

## THE COMBINED CODE

### PRINCIPLES OF GOOD GOVERNANCE AND CODE OF BEST PRACTICE

Derived by the Committee on Corporate Governance from the Committee's Final Report and from the Cadbury and Greenbury Reports.

#### PREAMBLE

- 1 In the Committee's final report we said that, in response to many requests, we intended to produce a set of principles and code which embraced Cadbury, Greenbury and the committee's own work. This Combined Code fulfils that undertaking.
- 2 The Combined Code is now issued in final form, and includes a number of changes made by the London Stock Exchange, with the Committee's agreement, following the consultation undertaken by the London Stock Exchange on the committee's original draft.
- 3 The Combined Code contains both principles and detailed Code provisions. We understand that it is the intention of the London Stock Exchange to introduce a requirement on listed companies to make a disclosure statement in two parts.
- 4 In the first part of the statement, the company will be required to report on how it applies the principles in the Combined Code. We make clear in our report that we do not prescribe the form or content of this part of the statement, the intention being that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances applying to them which have led to a particular approach. It must be for shareholders and others to evaluate this part of the company's statement.
- 5 In the second part of the statement the company will be required either to confirm that it complies with the Code provisions or - where it does not - provide an explanation. Again, it must be for shareholders and others to evaluate such explanations.
- 6 In our report we make clear that companies should be ready to explain their governance policies, including any circumstances justifying departure from best practice; and that those concerned with the evaluation of governance should do so with common sense, and with due regard to companies' individual circumstances.
- 7 We also make clear in our report that it is still too soon to assess definitively the results of the Cadbury and more especially the Greenbury codes. We see this Combined Code as a consolidation of the work of the three committees, not as a new departure. We have therefore retained the substance of the two earlier codes except in those few cases where we take a different view from our predecessors. We should in particular like to make clear, in relation to the detailed provisions in the Listing Rules on directors' remuneration, that we envisage no change except where we take a different view from the Greenbury committee. With two exceptions, relating to the status of the remuneration committee, and the compensation payable to an executive director on loss of office, these changes are minor.
- 8 Section 1 of the Combined Code contains the corporate governance principles and code provisions applicable to all listed companies incorporated in the United Kingdom. These would be covered by the statement referred to in paragraphs 3-5 above, which will be required by the Listing Rules. Section 2 contains principles and code provisions applicable to institutional shareholders with regard to their voting, dialogue with companies and evaluation of a company's governance arrangements. These are not matters which are appropriate for the Listing Rules to include within the disclosure requirement. Nevertheless we regard Section 2 of this Combined Code as an integral part of our recommendations; we commend it to the organisations representing institutional shareholders and we hope that at least the major institutions will voluntarily disclose to their clients and the public the extent to which they are able to give effect to these provisions.

- 9 We have not included in the Combined Code principle D.IV in Chapter 2 of our final report, which reads as follows:

“External Auditors. The external auditors should independently report to shareholders in accordance with statutory and professional requirements and independently assure the board on the discharge of its responsibilities under D.I and D.II above in accordance with professional guidance.”

We say in paragraph 6.7 of the report that we recommend neither any additional prescribed requirements nor the removal of any existing requirements for auditors in relation to governance or publicly reported information, some of which derive from the Listing Rules. This recommendation is accepted by the London Stock Exchange. But the existing requirements for auditors will be kept under review, as a matter of course, by the responsible organisations.

Committee on Corporate Governance

June 1998

## PRINCIPLES OF GOOD GOVERNANCE

### SECTION 1 COMPANIES

#### A. DIRECTORS

##### The Board

1. Every listed company should be headed by an effective board which should lead and control the company.

##### Chairman and CEO

2. There are two key tasks at the top of every public company - the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

##### Board Balance

3. The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision taking.

##### Supply of Information

4. The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

##### Appointments to the Board

5. There should be a formal and transparent procedure for the appointment of new directors to the board.

##### Re-election

6. All directors should be required to submit themselves for re-election at regular intervals and at least every three years.

#### B. DIRECTORS' REMUNERATION

##### The Level and Make-up of Remuneration

1. Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, but companies should avoid paying more than is necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

##### Procedure

2. Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

##### Disclosure

3. The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

**C. RELATIONS WITH SHAREHOLDERS****Dialogue with Institutional Shareholders**

1. Companies should be ready, where practicable, to enter into a dialogue with institutional shareholders based on the mutual understanding of objectives.

**Constructive Use of the AGM**

2. Boards should use the AGM to communicate with private investors and encourage their participation.

**D. ACCOUNTABILITY AND AUDIT****Financial Reporting**

1. The board should present a balanced and understandable assessment of the company's position and prospects.

**Internal Control**

2. The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

**Audit Committee and Auditors**

3. The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

**SECTION 2 INSTITUTIONAL SHAREHOLDERS.****E. INSTITUTIONAL INVESTORS****Shareholder Voting**

1. Institutional shareholders have a responsibility to make considered use of their votes.

**Dialogue with Companies**

2. Institutional shareholders should be ready, where practicable, to enter into a dialogue with companies based on the mutual understanding of objectives.

**Evaluation of Governance Disclosures**

3. When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.

## CODE OF BEST PRACTICE

### SECTION 1 COMPANIES

#### A. DIRECTORS

##### A.1 The Board

**Principle** Every listed company should be headed by an effective board which should lead and control the company.

##### Code Provisions

- A.1.1 The board should meet regularly.
- A.1.2 The board should have a formal schedule of matters specifically reserved to it for decision.
- A.1.3 There should be a procedure agreed by the board for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.
- A.1.4 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the company secretary should be a matter for the board as a whole.
- A.1.5 All directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
- A.1.6 Every director should receive appropriate training on the first occasion that he or she is appointed to the board of a listed company, and subsequently as necessary.

##### A.2 Chairman and CEO

**Principle** There are two key tasks at the top of every public company - the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

##### Code Provision

- A.2.1 A decision to combine the posts of chairman and chief executive officer in one person should be publicly justified. Whether the posts are held by different people or by the same person, there should be a strong and independent non-executive element on the board, with a recognised senior member other than the chairman to whom concerns can be conveyed. The chairman, chief executive and senior independent director should be identified in the annual report.

##### A.3 Board Balance

**Principle** The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision taking.

**Code Provisions**

- A.3.1 The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions. Non-executive directors should comprise not less than one third of the board.
- A.3.2 The majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Non-executive directors considered by the board to be independent in this sense should be identified in the annual report.

**A.4 Supply of Information**

**Principle** The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

**Code Provision**

- A.4.1 Management has an obligation to provide the board with appropriate and timely information, but information volunteered by management is unlikely to be enough in all circumstances and directors should make further enquiries where necessary. The chairman should ensure that all directors are properly briefed on issues arising at board meetings.

**A.5 Appointments to the Board**

**Principle** There should be a formal and transparent procedure for the appointment of new directors to the board.

**Code Provision**

- A.5.1 Unless the board is small, a nomination committee should be established to make recommendations to the board on all new board appointments. A majority of the members of this committee should be non-executive directors, and the chairman should be either the chairman of the board or a non-executive director. The chairman and members of the nomination committee should be identified in the annual report.

**A.6 Re-election**

**Principle** All directors should be required to submit themselves for re-election at regular intervals and at least every three years.

**Code Provisions**

- A.6.1 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Act provisions relating to the removal of a director, and reappointment should not be automatic.
- A.6.2 All directors should be subject to election by shareholders at the first opportunity after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details to enable shareholders to take an informed decision on their election.

**B. DIRECTORS' REMUNERATION****B.1 The Level and Make-up of Remuneration**

**Principle** Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, but companies should avoid paying more than is necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

**Code Provisions****Remuneration policy**

- B.1.1 The remuneration committee should provide the packages needed to attract, retain and motivate executive directors of the quality required but should avoid paying more than is necessary for this purpose.
- B.1.2 Remuneration committees should judge where to position their company relative to other companies. They should be aware what comparable companies are paying and should take account of relative performance. But they should use such comparisons with caution, in view of the risk that they can result in an upward ratchet of remuneration levels with no corresponding improvement in performance.
- B.1.3 Remuneration committees should be sensitive to the wider scene, including pay and employment conditions elsewhere in the group, especially when determining annual salary increases.
- B.1.4 The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels.
- B.1.5 Executive share options should not be offered at a discount save as permitted by paragraphs 13.30 and 13.31 of the Listing Rules.
- B.1.6 In designing schemes of performance related remuneration, remuneration committees should follow the provisions in Schedule A to this code.

**Service Contracts and Compensation**

- B.1.7 There is a strong case for setting notice or contract periods at, or reducing them to, one year or less. Boards should set this as an objective; but they should recognise that it may not be possible to achieve it immediately.
- B.1.8 If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce after the initial period.
- B.1.9 Remuneration committees should consider what compensation commitments (including pension contributions) their directors' contracts of service, if any, would entail in the event of early termination. They should in particular consider the advantages of providing explicitly in the initial contract for such compensation commitments except in the case of removal for misconduct.
- B.1.10 Where the initial contract does not explicitly provide for compensation commitments, remuneration committees should, within legal constraints, tailor their approach in individual early termination cases to the wide variety of circumstances. The broad aim should be to avoid rewarding poor performance while dealing fairly with cases where departure is not due to poor performance and to take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

**B.2 Procedure**

**Principle** Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

**Code Provisions**

- B.2.1 To avoid potential conflicts of interest, boards of directors should set up remuneration committees of independent non-executive directors to make recommendations to the board, within agreed terms of reference, on the company's framework of executive remuneration and its cost; and to determine on their behalf specific remuneration packages for each of the executive directors, including pension rights and any compensation payments.
- B.2.2 Remuneration committees should consist exclusively of non-executive directors who are independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.
- B.2.3 The members of the remuneration committee should be listed each year in the board's remuneration report to shareholders (B.3.1 below).
- B.2.4 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors, including members of the remuneration committee, within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a small sub-committee, which might include the chief executive officer.
- B.2.5 Remuneration committees should consult the chairman and/or chief executive officer about their proposals relating to the remuneration of other executive directors and have access to professional advice inside and outside the company.
- B.2.6 The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

**B.3 Disclosure**

**Principle** The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

**Code Provisions**

- B.3.1 The board should report to the shareholders each year on remuneration. The report should form part of, or be annexed to, the company's annual report and accounts. It should be the main vehicle through which the company reports to shareholders on directors' remuneration.
- B.3.2 The report should set out the company's policy on executive directors' remuneration. It should draw attention to factors specific to the company.
- B.3.3 In preparing the remuneration report, the board should follow the provisions in Schedule B to this code.
- B.3.4 Shareholders should be invited specifically to approve all new long term incentive schemes (as defined in the Listing Rules) save in the circumstances permitted by paragraph 13.13A of the Listing Rules.
- B.3.5 The board's annual remuneration report to shareholders need not be a standard item of agenda for AGMs. But the board should consider each year whether the circumstances are such that the AGM should be invited to approve the policy set out in the report and should minute their conclusions.



**C. RELATIONS WITH SHAREHOLDERS****C.1 Dialogue with Institutional Shareholders**

**Principle** Companies should be ready, where practicable, to enter into a dialogue with institutional shareholders based on the mutual understanding of objectives.

**C.2 Constructive Use of the AGM**

**Principle** Boards should use the AGM to communicate with private investors and encourage their participation.

**Code Provisions**

C.2.1 Companies should count all proxy votes and, except where a poll is called, should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution, after it has been dealt with on a show of hands.

C.2.2 Companies should propose a separate resolution at the AGM on each substantially separate issue, and should in particular propose a resolution at the AGM relating to the report and accounts.

C.2.3 The chairman of the board should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM.

C.2.4 Companies should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

**D. ACCOUNTABILITY AND AUDIT****D.1 Financial Reporting**

**Principle** The board should present a balanced and understandable assessment of the company's position and prospects.

**Code Provisions**

D.1.1 The directors should explain their responsibility for preparing the accounts, and there should be a statement by the auditors about their reporting responsibilities.

D.1.2 The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

D.1.3 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

**D.2      Internal Control**

**Principle** The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

**Code Provisions**

- D.2.1      The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.
- D.2.2      Companies which do not have an internal audit function should from time to time review the need for one.

**D.3      Audit Committee and Auditors**

**Principle** The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

**Code Provisions**

- D.3.1      The board should establish an audit committee of at least three directors, all non-executive, with written terms of reference which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent non-executive directors, should be named in the report and accounts.
- D.3.2      The duties of the audit committee should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money.

## SECTION 2 INSTITUTIONAL SHAREHOLDERS

### E. INSTITUTIONAL INVESTORS

#### E.1 Shareholder Voting

**Principle** Institutional shareholders have a responsibility to make considered use of their votes.

#### **Code Provisions**

E.1.1 Institutional shareholders should endeavour to eliminate unnecessary variations in the criteria which each applies to the corporate governance arrangements and performance of the companies in which they invest.

E.1.2 Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.

E.1.3 Institutional shareholders should take steps to ensure that their voting intentions are being translated into practice.

#### E.2 Dialogue with Companies

**Principle** Institutional shareholders should be ready, where practicable, to enter into a dialogue with companies based on the mutual understanding of objectives.

#### E.3 Evaluation of Governance Disclosures

**Principle** When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.

**Schedule A: Provisions on the Design of Performance Related Remuneration.**

- 1 Remuneration committees should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to enhance the business. Upper limits should always be considered. There may be a case for part payment in shares to be held for a significant period.
- 2 Remuneration committees should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in under three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liability.
- 3 Any new long term incentive schemes which are proposed should be approved by shareholders and should preferably replace existing schemes or at least form part of a well considered overall plan, incorporating existing schemes. The total rewards potentially available should not be excessive.
- 4 Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return.
- 5 Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.
- 6 Remuneration committees should consider the pension consequences and associated costs to the company of basic salary increases and other changes in remuneration, especially for directors close to retirement.
- 7 In general, neither annual bonuses nor benefits in kind should be pensionable.

**Schedule B: Provisions on what should be Included in the Remuneration Report.**

- 1 The report should include full details of all elements in the remuneration package of each individual director by name, such as basic salary, benefits in kind, annual bonuses and long term incentive schemes including share options.
- 2 Information on share options, including SAYE options, should be given for each director in accordance with the recommendations of the Accounting Standards Board's Urgent Issues Task Force Abstract 10 and its successors.
- 3 If grants under executive share option or other long-term incentive schemes are awarded in one large block rather than phased, the report should explain and justify.
- 4 Also included in the report should be pension entitlements earned by each individual director during the year, disclosed on one of the alternative bases recommended by the Faculty of Actuaries and the Institute of Actuaries and included in the UK Listing Authority's Listing Rules. Companies may wish to make clear that the transfer value represents a liability of the company, not a sum paid or due to the individual.
- 5 If annual bonuses or benefits in kind are pensionable the report should explain and justify.
- 6 The amounts received by, and commitments made to, each director under 1, 2 and 4 above should be subject to audit.
- 7 Any service contracts which provide for, or imply, notice periods in excess of one year (or any provisions for predetermined compensation on termination which exceed one year's salary and benefits) should be disclosed and the reasons for the longer notice periods explained.

## BIBLIOGRAPHY

1. Copies of the following Reports, can be obtained from Gee Publishing, 0345-573 113.
  - **Report of the Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice (Cadbury Code)** - 1 December 1992
  - **Report of the Committee on the Financial Aspects of Corporate Governance: Compliance with the Code of Best Practice** - 24 May 1995
  - **Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury** (Greenbury Committee report) - 17 July 1995
  - **Committee on Corporate Governance: Final Report** (Hampel Committee report) - 28 January 1998
2. Copies of the following Guidance documents can be obtained from the Institute of Chartered Accountants in England and Wales, tel: 020 7920 8100 xtn 8487.
  - **Going Concern and Financial Reporting: Guidance for Directors of Listed Companies registered in the UK** - November 1994
  - **Internal Control and Financial Reporting: Guidance for Directors of Listed Companies registered in the UK** - December 1994
3. Copies of the following Guidance Note can be obtained from the Institute of Actuaries, tel: 020 7632 2100.
  - **Faculty & Institute of Actuaries Guidance Note GN11: Retirement Benefit Schemes, Transfer Values**- updated March 1998
4. Copies of the following bulletins can be obtained from Accountancy Books, tel: 01908-248 000
  - **APB bulletins (1995/1 and 1996/3): Disclosures Relating to Corporate Governance**
5. Copies of the following document can be obtained from the DTI, tel: 020 7215 1994
  - **Developing a Winning Partnership: How companies and institutional investors are working together** (the Myners recommendations) - updated September 1996
6. Copies of the following Statements can be obtained from the ABI, tel: 020 7600 3333
  - **Institutional Shareholders' Committee: The Role and Duties of Directors - A Statement of Best Practice**
  - **Institutional Shareholders' Committee: The Responsibilities of Institutional Investors - A Statement of Best Practice**
7. **Association of British Insurers:** produce a range of corporate governance related publications, tel: 020 7600 3333
8. **National Association of Pension Funds:** produce a range of corporate governance related publications, tel: 020 7730 0585
9. **The Listing Rules** - copies of these rules can be obtained from the Financial Services Authority (Sales and Distribution), tel: 020 7676 3298, fax: 020 7676 9728.