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The UK Corporate Governance Code

By Natalie Diep

The Financial Reporting Council ("FRC") published a new UK Corporate Governance Code on 28 May 2010 (the "FRC Code"). The FRC Code replaces the Combined Code on Corporate Governance (the "Combined Code") for financial years beginning on or after 29 June 2010.

WHICH COMPANIES ARE AFFECTED BY THE FRC CODE?

The FRC Code applies to all companies with a premium listing of equity shares. This includes companies incorporated in the UK and those incorporated overseas. As the FRC Code applies in relation to accounting periods beginning on or after 29 June 2010, most companies will have a period of time in which to take any necessary steps to deal with the changes to be introduced before they are required to report on their compliance with the FRC Code.

In recognition of the fact that certain aspects of the FRC Code may prove unduly burdensome or expensive for smaller companies, certain provisions of the FRC Code will not apply to them. For example, the new provisions that all directors should be put forward for annual re-election, and that the effectiveness of boards should be externally reviewed every three years, will only apply to companies within the FTSE 350.

"COMPLY OR EXPLAIN"

The "comply or explain" approach remains central to the FRC Code. As with the Combined Code, it allows companies some flexibility in the manner in which they apply the FRC Code. Under the Listing Rules, companies that do not comply with the relevant provisions of the FRC Code must explain to shareholders in the company's annual report why the company does not comply.

In addition, the need for shareholders to monitor the FRC Code and for better interaction between boards and shareholders is also emphasised. The FRC published its Stewardship Code on 2 July 2010, which is largely based on the Institutional Shareholders Committee's Code on the Responsibilities of Institutional Investors (the "ISC Code"). The Stewardship Code highlights good practice for institutional shareholders in respect of the companies in which they have a significant interest.
[See our client alert on the Stewardship Code. http://www.mofo.com/files/Uploads/Images/100721UKStewardship.pdf]

KEY CHANGES INTRODUCED IN THE FRC CODE

The FRC Code re-emphasises the role and the responsibilities of the board and the commitment expected from each member of the board.

The leadership role of the chairman and the support given by the CEO are emphasised, as well as the need for effective and constructive challenge in the boardroom. Other parts of the FRC Code emphasise the collective responsibility of the board for matters including the long-term success of the company and the individual responsibility attached to the roles of different directors (for example, the chairman's role in ensuring a culture of openness and debate, and the senior independent director's role in providing a sounding board to the chairman and acting as intermediary for the other non-executive directors).

Other key changes in the FRC Code include:

Annual re-election of directors: The FRC Code requires the directors of FTSE 350 companies to stand for re-election annually, rather than re-election once every three years. Smaller companies may voluntarily decide to comply with this provision, equally, larger companies may choose to "explain" their non-compliance rather than comply with this provision if they believe that they can ensure proper accountability and effectiveness of the board or that some form of transitional period is appropriate before complying with this provision.

Balance and composition of the board: The FRC Code includes a new main principle which provides that the board should have an appropriate balance of skills, experience, independence and knowledge of the company. In addition, a new supporting principle provides that due regard should be given to diversity, including gender diversity, when considering board appointments.

Board performance: The FRC Code requires the boards of FTSE 350 companies to be externally evaluated at least once every three years, this is in addition to the board's own internal evaluation of its performance and that of individual directors. The FRC Code does not include any guidance on the extent of this review, the relevant criteria or the format for presentation of any conclusions. Finally, the FRC encourages a chairperson to report personally in his or her annual statements how the principles relating to the role and effectiveness of the board have been applied.

Business model, risk and transparency: The FRC Code now includes as a main principle that the board has responsibility for determining both the nature and also the extent of any significant risks it is willing to take in order to achieve the company's objectives. The board is also responsible for ensuring sound risk management and internal control systems are in place and maintained.

The FRC Code also includes a requirement for the annual report to include an explanation of the company's long-term business model and strategy for delivering on its objectives.

Remuneration: A new supporting principle has been added to emphasise the need for performance-related pay to be aligned with the long-term interest of the company and the company's risk policies and systems. The FRC Code also clarifies that all forms of performance-related remuneration are discouraged for non-executive directors, not just share options.

CONCLUSION

The FRC Code is a guide to good corporate governance and does not constitute a rule book. Simply complying with the FRC Code will not itself ensure effective corporate governance, this will be driven by the nature, quality and effectiveness of the board as well as the board's ability to engage effectively with shareholders.

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