in mind when selecting NEDs. It recommended that candidates be considered from the so-called 'marzipan' layer of corporate management below board level; from unlisted companies and private equity firms; from business services and consultancies; and from organisations in the non-commercial sector.

Length of service (A.7.2)

The Code provides that NEDs may serve beyond six years (ie two terms) but longer periods of service should be subject to rigorous review. This is a dilution of the Higgs recommendation that NEDs generally be limited to serving for six years and the reasons for any longer period of service explained to shareholders.

The Code states that serving for more than nine years 'could be relevant' in determining whether a NED is independent. As explained above, this is one of the factors listed in the test of independence.

Remuneration of NEDs (B.1.3)

The Code provides that NED remuneration should reflect the time commitment required from, and the responsibilities of, each NED. The fuller input required from NEDs following the Higgs Report is likely to result in an increase in NED remuneration.

The Code goes on to provide that NEDs should not receive share options. If, exceptionally, these are granted, shareholder approval should be sought in advance and NEDs should be required to hold any shares acquired for at least one year after leaving the board. Holding share options may be relevant in determining whether a NED is independent. It is possible that this wording creates an opening for companies to grant options to NEDs (although the company would have to justify why the grant of options would not result in a loss of independence). The share retention obligation is not particularly onerous, and shareholder approval is required anyway for an option scheme in which any director participates.

Role of chairman (A.2 and A.4.1)

The chairman must meet the test of independence on appointment but thereafter is not regarded as independent. The Higgs Report's reason for this was that the chairman will be in constant and close contact with the executive directors in carrying out his duties. As a result a test for independence was considered to be 'neither appropriate nor necessary' once a chairman had been appointed. This provision need only be complied with (or any non-compliance explained) in the year in which the chairman is appointed.

A chief executive should not become chairman of the company except in exceptional cases where major shareholders should be consulted in advance and the reasons for that appointment set out in the next annual report. This is a relaxation of the Higgs Report recommendation that a chief executive should not be permitted to become chairman of the company.

The chairman will be permitted to chair the nomination committee except when it is considering the appointment of a new chairman. Importantly, this provision rejects the Higgs recommendation that chairmen should not be permitted to chair nomination committees.

Directorships of other companies (A.4.4, A.4.5 and B.1.4)

The board should not agree to a full time executive director taking on more than one non-executive directorship in, or the chairmanship of, a FTSE 100 company. No individual should chair more than one FTSE 100 company.

The Code provides that companies must include a statement in the Remuneration Report as to whether executive directors are entitled to retain earnings received from serving as a NED elsewhere and, if so, what that remuneration is.

NEDs must inform the board if they accept any other NED appointments. This slightly waters down the Higgs recommendation that NEDs be required to inform the chairman before another appointment is accepted and the board should subsequently be informed.

Board committees

The Higgs recommendation that no director should sit on all of the remuneration, nomination and audit committees has been dropped in the Code. Nevertheless, one of the supporting principles provides that, in deciding the chairmanship and membership of committees, undue reliance should not be placed on particular individuals. Also, the value of ensuring committee membership is refreshed should be taken into account.

Many companies will welcome this, as the practical effect of the Higgs recommendation would have been that a company would need a minimum of four independent

NEDs to staff the committees. But, in any event compliance with the Code provision that at least half of the board must comprise independent NEDs will probably result in most companies having sufficient NEDs on the board to comply with the dropped recommendation.

Remuneration committee (B.2)

The remuneration committee must consist of at least three, or in the case of smaller companies two, independent NEDs. The remuneration committee should be responsible for setting the remuneration of executive directors and the chairman. The terms of reference of the remuneration committee must be 'made available'. A footnote to the Code states that the requirement to make information available will be met by making the information available on request and by including it on the company's website.

Where remuneration consultants are appointed to assist the remuneration committee, a statement indicating whether they have any other connection with the company should be made available. It is surprising that this has been included in the revised Code since it is also a requirement of the Directors' Remuneration Report Regulations 2002.

The remuneration committee should 'recommend and monitor' the remuneration of senior management below board level. The board is responsible for setting out who constitutes senior management, but the Code provides it should include the first layer of management below board level. This dilutes the Higgs recommendation that the remuneration committee should 'set' rather than 'recommend and monitor' the remuneration of senior management.

Audit committee (C.3)

The Smith Report – *Audit Committees: Combined Code Guidance* – was published at the same time as the Higgs Report and its recommendations have been included in the Code.

- The Code provides that every company should establish an audit committee consisting of at least three independent NEDs (save that two independent NEDs is sufficient in the case of smaller companies) and at least one member should have recent and relevant financial experience.
- The Code sets out the main role and responsibilities of the audit committee and provides that its terms of reference should be made available.
- New provisions are included relating to mechanisms through which staff may raise concerns about financial reporting; monitoring and review of internal audits; and the appointment of external auditors.
- The Code also provides that the annual report should explain how auditor objectivity and independence is ensured where the auditor also provides non-audit services.

Senior independent non-executive director (D.1 and A.3.3)

The recommendations relating to the role of the senior independent NED (SID) were some of the most controversial recommendations of the Higgs Report and have been diluted in the Code. Higgs recommended the SID, rather than the chairman, should be responsible for communicating shareholder views to the board. The Code now states that the chairman should communicate shareholder views to the board and should discuss governance and strategy with major shareholders. The SID is expected to attend sufficient meetings with major shareholders to develop an understanding of their concerns. The SID must also be available to meet with shareholders if they have concerns which have not been resolved by, or are inappropriate to discuss with, the chairman, chief executive or finance director.

Professional development and performance evaluation of the board (A.5, A.6 and A.1.3)

The chairman is responsible for ensuring all new directors receive an induction on joining the board. Major shareholders should be invited to meet new NEDs. The old Code provisions entitling board members to access to independent professional advice and the company secretary are retained.

The Code provides that the annual report must state how performance evaluations of the board, its committees and each individual director are conducted. The NEDs, led by the SID, are responsible for conducting the performance evaluation of the chairman.

Supporting principles (not subject to the 'comply or explain' requirement)

A number of the Higgs recommendations have been included in the Code as supporting principles and these are set out below. As supporting principles, they are not subject to the 'comply or explain' requirement.

- Further guidance is given on the role of the board and the NEDs (A.1).
- Further guidance is given on the role of the chairman (A.2).
- The size of the board and the balance of executive and non-executive directors. Undue reliance should not be placed on particular individuals in deciding the chairmanship and membership of committees and no one other than the members of the nomination, audit and remuneration committees may be present at meetings of those committees except by invitation (A.3).
- Plans should be in place for orderly succession for appointments to the board and to senior management. Appointments to the board should be on merit and objective criteria and the board should ensure appointees have sufficient time available, especially in the case of chairmanships (A.4).
- The chairman should ensure that directors receive all necessary information prior to board meetings and that they continually update their skills and knowledge of the company. The company secretary should be responsible for advising the board through the chairman on all governance matters (A.5).
- Each director should be individually assessed annually to examine whether the director continues to contribute effectively and demonstrate commitment to the role (A.6).
- The remuneration committee should consult the chairman and/or chief executive regarding its remuneration proposals for executive directors and should take care to avoid conflicts of interest where executive directors or senior management advise it. The chairman should ensure remuneration is discussed with major shareholders in the same way as other matters (B.2).
- The board is responsible for presenting balanced and understandable assessments of the company's position in interim and other price-sensitive public reports as well as in reports required by statute (C.1).
- The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient (D.1).
- Institutional shareholders should apply the principles set out in the Institutional Shareholders' Committee's *The Responsibilities of Institutional Shareholders and Agents – Statement of Principles* and these principles should be reflected in fund manager contracts (E.1).
- Institutional shareholders should consider explanations given by companies for non-compliance with Code provisions and make reasoned judgements as to the adequacy of each explanation, considering the size and complexity of the company and the nature of the risks it faces, and should provide the company with reasons where they do not accept its explanation (E.2).

Schedules to the Code

When the Code was first introduced in 1998, recommendations on the design of performance related remuneration and the content of the remuneration report were included as schedules A and B to the Code respectively. These recommendations were not subject to the 'comply or explain' requirement, but companies have generally complied with the schedules.

Schedule A has been retained and a new provision requiring companies to disclose the upper limits to annual bonuses has been included.

Schedule B, which gave guidance on the content of remuneration reports, has been removed since it has been superseded by the Directors' Remuneration Report Regulations 2002.

The revised Code contains new schedules B and C, which respectively provide guidance on the liability of non-executive directors and disclosure of corporate governance arrangements.

Schedule B

The new schedule B emphasises the importance of ongoing professional development of directors and summarises the Code provisions relating to the care, skill and diligence required of NEDs. It acknowledges that NEDs will devote significantly less time than executive directors to a company's affairs and will not have the detailed knowledge and experience of executive directors.

This may be relevant when assessing the knowledge, skill and diligence which can be reasonably expected of a NED.

Schedule B lists the provisions of the Code which are relevant in evaluating the duty of care expected of NEDs. The company must set out the amount of time a NED is expected to commit to the company in the letter of appointment. The chairman must ensure the board is supplied in good time with all necessary information required for it to perform its duties. NEDs themselves must undertake an induction on appointment and ensure their skills are constantly updated. They should seek clarification of information and/or take professional advice where necessary and should ensure any concerns they have regarding the company's affairs are addressed by the board or, if not resolved, recorded in the board minutes. NEDs must also give a statement to the board of any unresolved concerns they have regarding the company's affairs on resignation.

Schedule C

The Listing Rules require companies to include a statement in their annual reports confirming their compliance with the Code. Schedule C, which is a checklist of disclosure requirements with references to the relevant provisions of the Code, has been included to assist companies in preparing this statement. It also sets out information which should be 'made available' to shareholders and information that should be set out in papers accompanying a resolution to elect or re-elect directors and to appoint or re-appoint an external auditor.

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