

FRC Issues UK Corporate Governance Code

The Financial Reporting Council (the "FRC") published on 28 May 2010 the new UK Corporate Governance Code (formerly the Combined Code) (the "Code"). This applies directly to all UK companies with a Premium Listing of equity securities, and now on a "comply or explain" basis to non-UK companies with a Premium Listing of equity securities.

The new Code is the result of a year long consultation process carried out by the FRC, in parallel with Sir David Walker's review of corporate governance in banks and financial institutions, in light of the financial crisis. The Code sets out standards of good practice for listed companies in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders.

The new Code applies to accounting periods beginning on or after 29 June 2010.

Although largely restating the current Code, the new Code introduces a number of structural changes and new requirements aimed at improving the governance of listed companies. The most significant of these are:

- **business model and risk:** a new provision requiring the disclosure of the business model in the annual report and new main principle relating to the board's responsibility for risk;
- **performance related pay:** amendments to remuneration policy, including a new supporting principle that performance related pay should be designed to promote the long term success of the company;
- **board diversity:** a new supporting principle requiring that appointments to the board have due regard to the benefits of diversity, including gender;

- **annual re-election:** a new provision requiring the annual re-election of all directors of the board of FTSE 350 companies; and
- **external review:** a new provision requiring that the annual review of the performance of the board of FTSE 350 companies should be externally facilitated at least every three years.

Business Model and Risk

Under the new Code companies should disclose their business model in their annual report. The FRC noted that the majority of respondents shared their view, and the view of the House of Commons Select Committee, that this is currently a gap in the reporting regime and that setting out in layman's terms the company's strategy for generating long term value will enhance the ability of investors and other users of the annual report to assess the disclosures required under the business review.

In addition, new provisions have been included setting out the board's responsibilities in relation to risk. The board is now explicitly responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives, and for maintaining sound risk management and internal controls. In the description of the business model, the board should illustrate how it has applied the new principle on risk.

Performance-related Pay

Various changes have been introduced relating to remuneration policy. Some of the changes are intended to address the recommendations of Sir David Walker that the FRC considers should apply to all listed companies.

The provisions on remuneration have been amended to clarify that remuneration of non-executive directors should not include any performance related elements and that the performance related elements of executive directors' remuneration should be designed to promote the long term success of the company. Payments under incentive schemes should be subject to non-financial performance criteria where appropriate and compatible with companies' risk policies and systems, and companies should consider provisions that enable them to reclaim variable components in cases of misstatement or misconduct.

Boardroom Diversity

The new Code has amended the supporting principles on appointments to the board to state that they should be made "against objective criteria with due regard for the benefits of diversity on the board, including gender". The intention of this amendment is to encourage boards to consider the diversity of the board when making new appointments, with a specific emphasis on gender.

Annual Re-election of All Directors

Under the current Code all directors are subject to re-election at the first annual general meeting after their appointment and to re-election thereafter at least every three years. Non-executive directors that serve longer than nine years (which the Code discourages in itself) are subject to annual re-election.

The new Code has introduced the requirement that all directors of FTSE 350 companies be subject to annual re-election. The FRC is of the opinion that it is important that shareholders have an annual opportunity to express their views on performance of directors, and such a requirement will give boards a strong incentive to understand and respond to shareholders' concerns before the annual general meeting.

During the consultation, respondents were divided over whether all directors should be required to

stand for annual re-election. Some respondents raised concerns that it would encourage short-term thinking and create the potential to destabilise the board. The FRC has recognised that smaller companies with a more concentrated shareholder base might be exposed to disagreements between their major shareholders, and therefore has limited the new provision to FTSE 350 companies.

External Board Review

It is a requirement of the current Code that the performance of the board should be reviewed annually. The new Code builds upon this, providing that board reviews for FTSE 350 should be externally facilitated at least every three years. The FRC sees this as important because of the potential benefits resulting from the greater objectivity that an external facilitator can bring to the evaluation process.

This was originally proposed to apply to all companies, but during consultation a number of respondents raised concerns about the additional costs and the availability of such service providers. The FRC acknowledged that in the short to medium term there will be concerns about the cost and availability of board evaluation services and for that reason limited this provision to FTSE 350 companies (although it should be taken as best practice for others).

Going Forward

In response to Sir David Walker's recommendations and the Government's request, the FRC has taken on responsibility for a stewardship code on the responsibilities of institutional investors. The stewardship code will be based on the current code published by the Institutional Shareholders' Committee. The FRC's consultation on the new stewardship code closed on 19 April 2010 and an announcement on the next steps is expected in the near future.

The UK Corporate Governance Code will next be reviewed in 2013.

Practice group contacts

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