Proposals for a revised corporate governance code for listed companies

Over the course of last year, the British government published a swathe of papers on renewing and strengthening corporate governance in the country's firms. Among the measures proposed, the executive set the *Financial Reporting Council* (FRC) the task of revising the code of corporate governance for listed companies. Following this mandate, the FRC sent its proposals out for public consultation at the end of 2017. We analyze them below.

A code for the future

With its update of the corporate governance code, which applies to companies with a *premium listing* on the Stock Exchange, the FRC aims to give continuity over time to the Code so that it remains relevant for at least another 25 years. This has the two-fold objective of reinforcing market trust in British companies and of attracting investors, against the backdrop of Brexit.

The new code has been reorganized into the following five sections: i) Leadership and purpose; ii) Division of responsibilities; iii) Composition, succession and assessment; iv) Audit, risk & internal control, and v) Remuneration. We take a look below at the main issues covered in the revised Code:

Board of Directors and company culture

The proposals contain a new principle, relating to the importance of company culture. It highlights the key role played by the Board of Directors in promoting companies' long-term success, and how the Board must oversee the purpose, strategy and values of their corporation, making sure that these are aligned with its culture.

The Board must ensure that the company has the resources it needs to achieve its goals, and also be responsible for setting up effective, prudent internal control, to make the management and monitoring of risk more robust.

Stakeholders

The Code stresses the importance of companies being committed to a wider range of stakeholders, not just shareholders. Thus, the board should encourage regular communication with majority shareholders, and the committee Chairs should report on matters within their responsibility to the board. The Code stipulates that special focus should be put on understanding employee perspectives, for which it recommends adopting one of the following three mechanisms:

Designating a non-executive director to ensure that the workforce is considered when decisions are taken
Appointing a director from the company workforce
Creating a workforce advisory council

Employees should also have access to channels enabling them to raise concerns about the direction of the company or about other colleagues when they observe behavior inconsistent with the company's values and responsibilities.

On this issue, the code specifies that companies must provide information in their annual report about how they have engaged with their employees and other stakeholders, and how their concerns and considerations have impacted on the Board' decision making. This is consistent with the board members' duty of compliance with article 172 of the Companies Act 2006, as discussed in previous issues of *Progreso*.

Voting

Another of the new principles in the revised code is that where there have been a significant number of votes against a resolution in the Annual General Meeting, the company should explain what actions it intends to take to understand shareholders' concerns and to decide the best way of tackling them. Companies will have to provide feedback about these decisions within 6 months of the vote, and also include a reference to these decisions in its next annual report.

Board of Directors

A cornerstone premise of the Code is the division of responsibilities between the organ of governance and the company's executive management. The roles of the Chair of the Board and that of Executive President should not be shared by the same person, and the competences and responsibilities of boards and senior management must be clearly defined, approved and made publicly available.

The proposal highlights the leadership role of the Chair of the Board in demonstrating independent, objective judgement in decision making and fostering a climate of debate among board members.

The previous Code made clear that the Chair only had to be an independent board director at the moment of taking up the post. The new proposal recommends that this independence should last for the duration of the responsibility, so the Chair should not remain in place for more than 9 years.

Similarly, it proposes that half the board members, including the chair, should be independent non-executive directors. The new Code is more rigorous in its independence criteria, such that if the director fails to meet one or more criteria (for example, is or has been an employee of the company within the last five years, has ties with the company or with significant shareholders, or has served on the board for more than 9 years) that director will no longer be considered independent.

The revised Code also wants the exemptions currently applicable to smaller companies* to be removed, to require them to strengthen their governance standards. Among other changes, half the board members should be independent (the requirement is currently for two non-executive directors), all directors should be subject to annual re-election, and there should be an externally facilitated board evaluation every three years.

Diversity

Turning to the composition of the board, the proposals focus on encouraging diversity, in the widest sense, based on the conviction that a diverse organ of governance leads to better decision-making and enables companies to be competitive in a global market.

The proposal also recommends that companies employ external senior executive search agencies to appoint the Chair of the board and non-executive directors.

It also requires there to be a succession plan for board directors and senior management, based on objective criteria and merits, that promotes diversity of gender and ethnic backgrounds, cognitive and personal strengths. In this area, the revised Code highlights the role of the nomination committee, which should reflect in its annual report: i) its approach to succession planning and how it has supported a diverse pipeline for future appointments; and ii) an explanation of how diversity supports the company in meeting its strategic objectives.

Companies should also report on the gender balance in the board of directors and among senior management.

The revised Code proposes that the board and its members be assessed every year individually, considering the balance of skills, experience, independence and knowledge, its diversity and how effectively members work together to achieve corporate objectives. Furthermore, every three years this evaluation should be conducted by an independent expert.

Control functions

The Code states that the board should set up the following committees to support it in its functions:

Audit committee, made up of at least three members, all non-executive, of whom at least one should have financial experience. The chair of the board may not be a member.

Nomination committee, to lead the process for appointing board directors and ensure the orderly succession of these and of senior management. It should be made up of at least three directors and a majority must be independent. The chair of the board should not chair the committee when it is dealing with the appointment of his/her successor.

Remuneration committee, in charge of overseeing the remuneration and incentive payments in the company. The annual report must explain whether the remuneration of executives is aligned with the company's overall remuneration policy. Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months, unless there is a clear and valid rationale why this is not appropriate or possible, depending on the individual circumstances.

The Code recommends that the Board be responsible for monitoring at least once a year the company's risk management and internal control systems at least once a year. It will analyze the key risks faced by the company and explain in the annual management report how risks have been managed or mitigated.

Remuneration

Addressing the feedback to the government from the public consultation on the Green Paper, the Code recommends extending from 3 to 5 years the minimum holding period for shares in the company paid as part of remuneration packages.

With the aim of reinforcing their independence, remuneration for all non-executive directors should not include share options or other performance-related elements.

Next steps

The FRC is expected to publish the definitive version of the Code in the summer of 2018, to come into force on 1 January 2019.

We should bear in mind, however, that the Code operates under the "comply or explain" principle, so companies will be obliged to explain how they have followed its recommendations or otherwise clearly lay out in detail their reasons for non-compliance, although this non-observance will not result in any financial penalty.

* Under FTSE 350.