

CHANGES TO THE UK CORPORATE GOVERNANCE CODE

INTRODUCTION AND APPLICABILITY

Effective governance is an issue of shareholder and public interest, with publicly traded companies under particularly close scrutiny. Successful investment requires well informed decision making at all levels. At its core, good corporate governance creates an alignment of interests and a supportive environment for the mechanisms, attitudes and behaviours that allow for successful and sustainable businesses. Adherence to good standards of compliance and corporate governance standards is an aspiration that any organisation should strive towards.

Although the requirements of Listing Rule 9.8.6 (additional information to be included in annual financial reports of listed companies) currently only apply to listed companies incorporated in the United Kingdom, the UK Corporate Governance Code (the “**FRC Code**”) published by the UK’s Financial Reporting Council (the “**FRC**”) applies to all companies admitted to the FCA’s Official List with a premium listing, irrespective of their country of incorporation. In addition, the FCA’s Disclosure Guidance and Transparency Rules (the “**DGTRs**”) already apply to all companies admitted to trading on a regulated market, which includes both the London Stock Exchange’s Main Market and the Specialist Fund Segment thereof. The DGTRs require that relevant issuers include in annual financial reports a corporate governance statement, which must state inter alia the corporate governance code to which the issuer is subject or which it has voluntarily chosen to apply, as well as reporting on its compliance with the relevant code. Reporting against the FRC Code is stated to satisfy these requirements. The FRC states in the FRC Code that externally managed investment companies may use The AIC Code of Corporate Governance (the “**AIC Code**”) to meet their obligations under the FRC Code.

Companies admitted to trading on other markets, such as the London Stock Exchange’s Alternative Investment Market, are not currently required to report against any specified corporate governance code, although it is considered to be best practice for all companies publicly traded in the UK to report against either the FRC Code or the AIC Code and shareholders and proxy voting agencies expect it.

PUBLICATION OF THE REVISED FRC CODE AND BOARD GUIDANCE

The FRC Code is aimed at promoting successful and sustainable businesses and encouraging long-term investment. However, the FRC Code is not rigid in its application and does not provide set rules, but allows companies to adopt a flexible approach through the use of principles set out in the FRC Code and the “comply and explain” method of reporting. Accordingly, companies are encouraged to promote integrity and openness, value diversity and to be responsive to the views of shareholders and wider stakeholders.

On 16 July, 2018, the FRC published a revised UK Corporate Governance Code (the “**Revised FRC Code**”), which will apply to accounting periods commencing on or after 1 January, 2019. For issuers with a 31 December accounting year end, compliance with all relevant provisions in the Revised FRC Code should commence on 1 January, 2019, in order to enable reporting on compliance with the Revised FRC Code in the annual financial report in the 2019 annual financial report. Companies with later accounting reference dates should commence compliance with all relevant provisions in the Revised FRC Code no later than the start of their next financial year.

On 16 July, 2018, the FRC also published its Guidance on Board Effectiveness (the “**Board Guidance**”), which is designed “to stimulate boards’ thinking on how they can carry out their role and encourage them to focus on continually improving their effectiveness”. The Board Guidance is neither mandatory nor prescriptive; following the structure of the Revised FRC Code, it contains suggestions of good practice to support directors and their advisors in applying the Revised FRC Code. This suggested good practice assists Boards in developing their own good practice and provides stakeholders with a reference point against which actions taken by a Board can be assessed.

As stated above, externally managed investment companies may currently use the AIC Code to meet their obligations under the FRC Code. Following the publication of the Revised FRC Code and the Board Guidance, on 20 September, 2018 the AIC announced a members’ consultation on the revision of the AIC Code. The consultation will close on 5 November, 2018 and the draft revised AIC Code will then be finalised for submission to the FRC for endorsement prior to its publication for the AIC’s members’ use.

The Revised FRC Code is briefer than the current version, having removed the “Supporting Principles” and reducing the number of Provisions. The Revised FRC Code focuses on the Board’s application of the Principles set out in the Revised FRC Code and the Principles (with more detailed underlying Provisions / recommendations) are set out in five sections:

1. Board Leadership and Company Purpose
2. Division of Responsibilities
3. Composition, Succession and Evaluation
4. Audit, Risk and Internal Control
5. Remuneration

The main changes in the Revised FRC Code are:

Shareholder opposition (Provision 4) – Should 20% or more of the votes cast in a general meeting be cast against any resolution proposed by the Board, the company should explain, when announcing voting results, what actions it intends to take to consult with shareholders to understand the reasons for the opposition. An update on the views received from shareholders and actions taken should be published no later than six months after the shareholder meeting. The Board should then 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 the decisions the Board has taken and any actions or resolutions now proposed.

(Details of significant votes against and related company updates are already available on the public register maintained by The Investment Association – www.theinvestmentassociation.org/publicregister.html and the FCA has recommended that companies follow and report on this provision immediately in paragraph 1.11 of its feedback statement – <https://www.frc.org.uk/getattachment/90797f4b-37a1-463e-937f-5cfb14dbdcc4/2018-UK-Corporate-Governance-Code-Feedback-Statement-July-2018.pdf>).

Stakeholder engagement (Provision 5) – requires that companies enhance engagement with stakeholders, in addition to shareholders, and describe in annual financial reports how their interests have been considered in Board discussions and decision making. Engagement mechanisms should be kept under review to ensure that they remain effective.

Chair’s Position and definition of independence (Provisions 9, 10 and 19) – The Revised FRC Code retains the provision that the Chair should be independent on appointment. Subsequently the Chair is not counted in the assessment of Board independence, so that the Revised FRC Code now requires that “At least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent.” Although smaller companies are not required under the current Code to comply with requirement for at least half the Board to be independent, only to have two independent non-executive directors, the Revised FRC Code recommends that at least half the Board of every company be independent non-executive directors.

The FRC had previously proposed that service over nine years would be considered to make an individual non-independent. However, that change was not made and the Revised FRC Code now contains wording similar to the current version, in that service over nine years might impair independence, but that a Board may consider a long-serving director to continue to be independent, in which case a clear explanation should be provided in the company’s annual financial report.

Most significantly, the FRC has adopted provisions which presume a limit on the tenure of the Chair, stating at Provision 19 that “The chair should not remain in post beyond nine years from the date of their first appointment to the Board ...”, i.e. a Chair who had served four years as a director before being appointed Chair could only act as Chair for five years. This period can be extended “for a limited time” to facilitate effective succession planning and the development of a diverse Board, but excessive extension of a Chair’s term could lead to significant shareholder opposition and Boards should start planning for the Chair’s succession significantly in advance of the ninth anniversary of his appointment to the Board.

Annual Re-election (Provision 18) – The current Code recommends that directors of FTSE 350 companies and those directors who have served on the Board for more than nine years should be subject to annual re-election, with other directors to stand for re-election at intervals of no more than three years. Under the Revised FRC Code, all directors should be subject to annual re-election.

Board Evaluation (Provision 21) – The Code expects regular formal and rigorous annual evaluation of the performance of the Board, its committees, the chair and individual directors. Whereas externally facilitated evaluations are currently specifically recommended every three years only for FTSE 350 companies, the Revised FRC Code recommends that “The chair [of all companies reporting against the Revised FRC Code] should consider having a regular externally facilitated board evaluation.” For FTSE 350 companies this should still happen at least every three years.

Diversity (Provision 23) – The provisions relating to diversity have been expanded in the Revised FRC Code, with Provision 23 now requiring that the report on the work of the Nomination Committee describe “the policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives”. [Our emphasis of additional recommendations.] The Revised FRC Code also recommends that this report describe “the process used in relation to appointments, its approach to succession planning and how both support developing a diverse pipeline.”

Audit Committees (Provision 24) – The FRC has retained the capacity of companies outside the FTSE350 to have an audit committee comprising two individuals. However, whereas under the current Code the Chair may be a member of (but not chair) the Audit Committee, the Revised FRC Code recommends that “The chair of the board should not be a member.”

Remuneration Committees (Provisions 32 to 41) – The recommendations of the Revised FRC Code on remuneration committees are significantly more detailed than those in the current Code. Key changes include a new requirement that remuneration committee chairs should have served for at least 12 months on a remuneration committee before their appointment as chair of that committee and that, where a remuneration consultant is appointed, this should be the responsibility of the remuneration committee. The remuneration of non-executive directors is still to be determined in accordance with the company’s articles of incorporation or by the Board. Finally, Provision 41 recommends that a separate section describing the work of the remuneration committee in several specified areas should be included in each annual financial report.

WHAT SHOULD BOARDS OF AFFECTED COMPANIES BE THINKING ABOUT NOW?

Under the Revised FRC Code, companies will be expected to enhance their reporting on corporate governance and additional disclosures will be expected in annual financial reports published in respect of financial periods commencing on or after 1 January 2019. Boards should therefore be considering what changes to make to their structure and processes to facilitate compliance with relevant Principles and Provisions with effect from the start of their next annual financial reporting period. Boards should also be considering whether any significant long term changes will need to be made, including to the composition of the Board and its committees, and planning for succession.

Companies should also be reviewing their existing processes for shareholder engagement and should also consider the identity of all relevant stakeholders, how to engage with them and how to include their views in Board considerations and decision making.

With the existing exemptions for smaller companies (those outside of the FTSE 350) gradually being removed, smaller companies will be expected to enhance their corporate governance processes and procedures to align them more closely to the Revised FRC Code and best practice.

KEY QUESTIONS TO THINK ABOUT INCLUDE:

- > Do we actively engage with our shareholders and other stakeholders and are our mechanisms for considering their interests adequate and clearly articulated?
- > Does our Board comply with the recommendations of the Revised FRC Code as regards tenure, independence and diversity? If not, do we have objectives for the future composition of the Board and do we have concrete plans to achieve those objectives?
- > Do we have formal and rigorous processes for annual evaluations of the Board, its committees and individual directors and do we wish to engage an external party to assist with such evaluations?
- > Do we have adequate policies and procedures in place for seeking new candidates for the Board, including a formal succession plan or policy?
- > Do we have a policy on diversity and inclusion and does it comply with the Revised FRC Code?
- > Are we required to or do we wish to procure external facilitation of our Board evaluations and, if so, when?
- > Does our audit committee comply with the recommendations of the Revised FRC Code?
- > Do we need a nomination committee and, if so, do we have one and does it comply with the recommendations of the Revised FRC Code?
- > Do we need a remuneration committee and, if so, do we have one and does it comply with the recommendations of the Revised FRC Code?

If you would like to discuss with JTC how these changes might affect your company and how you can prepare, please contact your usual company secretarial contact in the first instance.