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CONDIE BRIEFING PAPER

FRC Proposed Revisions to the UK Corporate Governance Code 2018

KEY THEMES

Overview

It has been 25 years since the first Corporate Governance Code was published in the UK. The Cadbury Code and Report established the concept of a benchmark for good governance in companies listed on the London Stock Exchange. The Code was also widely adopted as the standard for all other types of organisations.

The Code itself (now referred to as the UK Corporate Governance Code) has had numerous adjustments in recent years. But governance best practice moves on and this time the Financial Reporting Council is undertaking "*a comprehensive review to ensure that the Code remains fit for purpose*."

The proposals include a significant restructuring of the Code, with an enhanced role for Board effectiveness requirements, and raises the importance of culture management in firms.

The Financial Reporting Council ("FRC") has published a consultation paper (responses required by 28 February 2018) supplemented by comprehensive appendices covering the full revised Code, a summary of changes and, importantly, revised Guidance on Board Effectiveness.[1]

Actions

Boards should consider what changes to their practices and operations are prompted by the key themes proposed in the review. Questions they may ask include:

- Are we confident we actively manage culture in the organisation?
- Is our Independent Board Effectiveness Review due, and does it take account of recent and proposed governance changes?
- How can we benefit from improved relationships with our stakeholders?

A thorough analysis of current practices as against the new Code expectations is recommended to ensure systems are in place prior to the effective start of the new approach in January 2019.

[1] Details can be found at https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code

Key Themes of the Proposed 2018 UK Corporate Governance Code

Structure of the Code

The FRC is seeking to "shorten and sharpen" the Code, deleting certain sections and transferring others to the Guidance on Board Effectiveness document. This means that users of the Code have to take account of both publications. The structure of Principles and Provisions will remain, but with greater expectation that all Principles will be applied, and the Provisions should be complied with or an explanation of non-compliance noted in the Annual Report.

Culture

The FRC's 2016 report on culture[2] forms a key element of good governance – both in terms of the way the company conducts its business and its engagement with shareholders. A very topical issue and one that directors may expect to be challenged on. The FRC note that a well-managed culture brings integrity, confidence, long-term success and trust. Conversely, in the view of the FRC, a poor culture is a significant risk.

Guidance on Board Effectiveness

The current Guidance on Board Effectiveness was published in 2011 and clearly the expectations of Boards has moved on materially since then, particularly in regard to what constitutes "effectiveness". The draft Revised Guidance on Board Effectiveness is not only more extensive but certain features of the Corporate Governance Code have been transferred to the Guidance.

A helpful move by the FRC has been the inclusion of sets of questions that Boards can use to check their compliance, or perhaps their approach to, various sections of the Guidance. Some examples indicate the breadth of the Board's role:

- How do we ensure that the board makes well-informed and high-quality decisions based on a clear line of sight into the business?
- How do we articulate and communicate what we consider to be acceptable business practices?
- How do we obtain assurance that the culture we are leading is open, accountable and aligned to purpose?
- Is there a forum for employees to share ideas and concerns?

[2] Corporate Culture and the Role of Boards, Financial Reporting Council, July 2016

Role of the Chair

The role of the Chair remains a key feature within Board effectiveness, with a heightened requirement to lead the annual Board evaluation, rather than just take responsibility for acting on results.

Workforce engagement

A material change to the proposed Code is the addition of a Provision requiring the adoption (on a comply or explain basis) of one (or more) of three "employee engagement" mechanisms, as part of the wider concept of understanding stakeholder views. The draft Code goes on to define a modern view of "workforce" to include all those engaged by the firm, including agency workers and contractors.

The three options are;

- A director employed from the workforce
- A formal workforce advisory Council
- A designated Non-Executive Director

Boards will have to give consideration as to which they prefer and exactly how they will make the engagement benefit the business.

Larger firms will see the benefits of formalising the approach to workforce engagement. Those firms with smaller workforces may feel the proposed requirement to be too prescriptive and unmanageable and are more likely to explain why they have not adopted this Provision in future annual reports.

Board composition, independence and tenure

The proposed new Code states that the Chair should be able (through actions and decisions made) to demonstrate independence at all times. This leads on to the Provision that the majority of members of the Board – now *including* the Chair should be independent non-executives, rather than half the Board excluding the Chair as at present.

In regard to the Chair and all other NEDs, emphasis is placed on only being considered independent if they do not have any current or previous relationships with the company or a significant shareholder.

The consultation paper goes on to say that where an NED serves for more than 9 years on the Board they can no longer be seen as independent. The FRC reminds us that this is consistent with the Code's approach to succession planning and the importance of Board refreshment.

Diversity

There is broad agreement that diversity in the workplace brings better financial performance. Whilst acknowledging there has been notable progress in this area, the proposed revisions to the Code seek greater effort and broader public reporting of gender, social and ethnic backgrounds. The responses to the consultation proposals may well be cautious here, as data on these matters may not currently be available and only developed over time.

Audit, Risk and Internal Controls

There are relatively few proposed changes under the audit and risk heading. Nevertheless, the broader Code review clearly ramps up the expectation that Boards should proactively set the risk culture and appetite in the organisation. The FRC places some importance on the approach firms take to compiling the Viability Statement.

Remuneration Committee

The new Code places greater responsibility and an expanded remit for the RemCo, building on the culture and workforce engagement. Among the implications for firms is the question of the frequency of meetings of the RemCo, where the tendency to have two or three meetings a year is unlikely to be sufficient, given the expanded brief of the Committee.

For further discussions please contact:

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