

New UK Corporate Governance Code

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Introduction

The UK Corporate Governance Code (previously called the Combined Code on Corporate Governance) (the "Code") is the principal set of corporate governance principles applicable to listed companies in the UK. Responsibility for the oversight of the Code rests with the Financial Reporting Council (the "FRC").

On 28 May 2010, the FRC published an updated version of the Code, together with a report summarising the outcome of its recent consultation process and the main issues that were raised throughout the review period. A summary of the principal changes is set out below. The Code is to apply to companies with reporting periods beginning on or after 29 June 2010.

The UK Listing Rules require that all companies with a premium listing of equity shares in the UK "comply or explain" against the Code. In addition, as the Code is considered to be the "gold standard" for corporate governance principles, in practice, all UK-listed companies (including AIM-listed companies) are encouraged to comply with it as far as possible.

This briefing will be of interest to UK and overseas issuers with or contemplating a UK listing and to investors in UK-listed securities, amongst others.

Background

This is the third review of the Code since the FRC assumed responsibility for it in 2003. The review had been scheduled for 2010, but was brought forward in light of the significant changes in economic conditions since the previous review in 2007.

The FRC's review ran parallel with the corporate governance review by Sir David Walker in relation to the corporate governance framework in UK banks and other financial institutions, which had been commissioned by the Government as a result of the recent financial crisis. Whilst Sir David's report was only focused on the financial sector, it addressed how far his recommendations might apply to all listed companies and might therefore be adopted by the FRC as part of its review.

Summary of Significant Changes and Additions

The FRC concluded that the Code was generally fit for purpose. There was a clear consensus that the Code and its predecessors have contributed to clear improvements in governance since the first code was introduced in 1992. There was a strong consensus for retaining the current approach requiring listed companies to "comply or explain" against the Code, rather than moving to a prescriptive regime reliant on legislation and regulation.

The FRC decided to rename the Combined Code as the UK Corporate Governance Code to make the Code's status as the UK's recognised corporate governance standard clearer to non-UK investors, and to overseas companies with a primary listing of equity shares in the UK.

While the changes to the Code principally go to tone and emphasis, there are some limited but significant changes, including the following (each of which is briefly discussed below):

- all directors of a FTSE 350 company are now expected to put themselves up for re-election annually;
- the Chairman should hold regular development reviews with each director, and board evaluation reviews of FTSE 350 companies should be externally facilitated at least once every three years;
- there are new provisions relating to boardroom diversity, encouraging board appointments to be made on merit against objective criteria and with due regard for the benefits of diversity on the board, including gender;
- the business model of a listed company should be explained, and the board should be responsible for determining the nature and extent of the significant risks that it is willing to take;
- performance-related pay should be aligned to the long-term interests of the company and its risk policies and systems; and
- there are new principles on the leadership of the Chairman, the responsibility of the non-executive directors to provide constructive challenge, and the time commitment expected of all directors.

One of the fundamental tenets arising out of both the Walker review and the FRC review is an emphasis on better engagement between shareholders and boards of listed companies, which is considered critical to the effectiveness of a "comply or explain" approach to corporate governance. This has led to the FRC agreeing to take responsibility for a new "Stewardship Code", which is to cover the best practice of institutional investors in their stewardship of UK-listed companies. The FRC's consultation on the Stewardship Code closed in April and the outcome is expected later this month.

1. Annual re-election of directors

The Code now provides that all directors of FTSE 350 companies should be submitted for re-election annually. Whilst this only applies to larger listed companies, in the preface to the Code the FRC also encourages boards of smaller companies to consider their policy on director re-election in this light.

Whilst there was some concern that such a provision may lead to "short-termism" and could destabilise boards, on balance the FRC felt that enhancing the board's accountability in this way would be beneficial. The FRC concluded that it was desirable that shareholders, as the company's owners, have an annual opportunity to state their views on performance, thereby hopefully encouraging more robust engagement between boards and their shareholders.

2. Directors' development and evaluation

The new Code recommends that, in addition to an annual internal evaluation of the board, there should be an externally facilitated evaluation at least once every three years.

During the consultation process, there were concerns raised as to the cost of engaging external consultants to provide that advice and that the external market may not have a sufficient number of good quality board evaluation providers to meet demand. As such, the provision is currently only applicable to FTSE 350 companies.

3. Boardroom diversity

The FRC acknowledges that diversity in the boardroom can improve the quality of decision-making and reduce the risk of "group think", though recognises that the number of women on the boards of listed companies remains very low. The Code introduces a new supporting principle that aims to improve the quality of decision-making by encouraging the board to consider the benefits of diversity, including gender, when making new appointments to the board.

4. Accountability - disclosure of the business model and risk management

The FRC has proposed two additions in relation to the provisions dealing with accountability: a new requirement that companies should disclose their business model in the annual report and a new principle setting out the board's responsibilities in relation to risk.

In response to the consultation, the FRC noted that there has previously been a gap in the requirement for boards to report on business strategy. Therefore, companies are now required to explain in their annual report the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company. The FRC has recommended that the description appear in the same part of the annual report as the business review (as required under section 417, Companies Act 2006).

In relation to risk management, the FRC has said that, with hindsight, it believes that the absence of a provision allocating the management of risk from the previous code was a significant omission. As such, the Code now contains a provision 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. In managing risk, the board should maintain sound risk management and internal control systems.

5. Remuneration

The FRC has added a new supporting principle to the Code whereby performance-related elements of executive director's remuneration should be designed to promote the long-term success of the company. The Code has also been amended to make clear that any pay-outs under incentive schemes should be subject to non-financial performance criteria where appropriate and compatible with the company's risk policies and systems; it also makes clear that companies should give consideration to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct. The Code has been amended to clarify that remuneration of non-executive directors should not include any performance-related elements.

6. Leadership of the Chairman and time commitment

The Code has enshrined new principles relating to leadership of the Chairman and effectiveness of the board. It provides that the Chairman is responsible for leadership of the board and ensuring its effectiveness and that non-executive directors should constructively challenge and help develop proposals on strategy.

It also contains a new main principle that all directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively. Whilst the Walker report had suggested

an indicative time commitment of 30 to 36 days for a non-executive director on a major bank board, the conclusion arising out of the FRC review was that it would not be appropriate to introduce such indicative levels for the directors of non-financial companies, recognising that there may be circumstances where a candidate might not be able or required to commit that amount of time, but could still make a worthwhile contribution. That said, implicit in the new Code and the review process is a general sentiment that the Chairman and other non-executive directors will be required to devote more time to the discharge of their responsibilities going forward.

Next Steps

As noted above, the Code will apply to companies with reporting periods beginning on or after 29 June 2010. The changes to the Code form part of the wider attempt to encourage increased engagement by companies and their shareholders with a view to improving governance and performance. The Stewardship Code is expected to be published at the end of June 2010, and will further attempt to enhance relations between companies and institutional investors.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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