



# New UK corporate governance code in force from 29 June 2010

The Financial Reporting Council (FRC) has published the new 'UK Corporate Governance Code' which replaces the Combined Code for accounting periods beginning on or after 29 June 2010. The new Code is largely in the form of the FRC's December 2009 consultation draft, but with a new recommendation that all directors of FTSE 350 companies be put up for re-election every year and an express reference to gender diversity in the Code principles on board appointments.

## Headlines

### Annual re-election

- All directors of FTSE 350 companies should be elected annually: this decision reflects the preference of institutional shareholders and is seen as key to improving shareholder engagement. While the majority of corporate responses argued for the existing three-year rotation, those companies who have already adopted annual re-election of the entire board were reported as not having identified any change to voting patterns.

### Diversity

- To reduce the risk of 'group think', the Code will contain a specific reference to diversity and, in particular, gender diversity. Unlike some other jurisdictions there is no specific 'quota' requirement.

### Board reviews

- Despite some opposition from listed companies, the Financial Reporting Council (FRC) is pressing ahead with the requirement for 'external evaluation' at least every three years, but initially just for FTSE 350 companies. Limiting the requirement in this way acknowledges some concerns about the current availability of sufficient high quality board evaluation services. The FRC is confident that the market will in due course respond, and will review the limitation accordingly.

### Risk

- The absence of a specific principle relating to risk management and control is acknowledged as a

failure of previous versions of the Code. This is now remedied with a specific obligation (now more neutrally worded) on boards to identify and monitor risk and is likely to lead to a significant increase in the formation of risk committees.

### Role of Chairman

- The new Code has added additional responsibility to and emphasis on the role of the Chairman: he is responsible for leadership of the board and ensuring its effectiveness; for achieving the requisite culture of constructive challenge by non-executives to the executives; and a particular responsibility for training, evaluation and board composition.

### Time commitment

- Implicit in the new Code is the recognition that the Chairman, the senior independent director (SID) and all other non-executive directors will be required to devote more time to the discharge of their responsibilities. Whether this should result in a corresponding increase in fees is not addressed in the Code.

### Reminder – no change to 'comply or explain' requirements in annual report

The Listing Rules are unchanged, so a company with a premium listing of equity shares (including, for financial years beginning after 31 December 2009, those incorporated outside the UK) must include a statement in its annual report:

- of how it has applied the Code's 'main principles' (enabling shareholders to evaluate how the principles have been applied); and
- as to whether or not it has complied throughout the accounting period with all the Code's 'relevant provisions' and, if it has not complied, identifying the relevant provisions and the period of non-compliance and reasons for it.

A new section on 'comply or explain' at the beginning of the Code recognises that non-compliance may be justified if good governance can be achieved in other ways. The company should 'clearly and carefully' explain its reasons for non-compliance to shareholders and should aim to illustrate how its practices are consistent with the principle to which the particular provision relates and contribute to good governance. In the preface to the Code, the FRC encourages chairmen 'to report personally in their annual statements how the principles relating to the role and effectiveness of the board ... have been applied'.

In relation to the new annual re-election requirements, the FRC points out that companies are free to explain rather than comply if they believe that their existing arrangements ensure proper accountability and underpin board effectiveness, or that a transitional period is needed before they comply.

## Key changes to 'main principles'

The FRC has changed the structure of the Code to emphasise its underlying principles. The main principles are now listed separately at the front of the Code. A number of previous supporting principles have been upgraded to main principles so that the company must report how they have been applied.

### Leadership

- The main principle that the board is collectively responsible for the success of the company has been expanded to emphasise that the success must be 'long-term'.
- A new main principle (upgraded from a supporting principle) emphasises the *chairman's responsibility* for leading the board and ensuring its effectiveness in all aspects of its role.

- A new main principle (upgraded from a supporting principle) says that non-executive directors (NEDs) should *constructively challenge* and help develop proposals on strategy.

### Board effectiveness

- A new main principle requires the board and its committees to have the 'appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively'. A new supporting principle re-inforces this by requiring an 'appropriate combination' of executive directors and NEDs (and in particular independent NEDs) such that no individual or small group of individuals can dominate the board's decision-taking.
- The Code still provides that at least half the board, excluding the chairman, should comprise NEDs determined by the board to be independent (except for companies below the FTSE 350, which should have at least two independent NEDs). The independence criteria are unchanged. The Code provision setting out the nomination committee's responsibilities has been amended to reflect the new principle, so companies may need to review the committee's terms of reference.
- A new main principle (upgraded from a supporting principle) emphasises that all directors should be able to allocate sufficient time to the company to perform their responsibilities effectively. The FRC has not specified minimum time commitments.

### Risk

- There is a new main principle that the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The FRC has indicated that any necessary further guidance on how to comply with this new principle might be given in the Turnbull Guidance, which is to be reviewed later in 2010.
- The main principle that requires a sound system of internal control has been expanded to cover risk management. The requirement for formal and transparent arrangements for considering how the board should apply the internal control principles also now applies to risk management.

## Key changes to supporting principles and provisions

### Directors' development and evaluation

- New provision – The chairman should regularly agree and review with each director their training and development needs.
- New provision – For FTSE 350 companies, board evaluation should be facilitated externally at least every three years, and a statement of whether an external facilitator has any other connection with the company should be made available. The Code continues to require the annual report to state how performance evaluation has been conducted. The contents of the statement are not prescribed.

### Re-election

- New provision – All directors of FTSE 350 companies should be subject to annual election by shareholders. For other companies, directors should be subject to election by shareholders at the first AGM after their appointment, and to re-election thereafter at intervals of no more than three years, and NEDs who have served more than nine years should be subject to annual re-election.

### Board composition – diversity

- New supporting principle – The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender.

### Chairman's responsibilities – facilitating strategic discussions and openness

- New provision – The chairman is responsible for setting the board's agenda and ensuring that adequate time is available for discussing all agenda items (in particular strategic issues). He or she should promote a culture of openness and debate by facilitating the effective contribution of NEDs in particular and constructive relations between executive directors and NEDs.

### Role of senior independent director

- New provision – The role of the senior independent director is to 'provide a sounding board for the chairman and... serve as an intermediary for the other directors when necessary'.

### Managing risk – systems

- Expanded provision – The requirement that the board should review at least annually the effectiveness of its internal control system has been expanded to include the risk management system.

### Accountability – financial and business reporting

- New provision – The annual report should explain the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the company's objectives. This wording has been amended in the final version of the Code to mirror the Accounting Standard Board's (ASB) voluntary Reporting Statement on the Operating and Financial Review, to which the FRC refers companies for guidance. The FRC recommends that the explanation appear in the same part of the annual report as the business review required by the Companies Act 2006.
- Clarification of Code provision – The directors should explain in the annual report their responsibility for preparing the annual report as well as (as previously provided) the accounts.
- Expanded Code provision – The directors should report on going concern in annual and half-yearly financial statements (previously the Code specified no place for the going concern report).
- Expanded Code provision – The annual report should identify members of all board committees, not just the nomination, audit and remuneration committees.

### Managing board changes

- Expanded supporting principle – The company should ensure that any change to the composition of board committees (as well as the board itself) can be managed without undue disruption.

### Information and support

- New supporting principle – All directors need appropriate knowledge of the company and access to its operations and staff to function effectively.

### Directors' remuneration

- New supporting principle – The performance-related elements of executive directors' remuneration should be designed to promote the long-term success of the company, as well as being stretching.

- Expanded provision – The Code discourages all forms of performance-related remuneration for NEDs, not only share options.
- Amended Schedule A – The performance-related remuneration provisions have been amended, and could require changes to the terms of incentive schemes. The main changes are as follows:
  - performance conditions should be designed to promote the long-term success of the company;
  - non-financial performance metrics should be reflected in performance criteria where appropriate;
  - the company should consider using provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct; and
  - remuneration incentives should be compatible with risk policies and systems. The previous suggestion that incentives should be specifically risk-adjusted has been removed.
- There are no changes to executive pay disclosures.
- Remuneration consultants – The FRC proposes to keep under review whether there should be future changes to the Code or appropriate guidance in respect of the code of practice developed by the Remuneration Consultants Group.

### Communicating with shareholders

- Expanded supporting principle – The chairman should ensure that all directors are made aware of their major shareholders’ issues and concerns. Previously, the chairman, senior independent director and ‘other directors as appropriate’ were required to maintain contact with major shareholders.

### Website publication

- The FRC has decided not to proceed with the suggestion in its consultation paper that companies be allowed to disclose information for Code purposes in the annual report or on a website. The FRC will consider this further as part of its wider project to reduce the complexity of annual reports.

## Other developments

### Improving reporting quality

The FRC commented in its *2009 review of the Combined Code: final report* on the variability of the quality

of companies’ reporting on corporate governance, with many boiler-plate and uninformative reports. It urged boards to embrace ‘confident and persuasive communication with shareholders rather than retreat into boiler-plate’ and encouraged chairmen, and the chairmen of the main board committees, to see the corporate governance statement as an opportunity to demonstrate to current and potential investors why they can have confidence in the board. The FRC also drew attention to the ASB’s October 2009 report on narrative reporting, *Rising to the challenge*, and suggested that it might consider producing a similar report on the corporate governance statement if this was found to be helpful.

### The Stewardship Code

The FRC’s 2009 Code review found that there were significant concerns about the quantity and effectiveness of engagement between institutional investors and the boards of listed companies. Sir David Walker’s review recommended that the FRC’s remit be extended to cover the development and encouragement of institutional investors’ adherence to best practice in the stewardship of listed companies. The FRC has consulted on a Stewardship Code based on the Institutional Shareholders’ Committee’s *Code on the responsibilities of institutional investors* (November 2009), which would replace Section E of the June 2008 Combined Code (now Section C). The FRC intends to announce the outcome of the consultation shortly. The FRC is separately considering options for developing good practice guidance on engagement between companies and investors.

### Review of Turnbull guidance

The FRC plans a limited review of the Turnbull Guidance on internal control during 2010 to address criticisms of the standards of risk reporting by companies. No consultation document has yet been published.

### Review of Higgs guidance

The FRC commissioned the Institute of Chartered Secretaries and Administrators (ICSA) to work with others to update the good practice guidance from the Good Practice Suggestions from the Higgs Report, last re-issued in 2006, and to consider whether additional guidance should be given on board leadership and

effectiveness. The ICSA consultation ended in April 2010 and should be followed by a second consultation in June 2010. ICSA plans to issue completed guidance to the FRC in October 2010.

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## More information

The UK Corporate Governance Code (2010)

[www.frc.org.uk/documents/pagemanager/Corporate\\_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf](http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

The Combined Code (2008)

[www.frc.org.uk/documents/pagemanager/frc/Combined\\_Code\\_June\\_2008/Combined%20Code%20Web%20Optimized%20June%202008\(2\).pdf](http://www.frc.org.uk/documents/pagemanager/frc/Combined_Code_June_2008/Combined%20Code%20Web%20Optimized%20June%202008(2).pdf)

The FRC's final report on its review of the Code and its consultation on the revised Code (2009)

[www.frc.org.uk/corporate/reviewCombined.cfm](http://www.frc.org.uk/corporate/reviewCombined.cfm)

Sir David Walker's recommendations (2009)

[http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/walker\\_review\\_information.htm](http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/walker_review_information.htm)

The Stewardship Code consultation (2010)

[www.frc.org.uk/corporate/investorgovernance.cfm](http://www.frc.org.uk/corporate/investorgovernance.cfm)

The Institutional Shareholders' Committee's (ISC) *Code on the responsibilities of institutional investors* (2009)

<http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCCode161109.pdf>

The Higgs report good practice suggestions (2006)

[www.frc.org.uk/documents/pagemanager/frc/Suggestions%20for%20good%20practice%20from%20the%20Higgs%20Report%20June%202006.pdf](http://www.frc.org.uk/documents/pagemanager/frc/Suggestions%20for%20good%20practice%20from%20the%20Higgs%20Report%20June%202006.pdf)

The Higgs review consultation (2010)

[www.frc.org.uk/documents/pagemanager/Corporate\\_Governance/ICSA%20Press%20Notice%203%20March%202010.pdf](http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/ICSA%20Press%20Notice%203%20March%202010.pdf)

The Turnbull Guidance on internal control (2005)

[www.frc.org.uk/corporate/internalcontrol.cfm](http://www.frc.org.uk/corporate/internalcontrol.cfm)

The ASB's reporting statement on the operating and financial review (2006)

[www.frc.org.uk/asb/technical/operating.cfm](http://www.frc.org.uk/asb/technical/operating.cfm)

The ASB's report *Rising to the challenge* (2009)

[www.frc.org.uk/asb/press/pub2148.html](http://www.frc.org.uk/asb/press/pub2148.html)