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FRC Releases Revised UK Corporate Governance Code

The revised Code clarifies requirements for accountability, workforce engagement, and board diversity.

Key Points:

- The revised Code focuses on the application of flexible Principles on a "comply or explain" basis.
- Greater emphasis on a company's purpose and culture and its relationship with the long-term sustainable success of the company.

Overview

On 16 July 2018, the Financial Reporting Council (FRC) published its revised, shorter and sharper, UK Corporate Governance Code (Code). The revised Code will apply to all companies with a premium listing on the London Stock Exchange, whether incorporated in the UK or elsewhere, for accounting periods beginning on or after 1 January 2019. The revised Code has moved towards focusing on the Principles of good corporate governance to encourage a more holistic approach to corporate governance, rather than tick-box compliance. The Code has been restructured with the supporting Principles from the previous version of the Code being removed, or, in some cases, being incorporated into the new Principles or Provisions, or moved to the associated guidance published by the FRC (*Guidance on Board Effectiveness)*. The FRC expects companies to demonstrate in their reporting how the governance of the company has contributed to its long-term sustainable success and has achieved its wider objectives.

The changes largely mirror the proposed amendments to the Code published by the FRC in December 2017. Notably, however, the FRC has rowed back on certain proposed changes and has elected to restate existing principles in certain other areas instead.

Board leadership and company purpose

The revised Code attempts to marry a company's culture and wider stakeholder interests with the goal of achieving long-term sustainability. Notably, the revised Code introduces the following key changes.

- **Increased stakeholder engagement:** The board is responsible for understanding the views of the company's key stakeholders. A company's annual report must describe how the board has considered the views of key stakeholders in its discussions and decisions, which is in line with their directors' duties under section 172 of the Companies Act 2006 (which will be mirrored in a new statutory provision for financial years beginning on or after 1 January 2019 requiring all companies to include a "section 172 statement" in their strategic report). The chair and committee chairs should seek regular engagement with major shareholders. The board should also continually review stakeholder engagement mechanisms to ensure that they remain effective.

- **Greater workforce engagement:** Companies are now required to take into account the views of the "workforce." This broad term seeks to capture the complexity and diversity of the modern relationship between companies and individuals undertaking work for them, in light of developments in the labour market, including the rise of the gig economy and the focus on zero hours contracts. Boards should use one or a combination of the following methods for workforce engagement: (i) a director appointed from the workforce, (ii) a formal workforce advisory panel, and/or (iii) a designated non-executive director responsible for "workforce" matters. If the board has not used one or more of these methods, it should explain what alternative methods are in place and why it considers such arrangements to be effective. The annual report should include an explanation of the company's approach to investing in and rewarding its workforce.

- **Demonstrated response to significant votes against resolutions:** If at least 20% of shareholders' votes are cast against the board's recommendation for a resolution, the company should explain what actions it intends to take to consult with shareholders to understand the reasons for the voting result. The company should publish an interim update on such shareholder engagement within six months of the vote. Furthermore, the company should include a final summary in its next annual report, and if applicable, in the explanatory notes to the resolution 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.

- **Increased consideration of company culture:** The concept of company culture features throughout the revised Code to reflect the important link between a healthy corporate culture, strong systems, and procedures with integrity, confidence, long-term success, and trust in the company. Boards should define the company's purpose, strategy, and values. They should also consider the types of behaviours they wish to promote in order to deliver business strategies. If the board is not satisfied that policies, practices, or behaviour throughout the business align with the company's purpose, values, and strategy, it should seek assurance that the management has taken corrective action. This information should be disclosed in the annual report.

- **Broader whistleblowing abilities:** The revised Code amends the existing rule on whistleblowing, so that the workforce can raise wider concerns beyond any improprieties in relation to financial reporting. The board, rather than the audit committee, is now responsible for whistleblowing processes and procedures.

Division of responsibilities

The revised Code more clearly defines the separation of duties within the board, as well as the importance of objectivity and challenges to the board. Nevertheless, the Code largely restates certain existing principles, including:

(1) The chair should be independent on appointment, but his or her independence is not assessed thereafter.

(2) The board retains the discretion to determine the independence of non-executive directors against certain factors that are likely to impair, or could appear to impair, the board's independence (rather than, as proposed by the FRC in December 2017, providing that non-executive directors could not be

independent if they satisfied any of the listed criteria). To the extent there is a factor that could be relevant to the determination of the independence of a non-executive director, and the board nonetheless considers the relevant director to be independent, the revised Code requires the board to provide a clear explanation of its decision.

(3) At least half the board, excluding the chair, should be independent non-executive directors (rather than, as proposed by the FRC in December 2017, that independent non-executive directors, including the chair, should constitute the majority of the board).

- **Time commitment:** Full-time executive directors should not take on more than one non-executive directorship in a FTSE 100 company or other significant appointment.

Composition, succession, and evaluation

The revised Code emphasises the importance of the composition of the board, diversity of board appointments, and succession planning. The key changes include:

- **Chair tenure:** The chair should not remain in office for more than nine years. However, the revised Code now permits a time extension for a limited period to facilitate succession planning and the development of a diverse board, particularly if the chair was already a non-executive director upon appointment.

- **Intensified board diversity efforts:** The revised Code requires the board to intensify its efforts to enhance boardroom diversity. Boards are required to ensure that appointment and succession planning practices promote gender, social, and ethnic diversity at the board level and senior management level.

- **Increased diversity reporting:** A company's annual report must report on the progress of diversity efforts, including in relation to senior managers — who serve as the first layer of management below the board and the board's direct reports.

- **Regular board evaluations:** The chair should consider holding externally facilitated board evaluations on a regular basis. For FTSE 350 companies, this should occur at least every three years.

- **Annual re-election**: all directors should be subject to re-election (rather than just those in the FTSE 350 as provided in the previous Code).

Audit, risk, and internal control

The revised Code broadly reiterates the previous Code's audit, risk, and internal control provisions. However, the revised Code emphasises that the board should carry out a robust assessment of the company's emerging and principal risks, which may be, but are not necessarily, events or circumstances that might threaten the company's business model, future performance, solvency, or liquidity and reputation.

The FRC also encourages companies to develop their viability statements in the annual report in the following two stages, in order to provide more transparency and meaning to the reporting:

(1) A company should consider its prospects over a period of time that reflects its business and investment cycles.

(2) A company should then state whether there is a reasonable expectation that the company will be able to meet its liabilities as they fall due over the assessment period.

Remuneration

Executive pay is a notable and continued areas of focus in the UK, as reflected by the following amendments to the Code:

- **Greater emphasis on facilitating boards' exercise of independent judgment:** Company incentive schemes should make provisions for boards to be able to override formulaic outcomes.

- **Expanded remit for remuneration committee:** Remuneration committees will now have an expanded remit to set the remuneration for senior managers, and they will review workforce remuneration and related practices, and the alignment of incentives and rewards with culture, taking these into account when setting executive director remuneration.

- **New experience requirement for remuneration committee chairs:** The chair of the remuneration committee must serve at least 12 months on a remuneration committee before taking the role.

- **New remuneration committee reporting requirement:** The remuneration committee should explain what workforce engagement has occurred during the relevant reporting period in order to demonstrate how executive remuneration aligns with a company's wider pay policy.

- **Vesting periods:** Companies should release executives' awards for sale on a phased basis, subject to a total vesting and holding period of five years or more (compared with three-years under the previous Code). The remuneration committee should develop a policy governing post-employment shareholding requirements covering vested and unvested shares.

The revised Code is an important step to help restore confidence in businesses by focusing on building and strengthening the relationship between companies, shareholders and wider stakeholders. The emphasis on long-term value creation, success and sustainability of companies is to be welcomed in the UK, and perhaps further afield if the principles of the Code are imported into the corporate governance practices of other jurisdictions, including the United States, where there is increasing pressure for companies to focus on sustainable business and investment strategies. Premium listed companies in the UK should review their existing corporate governance policies and practices as soon as possible to ensure compliance with the revised Code.

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