



The new UK Corporate Governance Code

What you need to know

June 2010

On 28 May 2010 the Financial Reporting Council (FRC) published a revised corporate governance code. This follows the review of the effectiveness of the Combined Code carried out by the FRC in 2009/10. It has been renamed the UK Corporate Governance Code (the Code) and will apply to accounting periods beginning on or after 29 June 2010.

The new Code – reinforcing key messages

The FRC has not found evidence of serious failings in the governance of British business outside the banking sector. The consensus view is that the Code remains fit for purpose and the absence of dramatic changes to it reflects this.

Instead a prime objective of the FRC review has been to refocus attention on the underlying principles of the Code, which should take precedence over its detailed provisions. The aim is to remind companies and institutional investors that the Code should be seen as a means of promoting appropriate behaviour by boards and good communication between boards and shareholders rather than merely a compliance exercise.

The revisions are also designed to reinforce board quality and debate, the importance of risk management and accountability

to shareholders. In return, the proposed new Stewardship Code, which will set out standards of good governance for institutional investors, is expected to bring advances in responsible engagement by shareholders. The FRC are aiming to publish the Stewardship Code by the end of June 2010 (see further **Upcoming developments** below).

Taken together, hopefully the two Codes will bring about an improved governance environment with a decline in both boilerplate reporting by companies and box-ticking by investors. Whether this happens will depend on the approach taken by companies, institutional investors and proxy voting agencies when the new codes come into force.

At a glance – what are the key changes?

Improving effectiveness:

- The entire board of FTSE 350 companies should stand for annual re-election.
- There should be a balance of skills, experience, independence and knowledge of the company on the board and appointments, whilst based on merit, should take into account the benefits of diversity, including gender.
- The chairman should hold regular development reviews with each director and there should be an external evaluation of the board of FTSE 350 companies at least every three years.
- The importance of the chairman and the non-executives in providing leadership and constructive debate respectively is brought to the forefront of the Code.

Improving accountability and risk management:

- The annual report should include an explanation of the business model and strategy.
- The board's responsibilities in relation to risk have been emphasised.

Improving remuneration behaviour:

Performance-related pay should be designed to promote the long-term success of the company.

Emphasising the underlying spirit of the Code

A new introductory section has been included which aims to draw more attention to the way in which the Code should be viewed and applied, in particular:

- **Chairman's report** - chairmen are encouraged to report personally in their annual statements on how the principles relating to the role and effectiveness of the board have been applied. The idea is to encourage clear dialogue from companies which, in turn, may make investors more inclined to accept reasonable non-compliance explanations.

Chairmen will need to consider how any personal report helps to improve communication and whether it provides a genuine insight into board behaviours and practices.

- **Comply or explain** - supplementary guidance is given to both companies and investors on how to operate the "comply or explain" approach to compliance – a reminder that the key to the Code is found in its spirit as much as its letter.

Companies are advised to explain reasons for non-compliance clearly - to illustrate how their actual practices are consistent with the underlying principles of the Code. On the flip side, shareholders are urged to look at the individual circumstances of a company and to remember that departures from the Code's detailed provisions should not automatically be treated as breaches.

Key issues in more detail

Annual re-election of directors

Re-election of directors has been the most controversial change and has clearly proved a difficult issue for the FRC to resolve. Companies mainly favoured retaining the status quo (re-election at least every three years) on the basis that annual re-election could encourage short-term thinking and create the potential to destabilise the board. Investors on the other hand were heavily in favour of

annual re-election on the basis that it would promote better engagement. An alternative option, which would have seen just the chairman face annual re-election, received only limited support from either side of the fence.

Ultimately the FRC has sided with the investors – the Code recommends that directors of FTSE 350 companies should be subject to annual re-election. The FRC says this will allow shareholders of larger companies an annual opportunity to express their views on the performance of the board. FRC findings indicate that, where companies have already voluntarily moved to annual re-election, voting patterns have not noticeably changed. It intends however to keep a close watch on patterns in the run-up to its next review of the Code, scheduled for 2013. It also acknowledges that the quid pro quo must be greater willingness by institutional investors to engage constructively – a key objective of the proposed new Stewardship Code for investors.

No doubt due to the disparity of views on this particular issue, the new introduction to the Code expressly acknowledges that companies are free to explain rather than comply if either they believe their existing re-election arrangements ensure proper accountability and board effectiveness, or need to phase in annual re-election over a transitional period.

It will be interesting to see how companies approach this new re-election provision and how investors will respond if a company decides to take a different approach. Will this provision turn into another "rule" or will investors be happy to accept a different re-election timetable provided the reasons for it are properly explained?

Whilst the FRC also urges smaller companies to consider their director re-election policies they are not obliged to - the existing three-year re-election regime continues to apply to all companies outside of the FTSE 350. Limiting the provision to the FTSE 350 recognises that, in **smaller companies** with a narrower shareholder base, annual re-election has the potential to give excessive power to hostile minorities seeking board control or pushing for changes in corporate strategy.

At a glance – what hasn't changed?

- **All disclosure requirements have been retained** despite the view that the Code requires too many detailed disclosures which add little value. Also the **requirement for publication of disclosures via the annual report has been retained**. The FRC has decided not to give companies the flexibility to opt for website publication for the time being but has committed to reviewing this as part of its wider project to reduce the complexity of annual reports.
- **No Code requirement for Risk Committee or Chief Risk Officer** All directors (executive and non-executive) should have an involvement in reviewing and setting the acceptable level of risk for a company as a natural part of the operation of the board.
- **No prescribed minimum time commitments** This recognises that time commitment will vary according to the complexity of a company's business and the particular conditions and events experienced by it.
- **No advisory vote on corporate governance statements.**
- **"Nine year rule" retained** despite concerns that this can result in experienced non-executive directors leaving boards prematurely. Hopefully the new focus on having an appropriate balance on the board and the focus elsewhere in the Code on directors having a detailed knowledge of the company will help set the "nine year rule" in context. If so, we may see a reduction in proxy voting agencies automatically recommending a vote against the re-election of any non-executive who has served more than nine years.

Balance and diversity on the board

The Code has been fine-tuned to encourage boards to be "well-balanced" and avoid a "group think" mentality.

To address concerns that there has previously been too much emphasis on independence, a new main principle has been added underlining the need for an appropriate balance of skills, experience, independence and knowledge of the company on the board and its committees.

Following concerns raised during the consultation period, the Code now also explicitly addresses the issue of diversity, in particular the lack of women in boardrooms.

A 2009 study quoted by the FRC in its report on the Code indicates that only 12 per cent. of directors of FTSE 100 companies are women and a quarter of those companies have all-male boards.

A new supporting principle states that both the search for candidates and any appointments should be made with due regard for the benefits of diversity on the board, including gender. It is hoped that this will go some way to encourage nomination committees to look at a wider selection pool – whether it goes far enough to bring about a cultural shift remains to be seen.

External board evaluations

The Code has for some time included a principle that board performance should be evaluated annually. The Code recommends that for FTSE 350 companies this review should be carried out by external evaluators at least every three years.

It has been restricted to FTSE 350 companies to address concerns about whether there are enough good quality external evaluators to satisfy the increased demand. Concerns were also raised about the cost implications involved and the lack of adequate knowledge an external evaluator would have of the business model or issues facing the company and its board. For the time being at least, the potential benefits which flow from the greater objectivity of an external review have won out.

Whilst it will not apply to **smaller companies** at the outset, the FRC has said it will consider whether to extend it to companies outside the FTSE 350 when it next reviews the Code in 2013 – much will depend on whether it is judged to be a success for the larger companies and how the pool of suitable evaluators has grown in the meantime.

Risk management

The board's responsibility for deciding how much risk the company can bear and how willing it should be to take risk has been made more explicit in the Code. The FRC has said it considers this message to have been a significant omission from previous versions of the Code and there was strong support for its addition during the consultation.

A new principle has been included which emphasises this by stating that the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives and should maintain sound risk management and internal

control systems. Further guidance on what this entails in practice may flow from the review of the Turnbull Guidance later this year (see below).

There is also a new provision recommending that the annual report should include an explanation of the business model and the strategy for delivering the objectives of the company. Concerns were raised during the consultation that this would just lead to confusion and duplication of reporting. However, the proposal received support on the grounds that a description in layman's terms would help investors and others to assess both the more formal business review section of the report and how the board has applied the new principle on risk.

It remains to be seen what will be achieved in practice and whether many companies will conclude that their annual report already complies with this provision.

This Code recommendation may just be a precursor to further mandatory narrative reporting. The new Government appears committed to reinstating the Operating and Financial Review (OFR) to "investigate further ways of improving corporate accountability and transparency." This decision is unexpected as the mandatory OFR was withdrawn in 2006 after less than a year as law (being replaced in part by the business review).

Remuneration

The Code includes a new supporting principle that the performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company. Other changes, some of which address recommendations made by Sir David Walker in his report on the corporate governance of banks and financial institutions, include:

- performance conditions for annual bonuses should also be designed to promote the long-term success of the company;
- remuneration for non-executives should not include any performance-related elements;
- payouts or grants under all incentive schemes should be subject to challenging performance criteria, including non-financial performance metrics where appropriate and remuneration incentives should be compatible with risk policies and systems; and
- clawback provisions allowing the company to reclaim variable components in exceptional circumstances of misstatement or misconduct should be considered.

Other changes

Most significantly:

- a new main principle that all directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively; and
- a new supporting principle that all directors need appropriate knowledge of the company and access to its operations and staff.

Does the Code apply to my company?

Official List premium listing	The Listing Rules require a company, incorporated in the UK, with a premium listing of equity shares, to make a corporate governance disclosure statement in its annual report. This must set out how it has applied the main principles of the Code and whether or not it has complied with the Code's provisions (with details of and reasons for any non-compliance). Overseas companies with a premium listing are also required to make these disclosures for financial years beginning after 31 December 2009.
Official List standard listing	Companies with a standard listing are not subject to the same Listing Rules obligation as premium listed companies to comply or explain against the Code. They are however required by the Disclosure and Transparency Rules to publish a statement detailing their approach to corporate governance. Overseas companies with a standard listing are required to make this statement for financial years beginning after 31 December 2009.
AIM	There is no prescribed corporate governance regime for AIM companies, who should discuss an appropriate course of action with their Nomad. The following corporate governance guidelines have been published for companies on AIM: <ul style="list-style-type: none">■ The Corporate Governance Guidelines for AIM Companies published by the Quoted Companies Alliance (QCA) and based on the Combined Code. Intended as a simple set of guidelines which all AIM companies should be able to follow. The QCA stresses that they represent a floor for standards of good governance and not a cap on them and that as AIM companies grow they should continue to aspire to compliance with the Code.■ The Corporate Governance Policy and Voting Guidelines for AIM Companies published by the National Association of Pension Funds (NAPF), which state that boards of AIM companies should be familiar with the main principles of the Code and should seek to apply them as appropriate to their circumstances. NAPF expects companies at the top end of the AIM market capitalisation range to comply with the provisions of the Code (or to explain non-compliance).
PLUS-quoted	Under current guidance notes to the PLUS Rules for Issuers a company should have due regard to the principles laid down by Code, as appropriate in relation to its nature and size.

Upcoming developments

- The Institute of Chartered Secretaries & Administrators (ICSA) has been tasked with updating the **"Good Practice Suggestions from the Higgs Report"**. These are designed to assist boards when implementing the Code and give guidance on issues relating to the role of the chairman and non-executives, the remuneration and nomination committees and performance evaluation guidance amongst others. ICSA started a consultation process in March 2010 and revised guidance is expected by the end of this year.
- The FRC is developing a separate **Stewardship Code** setting out standards of good governance for institutional investors when engaging with UK listed companies. The FRC's consultation on a Stewardship Code was based on the Code on the Responsibilities of Institutional Investors published by the Institutional Shareholders' Committee (ISC). Publication of the Stewardship Code is expected by the end of June 2010 (at which point the section of the Code which is currently aimed at investors will be removed). It will be interesting to see how this affects engagement between companies and institutional investors. Whatever happens, the Stewardship Code will have the distinction of being the first of its kind in the world.
- In another development the ISC has agreed to establish a new senior body, the **Institutional Investor Council**, to build a single voice for the institutional investor community. Its objectives include working closely with the FRC in promoting the new Stewardship Code.
- The FRC will also carry out a limited review of the **Turnbull Guidance on Internal Control** this year.

If you would like any further information on the UK Corporate Governance Code please speak to your usual contact at Burges Salmon or:



Nick Graves

+44 (0) 117 939 2200

nick.graves@burges-salmon.com



Rupert Weston

+44 (0) 117 939 2228

rupert.weston@burges-salmon.com