Crisis of trust: corporate governance update 2023

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Following a series of accounting and audit scandals in recent years and what has been described as a "crisis of trust", the UK Government, regulatory bodies, and institutional investor groups have set out to reform the UK's audit, corporate reporting, and corporate governance systems.

We have summarised below some of the key developments as they relate to UK companies. The updates discussed below are particularly in focus now, at a time of political and economic volatility, and will be of special interest to those working in, or advising, both listed UK businesses and large unlisted companies.

We also consider the latest guidance from key proxy advisors and investor bodies, and look at recent research on how influential those proxy advisors and investor bodies are in influencing the voting actions of investors, and therefore how seriously their guidance should be taken by companies.

Restoring trust in audit and corporate governance

The UK Government has set out its objectives of (i) building trust and credibility in the UK's audit, corporate reporting and corporate governance system; (ii) ensuring accountability for those playing key roles in that system; and (iii) increasing resilience and choice in the statutory audit market.

In pursuing these objectives, the UK Government released a White Paper in March 2021 called "Restoring trust in audit and corporate governance" (the "White Paper") which included proposals for the creation of a more effective and better-constituted regulator, called the Audit, Reporting and Governance Authority ("ARGA"); improvements in reporting and directors' accountability at the largest companies, public and private; action to improve competition and choice in the audits of the largest publicly traded companies; and making audit a more effective tool for giving stakeholders reliable and relevant information about companies.

Following a consultation on the proposals contained in the White Paper, the UK Government now plans to legislate to create ARGA, and for other proposals that require primary legislation, whilst proceeding with reforms to regulation and guidance not requiring change to primary legislation, such as amendments to the UK Corporate Governance Code (the "Code").

The UK Government has not committed to a specific date for publication of the draft bill to implement any primary legislative changes, instead noting only that "The Government is committed to legislating when Parliamentary time allows."

Establishment of ARGA

As set out in the White Paper, the UK Government has confirmed that it will be establishing ARGA as the successor to the Financial Reporting Council ("FRC"). It had previously been thought that ARGA would be created with a start date of April 2023. However, delays in the legislative timetable now mean that it is unlikely that the FRC will transition to ARGA any earlier than April 2024.

The FRC is being replaced following criticism of its effectiveness, including by the UK Government's business select committee in 2019, which said that its "weak response" contributed to a "crisis of trust in audit". An independent review by Sir John Kingman in 2018 found it to be "an institution constructed in a different era – a rather ramshackle house, cobbled together with all sorts of extensions over time". The review called for the establishment of a new regulatory body with a stronger statutory foundation and more robust powers.

ARGA, when created, will be given broad powers in relation to corporate reporting and audit, including abilities to:

- direct changes to company reports and accounts without a court order;
- investigate and sanction

breaches of corporate reporting by directors; and

- review the contents of the annual report and accounts (extending the review scope to, inter alia, the corporate governance statement and the directors' remuneration report).

Primary legislation is needed to create ARGA and there has been delay within Parliament to bring this forward. Impacted companies should use this extra time before the establishment of ARGA to ensure they have the right governance frameworks and record keeping procedures in place to ensure that they can comply with the requirements of what is expected to be a more active regulator than the FRC before it.

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Public interest entities

The White Paper sets out options for expanding the scope of regulation to large private companies, and for recognising the changing nature of the UK economy and the need for higher standards of corporate governance in the most significant UK companies, given the importance of standards for employees, shareholders, and the company as a whole.

The UK Government intends to treat large private companies and LLPs with both 750+ employees and an annual turnover of £750m+ as public interest entities ("PIEs"). Companies traded on AIM or other multilateral trading facilities will only be included in the PIE definition where they meet the same size threshold as for large private companies. However, companies listed on the Main Market will still remain within the PIE definition irrespective of size.

The impact of this extension of the definition of PIEs is that these companies will be subject to additional financial and reporting requirements including the need for an annual resilience statement, reporting on distributable profits, and an audit and assurance policy, as well as a duty to report on anti-fraud measures. Once established, the new regulator, ARGA, will have greater enforcement powers over directors of PIE companies.

Review of the Corporate Governance Code

On 24 May 2023, the FRC published a consultation on changes to the Corporate Governance Code in the light of the proposals included in the White Paper. This consultation does not propose wholesale change to the Code, as was seen in 2018, but nevertheless there are a number of notable proposed amendments that companies that are subject to the Code should take into account.

The key areas under consultation are summarised below:

- *Section 1 - Board leadership and company purpose*:
  Introduction of a new principle whereby companies should, when reporting their governance activity, focus on outcomes-based reporting to demonstrate how the Code is being applied;

- *Section 2 – Division of Responsibilities*:
  To address investor concerns about the ability of board members to devote sufficient time to their responsibilities, there is a proposed requirement that annual reports contain more information about director's yearly commitments and how they are managed (i.e. set out board positions, committee roles, and the number of their commitments);

- *Section 3 – Composition, successions and evaluation*:
  Proposed changes to support new Listing Rule requirements on board diversity, and to expand inclusion to non-protected categories (e.g. cognitive and personal strengths);

- *Section 4 – Audit, risk and internal control*:
  Proposed changes to expanding the Audit committee's responsibilities, to include monitoring the integrity of narrative reporting, including risk management and internal control systems, sustainability reporting, and describing its work in the area in annual reports;

- *Section 5 – Remuneration*:
  Proposal that director contracts or other agreements should include malus and clawback provisions and for these to be described in the annual remuneration report.

The FRC requested comments on the proposals by 13 September 2023 and, in terms of expected responses to date, the general market view has been that the proposed changes are likely to impact smaller listed businesses the most due to the increased reporting requirements. However, it is noted that the Code's "comply and explain" model is still in place, meaning that companies can still deviate from Code requirements provided the reasons for the deviation are sufficiently well explained.

It is expected that the revised Code will apply to financial years beginning on or after 1 January 2025. This will allow companies that follow the Code plenty of lead time to ensure that they have the right systems and practices in place.

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Institutional investor guidelines for 2023

Proxy advisor groups and investor bodies operate as one of the key influences on best practice for corporate governance in listed companies as they influence the resolutions and the voting at the AGM. The three most prominent proxy advisor groups and investor bodies, Glass Lewis, Institutional Shareholder Services ("ISS") and the Investment Association ("IA"), have each published their institutional investor guidelines for 2023. The positions on some of the key themes in these reports – board diversity, climate-related compliance and audit reporting - are summarised below.

ISS United Kingdom & Ireland Proxy Voting Guidelines

Board diversity

ISS will generally recommend voting against the chair of the nomination committee if companies have not met the following targets:

- In the case of constituents of the FTSE 350 (excluding investment companies), the board does not comprise at least 33 percent representation of women. This aligns with the target set by the Hampton-Alexander Review;
- In the case of FTSE SmallCap, ISEQ20 and AIM companies with a market capitalisation of more than £500m, there is at least one woman on the board;
- In the case of standard and premium listed companies, at least 40% of the board is female and at least one of the senior board positions is held by a woman. This aligns with the targets set out in the FCA Listing Rules;
- The policy also contains mitigating factors that companies can cite in order to explain non-compliance with these guidelines. As recommended under the Code, companies should consider diversity beyond gender and ethnic diversity, taking into account factors such as social background and neurodiversity.

Climate accountability

For companies which are significant greenhouse gas ("GHG") emitters, ISS will generally recommend voting against the board chair in cases where it determines that the company is not taking the minimum steps needed to understand, assess, and mitigate risks related to climate change to the company and the larger economy.

Companies which are significant GHG emitters should consider (1) setting appropriate GHG emissions reduction targets, and (2) making detailed disclosure of climate-related risks in line with the Task Force on Climate-related Financial Disclosures ("TCFD").

> ***"there is work across the UK Government and the broader industry to restore trust and confidence in the UK's audit and corporate governance systems...proxy advisor groups are continuing to push companies towards better reporting standards, including in relation to diversity and environmental issues"***

Glass Lewis UK 2023 Policy Guidelines

Board diversity

In line with ISS, Glass Lewis has the expectation that FTSE 350 boards will comprise at least 33% women (with 40% female representation as a target by 2025).

All Main Market boards should report on a "comply or explain basis" against certain diversity targets, including at least 40% of the board being women and at least one of the senior board positions being held by a woman.

Climate accountability

Glass Lewis has introduced a new section for 2023 on director accountability for climate-related issues. It has defined climate risk in a broader context than ISS, viewing climate issues as a material risk for all companies, not just companies that are significant GHG emitters.

Glass Lewis may recommend voting against the chair of the committee (or board) responsible for oversight of climate-related issues (or the chair of the governance committee if no such committee is responsible) if companies fail to make disclosures in line with TCFD, or if they have not clearly and explicitly defined board oversight responsibility for climate-related issues.

Investment Association shareholder priorities for 2023

The IA will continue to "amber-top" (meaning the company has areas of concern which require a significant shareholder judgment) all companies that do not make disclosures against all four pillars of TCFD.

In 2022, the IA found that standards of reporting in compliance with TCFD were high among the UK's biggest companies: 98.8% of FTSE 100 companies made disclosures in line with TCFD.

However, issues continue with the quality of audit and how companies demonstrate how they have judged the quality of the audit they have received. In 2022, only 8% of FTSE companies were able to adequately demonstrate how they had assessed the quality of their audit (in comparison to 20% in 2021). Clearly more

work among audit committees is needed to meet this requirement.

FRC paper on proxy advisors

So, how important are these guidelines from proxy advisors and investor bodies? This was the question raised by the FRC in its recently published research. This research considered how influential the proxy advisors (mainly Glass Lewis and ISS) and ESG rating agencies actually are on the actions and reporting of FTSE 350 companies and investor voting. The research tests the assumption that investors will automatically follow the voting recommendations of their chosen proxy advisors or ESG rating agencies.

The findings were as follows:

Influence of proxy advisors:

- Due to limited resources, most investors surveyed stated that they will use the voting instructions based on recommendations from proxy advisors without manual intervention where the resolution is uncontroversial.
- The majority of company representatives that were interviewed or who took part in the roundtable meetings believe that at least some investors have in effect outsourced many or all of their voting decisions to proxy advisors, with the result that the advisors exercise considerable influence over voting outcomes.
- By way of example, one Company Secretary interviewed noted that there is a reticence to vote against the recommendation of the proxy advisor, as this would require them to escalate the matter to their investment committee.
- However, those investors who were interviewed said they would review recommendations to vote against management and other resolutions where, for example, companies are over a certain size, they hold a certain percentage of shares, or where they have previously engaged on governance concerns.
- Behaviour did not vary hugely based on the size of the investor and the proxy advisor they chose. However, comparing investors with UK-based teams to those without UK-based teams, a much higher proportion of the latter voted in line with their proxy advisor on more than 50% of resolutions.
- All proxy advisors interviewees confirmed that the Code is one of the main sources for their UK benchmark policy (see above for the proposed changes to the Code).
- Recommendations by the largest proxy advisors to vote against resolutions are relatively rare on most topics. For example, only 1.2% of all board appointment resolutions in FTSE 350 companies in 2022 attracted a vote against recommendation from one or both of ISS or Glass Lewis. By contrast, 14.6% of remuneration resolutions attracted a vote against recommendation.

Influence of ESG rating agencies

- The majority of companies interviewed said that the fear of receiving an adverse ESG rating was not a significant consideration when setting the strategy and developing action plans to address ESG related issues.
- As a result, companies stated that they needed to 'play the game' by providing the information used by ESG rating agencies, with the hope that they would receive a positive rating.
- There is concern among company representatives about the quality of data points gathered by ESG agencies and the extent to which they accurately reflect the ESG credentials of companies.

A clear conclusion from the research is that proxy advisors continue to have a strong influence on investor decisions. There is a reticence to disagree with the proxy advisors where to do so would be out of step with the market. However, proxy advisor guidelines continue to be by no means determinative, and there is a large disparity between the types of resolutions which attract a vote against recommendation.

Conclusion

As this update has considered, there is work across the UK Government and the broader industry to restore trust and confidence in the UK's audit and corporate governance systems. We have highlighted that proxy advisor groups are continuing to push companies towards better reporting standards, including in relation to diversity and environmental issues. But across the industry, pace of reform has admittedly been slow, and decisive action in these areas will be of importance in rebuilding the global reputation of the UK's equity capital markets.

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