People get ready! The proposed new UK Corporate Governance Code

"People get ready.
There's a [corporate governance] train a-coming.
You don't need no baggage.
You just get on board.
All you need is faith."

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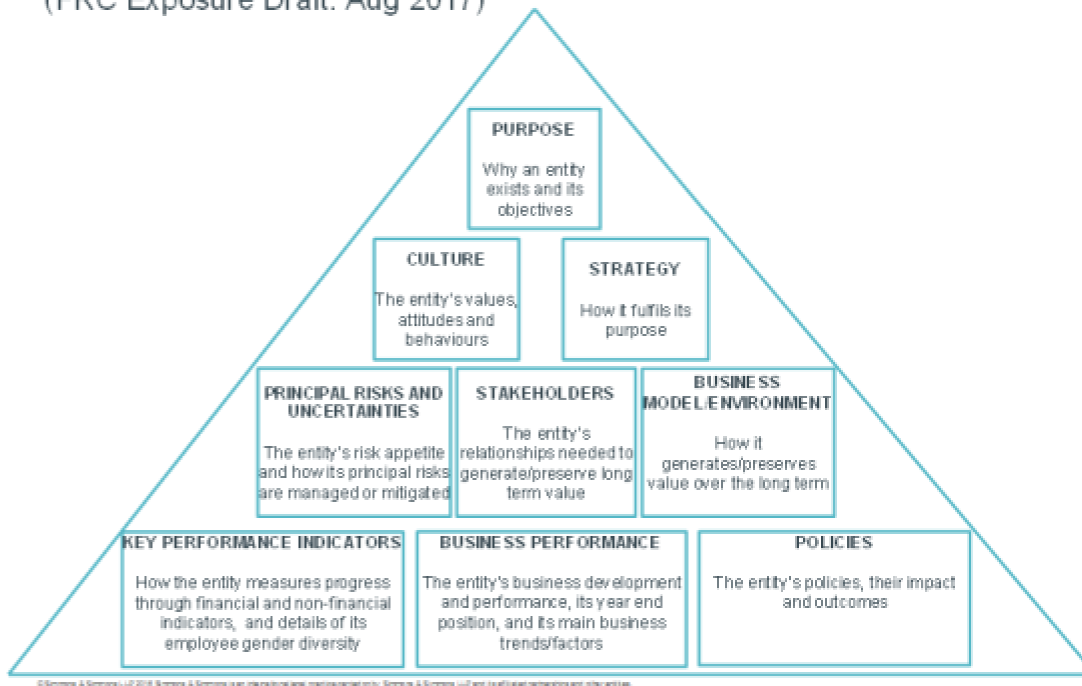
I like the way Joss Stone sings it. I am choosing it as my theme song for the proposed new Governance Code: a fundamental development in corporate governance and which will have a material impact on directors' duties.

The Financial Reporting Council (FRC) has proposed revisions to the UK Corporate Governance Code. It aims to publish a final version of the Code by early summer 2018, to apply to accounting periods beginning on or after 01 January 2019.

The new Code, if adopted in the form proposed (Revised Code), will, in my view, be a fundamental development in corporate governance and will have a material impact on directors' duties. "Surely not?" you say. The Revised Code however needs to be read together with the FRC's proposed revised guidance on board effectiveness, the government's proposals for legislative reform and the FRC's exposure draft on strategic statements (FRC Exposure Draft). In effect, the Revised Code draws together a new architecture of corporate governance (shown in the triangle below).



What is a company's purpose?

Under the Revised Code the board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned, making explicit what is already good governance. It puts the company's purpose at the forefront. It establishes that a company's purpose should be more than promoting the success of the company for the benefit of its shareholders; it should also include long-term sustainable success with responsibilities to the workforce and other stakeholders critical to the creation of long term value and to society to act with integrity. New Principle A says that a successful company is led by an effective and entrepreneurial board, whose function is "to promote the long-term sustainable success of the company, generate value for shareholders and contribute to wider society".

So is the Revised Code to be applied or is it still "comply or explain"?

It's a trick question. The Listing Rules require all premium listed companies to disclose how they have applied the Principles in a manner that enables shareholders to evaluate how these have been applied. They also require these companies to disclose whether they have complied with all relevant provisions of the Code or, if not, to explain the non-compliance. This remains.

The Revised Code will only have Principles and provisions. Gone are the supporting Principles. The more demanding the Principles, the less straightforward it is for companies to state how they have applied those Principles. There are frequent references to "ensuring" matters: the board must "ensure" that the necessary resources are in place for the company to meet its objectives and "ensure" effective engagement with stakeholders. The chairman should "ensure" the effective contribution of all non-executive directors (NEDs). I'd prefer these sorts of matters are expressed as "enabling", rather than "ensuring".

What is the new legislation proposed?

The government intends new secondary legislation to require all companies of a significant size (private as well as

public) to explain how their directors comply with the requirements of section 172, Companies Act 2006, about employee interests and fostering relationships with suppliers, customers and others. It's possible these regulations will make the adequacy of those disclosures within the remit of the FRC's powers, quite apart from any informal influence that the FRC chooses to exercise.

If directors have to report at the end of the year how they have fulfilled their statutory duties as directors, this then shapes and influences what directors need to do during the year in order to be able to report properly at the end of the year. In this very subtle, very English way, I do think it will materially raise the standard of directors' duties. It may make more visible, and more express, some things that many listed companies would have regarded as good practice anyway. But, I think clearer responsibility produces greater responsibility and one that must be fulfilled to the requisite standards of reasonable care, skill and diligence.

But it doesn't just stop there. Here's a selection of other material changes in the Revised Code.

What is new for stakeholders?

New Principle C requires that for a company to meet its responsibilities to shareholders and stakeholders the board must ensure effective engagement, and encourage participation from them. To achieve a wider stakeholder focus the FRC has drawn on its Culture Report which demonstrated the importance of aligning company purpose, strategy and values in order to achieve long-term success. That report endorsed the proposition that successful companies are open and accountable to their workforce. There is good guidance on relationships with stakeholders contained in 'The Stakeholder Voice in Board Decision Making' published by ICSA: The Governance Institute and the Investment Association.

What about companies outside the FTSE 350?

A controversial part of the Revised Code is no longer to distinguish between FTSE 350 companies and small listed companies. An effect for small companies would be the composition of their board should change to have a majority of independent NEDs (see though below about the position of the chairman).

There is possibly something of a disconnect between what the Revised Code is proposing for smaller companies and what the FCA is proposing for the governance of asset managers. The FCA's proposals should lead to a need for asset managers to appoint, in total, an additional 480 NEDs (assuming that number are available and conflict-free) where the FCA proposed that asset managers should have at least 2 independent NEDs and one third of the overall board should comprise independent NEDs. (I think the one third requirement is artificial and the requirement for 2, as opposed to 1, independent NEDs potentially excessive, particularly for smaller asset managers.)

The Revised Code, though, treats the chairman as capable of being an independent NED. The drafting is not absolutely clear on this but the intent appears to be that. if the chairman is independent, he or she can count towards the requirement that a majority of the board are independent NEDs. As you know, the current requirement for FTSE 350 companies is that the majority of the board, excluding the chairman, should comprise independent NEDs. In theory, under the Revised Code, companies could slightly downsize the size of their boards and still meet the new requirement. In practice, I suspect that most larger companies will not do so, particularly where the chairman has a substantive part-time role.

Surely the Revised Code addresses "governance information risk"?

This is the risk that boards do not receive the right information at the right time in order to make the right decisions. The

current Code is (to the some people's surprise) remarkably strict - "the chairman is responsible for ensuring that the directors receive accurate, timely and clear information." In the Revised Code, it is "the chief executive who is responsible for proposing strategy to the board, delivering it as agreed and "ensuring" (that word again) timely and balanced information is presented in order for the board to make decisions effectively" (Provision 10). New Principle H now says the board, supported by the company secretary, "should ensure that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently". While this Principle is much broader than this issue, I continue to think boards can help themselves by having a governance information risk policy that helps support high quality decision making and more broadly helps support the culture in which the board receive candid views from management, and the workforce (explained below) are encouraged to speak up. And, for financial services business already (or to become) subject to the Senior Managers Regime such a policy helps demonstrate compliance with the SYSC rules on management information and can act as a reasonable step for the purposes of that regime.

What about senior management?

The Revised Code extends the board's responsibilities relating to senior management (treated as the executive committee or the first layer of management below board level, including the company secretary). Under the Revised Code, the nomination committee should ensure plans are in place for orderly succession to both the board and senior management positions. Similarly, under the Revised Code, the remuneration committee should have delegated responsibility for determining the policy for directors' remuneration and setting remuneration for the board (as currently) and also (under the Revised Code) senior management. The composition of senior management is then linked through to increasing diversity.

What about the workforce?

The Revised Code expects companies to take in to account the views of the "workforce". The term has been chosen to cover the diversity of modern contractual relationships between companies and individuals undertaking work for them. It is intended to include not only those with a formal contract of employment but other workers, agency workers and those providing services as a contractor (self-employed). The logic is that the culture of the company, its strategy and values, and decisions made by the board and senior management, will impact on all those paid to work for the company and, in return, these individuals will have a direct impact on the success of the company. Under the Revised Code, the remuneration committee should oversee remuneration and workforce policies and practices, taking these in to account when setting the policy for directors' remuneration. This, together with pay ratios, seek to make remuneration committees much more mindful of the alignment of directors' and senior management's remuneration with the overall remuneration of the workforce.

What about "worker directors"?

New Provision 3 requires the board to establish a method for gathering the views of the workforce. The government proposed one of three methods. The Revised Code takes those three methods and says they should "normally" be a director appointed from the workforce, a formal workforce advisory panel or a designated NED. A fourth method can be used but with explanation and being treated as, in effect, "abnormal". All very British!

Has the definition of independence changed?

The criteria for independence are the same but the overriding test of independence in character and judgement has been removed. The effect is to force directors who do not meet one of the criteria but whom the board still considers independent in character and judgement into non-compliance with the Revised Code and explanation. It is clear, too, from the Revised Code that nine years' tenure for an independent NED is very much to be regarded as the maximum.

How is diversity addressed?

Under the current Code, appointments to the board have to be made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender. Under the Revised Code (Principle J), both appointments and succession plans (I think for both the board and senior management) should be based on merit and objective criteria, and promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths. In support of this, Provision 23 requires disclosure in the annual report of (1) its appointment process and approach to succession planning and how both support building a diverse pipeline under Principle J; and (2) the other actions taken by the nomination committee to oversee the development of a diverse pipeline for future succession to board and senior management appointments.

According to the FRC, the Revised Code asks boards to intensify their efforts to promote greater diversity. Provision 23 also requires disclosure in the annual report of the gender balance of those in the senior management and their direct reports. It also requires an explanation of how diversity supports the company in meeting its strategic objectives. Companies are already required (under DTR7.2.8A(R)) to disclose their board diversity policy about aspects such as, for instance, age, gender, or education or professional backgrounds; the objectives of the diversity policy; how it has been implemented; and the results in the reporting period.

Is there going to be a new "naughty register"?

The government had already asked the Investment Association (IA) to maintain a public register of those companies that experience shareholder dissent of more than 20% of votes cast against executive remuneration resolutions and to keep a record of what those companies say they are doing to address shareholder concerns. The IA has now launched this public register which applies to companies in the FTSE All-Share Index which have received votes of 20% or more against any resolution or who withdrew a resolution before the shareholder vote. The register includes a description of the resolution, the results of the shareholder vote, a link to the AGM results announcement (including any statement the company has made under the Code) and a link to any further announcement(s) the company has made in response to the dissent.

A new Code provision would extend this to require greater explanations when more than 20% of votes are cast against any resolution. A company would have to explain, when announcing voting results, what actions it intends to take to consult shareholders to understand the reasons behind the result. The board would then be expected to provide (i) an update no later than six months after the vote; and (ii) a final summary in the annual report (or in the explanatory notes to resolutions at the next meeting) on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed.

So, what's not there that should have been there?

The Revised Code doesn't directly refer to a supply chain or, more broadly, a value chain. This is better addressed in the FRC Exposure Draft which refers to the importance of the supply chain. Given increasing legislation where companies can be vulnerable to the acts of their agents or various third parties for bribery, modern slavery and facilitating tax evasion, the Revised Code might have referred explicitly to supply chains. The counter argument is that a supply chain is an inherent part of a company's business model, and to be described under non-financial reporting rules.

How does this all fit in with non-financial reporting?

If you look at the Revised Code, the various guidance from the FRC, the FRC Exposure Draft and the non- financial reporting regulations themselves, the FRC has skilfully sought to blend them all together.

The non-financial reporting regulations are themselves very significant in their own right. They apply to financial years beginning on or after 01 January 2017. These regulations require a strategic report for a company subject to the regulations to include a non-financial information statement with information to the extent necessary for an understanding of the "impact of its activity" relating to, as a minimum,: environmental, social and employee related matters, respect for human rights and anti-corruption and bribery matters (non-financial matters). The information must include a brief description of the company's business model, a description of the policies pursued by the company in relation to these non-financial matters, the outcome of such policies, a description of the principal risks relating to these non-financial matters and how the company manages such risks.

The requirement to report on "impact of its activities", the outcome of various polices and the business relationships, products and services likely to cause adverse impacts to principal risks and how the company manages those principal risks are all in themselves very significant developments in non-financial reporting. When read in conjunction with the Revised Code, they take on, I think, even greater significance.

In conclusion...

The more you read the Revised Code, the more nuances there are. I regard the Revised Code as a fundamental development in corporate governance and hence one which will materially impact directors' duties. The FRC is clear in its approach, they say "we are retaining those elements of the current Code that are still relevant today, and adapting others to reflect the changing economic and social climate to ensure that UK-listed companies achieve the high standards of governance." The FRC are to be complimented for the way in which they have sought to do so in the Revised Code, but the significance of the changes should not be underestimated.

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