Financial Reporting Council Publishes Revised UK Corporate Governance Code

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Scott C. Hopkins
Partner / London
44.20.7519.7187
scott.hopkins@skadden.com

Helena J. Derbyshire
Of Counsel / London
44.20.7519.7086
helena.derbyshire@skadden.com

Claire Consoli
Associate / London
44.20.7519.7216
claire.consoli@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

40 Bank St., Canary Wharf
London, E14 5DS, UK
44.20.7519.7000

skadden.com

On July 16, 2018, the U.K. Financial Reporting Council (FRC) published a revised U.K. Corporate Governance Code (the Revised Code), following feedback received from its consultation paper published in December 2017. The FRC's thorough review is set against the backdrop of the House of Commons Business, Energy and Industrial Strategy Committee (BEIS Committee) review and the U.K. government's green paper (the Green Paper), both addressing corporate governance issues. These reviews and consultations are indicative of an increased focus on reforming certain aspects of the U.K.'s corporate governance landscape to promote higher standards and greater transparency and integrity in business, not only to attract long-term investment in the U.K., but also to benefit the economy and wider society.

Scope of Application

Like the existing U.K. Corporate Governance Code, published in 2016 (the 2016 Code), the Revised Code applies to companies with a premium listing of equity shares on the London Stock Exchange (whether or not the company is incorporated in the U.K.).

The Revised Code seeks to offer a flexible corporate governance framework through the application of key Principles and by retaining the existing "comply or explain" regime, which will apply to the more detailed Provisions in the Revised Code, which support the Principles (meaning that companies must report on how they have complied with the Provisions, or explain how and why they have failed to do so) — as such, there is no change to the basis of application compared to the 2016 Code. There is, however, a renewed focus on the revised Principles and the FRC expects that:

- by reporting on the application of the Principles in a manner that can be evaluated, companies will demonstrate how their governance supports the Principles and contributes to the achievement of long-term success of the company;
- reporting should cover the application of the Principles in the context of companies' particular circumstances; and
- high-quality reporting will include sign-posting and cross-referencing to other relevant parts of the annual report.

Drivers for Change

The changes made by the FRC to the Revised Code seek to promote:

- positive relationships between companies, shareholders and stakeholders;
- the formulation of a clear purpose and strategy aligned with a healthy corporate culture;
- high-quality board composition with an emphasis on diversity; and
- executive remuneration that is proportionate and supports long-term success.

The FRC's press release announcing the publication of the Revised Code on July 16 stated that it "puts the relationships between companies, shareholders and stakeholders at the heart of long-term sustainable growth in the U.K. economy." Indeed, one of the key aims of the Revised Code is to encourage companies to provide meaningful, substantive and relevant disclosure to enable investors and proxy advisers to critically assess explanations for deviation and to discourage a "tick-box" approach to the comply or explain regime.

The preamble to the Revised Code states that "explanations are a positive opportunity to communicate, not an onerous obligation."

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How the Code Has Changed

The Revised Code is structured in five sections, which reflect the FRC's key drivers for change: (1) Board Leadership and Company Purpose; (2) Division of Responsibilities; (3) Composition, Succession and Evaluation; (4) Audit, Risk and Internal Control; and (5) Remuneration.

Key Themes

1. **Leadership and purpose: engagement with the workforce and key stakeholders**

   The changes to Section 1 reflect the findings of the FRC's previous work on corporate culture, which considered the board's role in developing healthy culture geared towards delivering long-term success. In particular, the Revised Code:

   - emphasizes the importance of an effective and entrepreneurial board (Principle A);
   - encourages regular engagement with major shareholders (Provision 2) and other key stakeholders (Provision 5);
   - prompts companies to consult with shareholders if 20 percent or more of shareholder votes have been cast against a board recommendation for a resolution and to promptly publish any update on views received from shareholders (Provision 4);
   - expects companies to have an anonymous whistleblower policy to allow the workforce to raise concerns in confidence (Provision 6); and
   - requires companies to establish a method for gathering views from their workforce (normally one of, or a combination of, a director appointed by the workforce, an advisory council or a designated non-executive director, or other appropriate arrangements) (Provision 5).

2. **Division of responsibilities at board level**

   Section 2 of the Revised Code:

   - focuses on the importance of board independence and constructive challenge in boardrooms (including a requirement for the chair to be independent on appointment and demonstrate objective judgment throughout his or her tenure) (Principle F); and
   - highlights the risk of "over-boarding" (where non-executive directors hold multiple directorships), but requires only "significant" commitments to be reported on at the time of appointment (Principle H and Provision 15).

3. **A balanced and regularly refreshed board**

   The Principles and Provisions in Section 3 encourage:

   - annually evaluating the board's composition and diversity and how effectively members work together to achieve the company's objectives (Principle L);
   - capping the chair's tenure to nine years from the date of his or her first appointment to the board (Provision 19);
   - delegating increased responsibility to the nomination committee for orderly succession planning and ensuring a diverse pipeline (Principle K and Provision 17); and
   - regular externally facilitated board evaluations (at least every three years for FTSE 350 companies) (Provision 21).

4. **Audit, risk and internal control**

   The Revised Code has reformulated the provisions dealing with the company's audit, risk and internal control framework to emphasise the importance of independence and efficacy (Principle O), but no substantive changes have been made to the supporting Provisions.

5. **Remuneration**

   The Revised Code confers a broader role on the Remuneration Committee; its responsibilities now extend to determining the remuneration policy applicable to senior management as well as to directors. Section 5 is underpinned by the principle that remuneration policies and practices should promote the long-term success of the company (Principle P). The Revised Code supports this principle in the following ways:

   - the Remuneration Committee should also review workforce remuneration and related policies and seek to align incentive awards with the company's culture (Provision 32);
   - specifically, remuneration for all non-executive directors should not include share options or other performance-related elements (Principle 34);
   - the chair of the remuneration committee should have served on the remuneration committee for at least 12 months prior to appointment as chair of the committee (Provision 32); and
   - the Remuneration Committee should consider the following factors when determining executive remuneration policy and practices: clarity, simplicity, risk, predictability, proportionality and alignment to culture (Provision 40).

Reporting Requirements

Quoted Companies

Some of these provisions tie into the recently published Companies (Miscellaneous Reporting) Regulations 2018 (the Regulations), which require:

- quoted companies to include in their director's remuneration report an illustration of impact of share price growth on director's remuneration outcomes and an estimate of the amount of their single total figure of remuneration (STFR) that is attributable to share-price appreciation;
- quoted companies with 250 or more employees in the U.K. to publish the ratio of their CEO's STFR to the 25th, 50th and 75th percentile full-time equivalent remuneration of U.K. employees, with an explanation of why the company believes that the median (50th percentile) ratio is consistent with the company's general policies on employee pay, reward and progression; and
- the directors' strategic report for quoted companies with 250 or more U.K. employees to describe the steps the company has taken in the financial year to consult employees or their representatives on a regular basis, so that their views can be taken into account in making decisions likely to affect their interests, and to systematically provide them with information on matters of concern to them and encourage employee involvement in the company's performance.

Such reporting requirements are designed to encourage companies to engage with their workforce and actively address their concerns.

Large Private Companies and Unlisted PLCs

The BEIS Committee review and the publication of the Green Paper also led to the formation of a coalition group tasked with developing corporate governance principles for large private companies, chaired by James Wates CBE. On 13 June 2018, on behalf of the coalition group, the FRC issued a draft of the Wates Corporate Governance Principles for Large Private Companies (the Wates Principles), together with supporting guidance, for public consultation. The consultation paper indicates that it is expected that the Wates Principles will be used not only by large private companies and unlisted PLCs subject to the Regulations, but also by other companies. As such, there was a need for the Wates Principles to be sufficiently flexible to be applied by a range of different types of companies, yet robust enough to be meaningful. The result is a set of six high-level principles, set out below, with associated guidance.

- **Principle One: Purpose**
  An effective board promotes the purpose of a company, and ensures that its values, strategy and culture align with that practice.
- **Principle Two: Composition**
  Effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual directors having sufficient capacity to make a valuable contribution. The size of a board should be guided by the scale and complexity of the company.
- **Principle Three: Responsibilities**
  A board should have a clear understanding of its accountability and terms of reference. Its policies and procedures should support effective decision-making and independent challenge.
- **Principle Four: Opportunity and Risk**
  A board should promote the long-term success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.
- **Principle Five: Remuneration**
  A board should promote executive remuneration structures aligned to the sustainable long-term success of a company, taking into account pay and conditions elsewhere in the company.
- **Principle Six: Stakeholders**
  A board has a responsibility to oversee meaningful engagement with material stakeholders, including the workforce, and have regard to that discussion when taking decisions. The board has a responsibility to foster good stakeholder relationships based on the company's purpose.

A key difference between the Revised Code and the Wates Principles is that while the Revised Code is applied on a "comply or explain" basis, the Wates Principles are intended to work on an "apply and explain" basis. Compliance is voluntary, but if a company wishes to report in its annual report that it does comply with the Wates Principles, it also must state how it has applied each of the six principles in practice.

Next Steps

The Revised Code applies to reporting years beginning on or after 1 January 2019. The first reporting against the Revised Code will therefore be contained in annual reports published in 2020, unless companies decide to adopt all or part of the new Code early. It would be prudent, however, for companies subject to the Revised Code to consider its requirements when developing future remuneration policies (and proposed changes to existing policies) and the board's succession plans for the remainder of 2018 into the new year.

The final Wates Principles and guidance will be published in December 2018, following closure of the consultation period to align with the coming into force of the Regulations (expected to occur on 1 January 2019).