ALLEN & OVERY

NEW UK CORPORATE GOVERNANCE CODE PUBLISHED BY FRC

The Financial Reporting Council (FRC) has published its new UK Corporate Governance Code, following a consultation that began in December 2017. The new Code is largely built upon the current Code, but it is in a shorter and simpler format, with some provisions moved into the revised FRC Guidance on Board Effectiveness.

Some of the more controversial provisions from the draft published for consultation have been dropped. In particular, the FRC has reverted to the approach in the current Code of only requiring the chair to be independent on appointment (rather than on an on-going basis). The new Code also reinstates a board's discretion to consider a director independent, notwithstanding the existence of circumstances that could appear likely to impair independence.

The new Code will apply to accounting periods beginning on or after 1 January 2019, with the first annual reports under the new Code to be published in early 2020. In practice, companies are likely to seek to adopt the recommendations of the new Code early, and to enhance the disclosure in their next annual report to take account of the new Code. As with the current Code, the new Code will apply to all companies with a premium listing of equity shares.

Key additions to and changes from the current Code are summarised below.

Length of service of chair

The new Code includes a significant new provision that the chair should not remain in post beyond nine years from the date of first appointment to the board. The new Code avoids placing companies in a "cliff-edge" situation by providing that, to facilitate effective succession planning and the development of a diverse board, this period can be extended for a limited time, particularly in those cases where the chair was an existing non-executive director on appointment as chair. A clear explanation will need to be provided.

Corporate culture

The new Code has an increased focus on corporate culture, which the board should assess and monitor. Where the board is not satisfied that policy, practices or behaviour throughout the business are aligned with the company's purpose, values and strategy, it should seek assurance that management has taken corrective action. The annual report should explain the board's activities and any action taken.

Stakeholder engagement

The new Code emphasises the importance of positive relationships between a company, its shareholders and its other stakeholders. Particular points to note are:

Shareholders: The new Code clarifies, and expands on, current Code recommendations on the action expected where there is significant shareholder dissent. The new Code specifies that action is expected when 20% or more of votes have been cast against the board recommendation for a resolution. The new Code includes: (i) a provision, consistent with the current Code, that a company should explain, when announcing voting results, what actions it intends to take to consult shareholders to understand the reasons behind the result; (ii) a new provision that a company should publish an update on the views received from shareholders and action taken no later than six months after the vote; and (iii) a new provision that the board should provide a final summary in the annual report and, if applicable, in the explanatory notes to resolutions at the next shareholder meeting, on what impact the feedback has had on board decisions and any actions or resolutions now proposed.

Other stakeholders: The new Code provides that the board should understand the views of the company's other key stakeholders and should describe in the annual report how their interests and the matters set out in section 172 Companies Act 2006 influenced the board's decision making. The provision overlaps with requirements of new UK secondary legislation (the Companies (Miscellaneous Reporting) Regulations 2018). The board should keep engagement mechanisms under review so that they remain effective.

The workforce: For engagement with the workforce, the new Code specifies that one or a combination of the following methods should be used: (i) a director appointed from the workforce; (ii) a formal workforce advisory panel; and (iii) a designated non-executive director. If the board has not chosen one or more of these methods, it should explain what alternative arrangements are in place and why it considers that they are effective.

The new Code provides that the annual report should include an explanation of the company's approach to investing in and rewarding its workforce.

Remuneration

The role of the remuneration committee is expanded to include reviewing workforce remuneration and related policies, and the alignment of reward with culture. The chair of the remuneration committee is required to have served on a remuneration committee for at least 12 months. There is a renewed focus on long term shareholdings, with requirements for phased release for sale and total vesting and holding periods of five years or more for share awards, and a policy on post-employment shareholding requirements.

In addition to these enhanced requirements, companies and remuneration committees will be preparing for the obligations under the Companies (Miscellaneous Reporting) Regulations 2018, in particular the requirement to disclose pay ratios comparing CEO remuneration to average pay in the wider workforce, and the requirement to report on the impact of share price growth on share-based executive pay.

Diversity

The new Code reflects an increased focus on diversity, beyond gender. Board appointments should be based on merit and objective criteria, and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths. The nomination committee disclosure in the annual report should include information on the policy on diversity and inclusion, the policy's objectives and linkage to company strategy, how the policy has been implemented and progress on achieving the objectives. There is a new emphasis on how the nomination committee can support developing a diverse pipeline.

Board evaluation

The new Code provides for enhanced disclosure around board evaluation in the annual report, including the nature and extent of an external evaluator's contact with the board and individual directors, the outcomes and actions taken following the evaluation, and how the evaluation has or will influence board composition.

Over boarding

The new Code emphasises that, when making board appointments, the board should take into account other demands on the directors' time. Prior to appointment, significant commitments and the time involved should be disclosed. Additional external appointments should not be undertaken without prior board approval, with the reasons for permitting significant appointments explained in the annual report.

Emerging risk

The current Code emphasises the board's responsibility to carry out a robust assessment of the principal risks facing the company. The new Code extends this responsibility to emerging risks. The annual report should describe the procedures in place to identify emerging risks.

Companies below the FTSE 350

The new Code includes fewer exemptions for companies below the FTSE 350. In particular, for smaller companies to comply with the new Code, their directors should be subject to annual re-election by shareholders, and their chair will need to consider a regular external board evaluation.

For more information on corporate governance, or to discuss any of the issues raised in this publication, please call any of our Corporate partners or your usual contact at Allen & Overy.

