

December 2017

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# Proposed Revisions to the UK Corporate Governance Code

## Appendix A – Revised UK Corporate Governance Code

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## Introduction

The first version of the UK Corporate Governance Code (the Code) was published in 1992 by the Cadbury Committee. It defined corporate governance as ‘the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.’ This remains true today, but the environment in which companies, their shareholders and wider stakeholders operate continues to develop rapidly.

Companies do not exist in isolation. Successful and sustainable businesses underpin our economy and society by providing employment and creating prosperity. To succeed in the long-term, directors and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders. These relationships will be successful and enduring if they are based on respect, trust and mutual benefit. Accordingly, a company’s culture should promote integrity and openness, value diversity and be responsive to the views of shareholders and wider stakeholders.

Over the years the Code has been revised and expanded to take account of the increasing demands on the UK’s corporate governance framework. The principle of collective responsibility within a unitary board has been a success and – alongside the stewardship activities of investors – played a vital role in delivering high standards of governance and encouraging long-term investment. Nevertheless, the debate about the nature and extent of the framework has intensified as a result of financial crises and some high-profile examples of inadequate governance and misconduct, which have led to poor outcomes for a wide range of stakeholders.

At the heart of this Code is an updated set of Principles that emphasises the value of good corporate governance to long-term success in this wider context. By applying the Principles, following the more detailed Provisions and using the associated guidance, companies are able to demonstrate throughout their reporting how the governance of the company contributes to its long-term success and achieves wider objectives.

Achieving this depends crucially on the way boards, companies and investors apply the spirit of the Principles. The Code does not set out a rigid set of rules; instead it offers flexibility through ‘comply or explain’ Provisions and associated guidance. It is the responsibility of companies and their boards to use this flexibility wisely and for investors and their advisors to assess differing company approaches thoughtfully.

### Reporting on the Code

This revised Code focuses on the application of the Principles. The Listing Rules require companies to make a statement of how they have applied the Principles ‘in a manner that would enable shareholders to evaluate how the principles have been applied’. The ability of investors to evaluate the approach to governance is important. The statement should cover the application of the Principles in the context of the particular circumstances of the company and how the board has set the company’s purpose and strategy, met objectives and achieved outcomes through the decisions it has taken.

It is important to report meaningfully when discussing the application of the Principles and to avoid boiler-plate reporting. Instead, focus on how these have been applied, articulating what action has been taken and the resulting outcomes. Good practice examples of reporting will include signposting and cross-referencing to those parts of the annual report that describe how the Principles have been applied; this will help investors with their evaluation.

The effective application of the Principles should be supported by high-quality reporting on the Provisions. Companies should avoid a 'tick-box approach'. The Provisions establish good practice on a 'comply or explain' basis as required by the Listing Rules. An alternative to complying with a Provision may be justified in particular circumstances based on a range of factors, including the size, complexity, history and ownership structure of a company. Explanations should set out the background, provide a clear rationale for the action the company is taking, and explain the impact that the action has had. Where a departure from a Provision is intended to be limited in time, the explanation should indicate when the company expects to conform to the Provision. Explanations should be seen as a positive opportunity, not an onerous obligation.

In line with their responsibilities under the UK Stewardship Code, shareholders should engage constructively and discuss with the company any departures from recommended practice. In their consideration of explanations, shareholders and their advisors should pay due regard to companies' individual circumstances. While they have every right to challenge explanations if they are unconvincing, they must not be evaluated in a mechanistic way. Shareholders and their advisors should also give companies sufficient time to respond to enquiries about corporate governance reporting.

The Corporate Governance statement should also relate coherently to other parts of the annual report – particularly the strategic report and other complementary information – so that shareholders can effectively assess the quality of the company's governance arrangements, and the board's activities and contributions. This should include providing information that would enable shareholders to assess how the directors have performed their duty under section 172 of the Companies Act 2006 to promote the success of the company.

The Code is also supported by *Guidance on Board Effectiveness*, which assists boards when applying the Principles. It does not set out the 'right way' to apply the Code. It is intended to stimulate thinking on how boards can carry out their role most effectively. When reporting on the application of the Code's Principles the board should consider how the guidance supports their actions and the decisions they have taken in response to the questions posed by it. The board should also take into account additional guidance, such as the *Guidance on Audit Committees* and the *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*.

## Application

The Code is applicable to all companies with a premium listing of equity shares, whether they are incorporated in the UK or elsewhere, and applies to accounting periods beginning on or after 1 January 2019.

Other listed or unlisted companies may wish to adopt it in whole or in part. Externally managed investment companies (which typically have a different board structure) may wish to use the Association of Investment Companies Corporate Governance Code and Guide to meet their obligations under the Code. In addition, the Association of Financial Mutuals produces an annotated version of the Code for mutual insurers to use.

## Section 1 – Leadership and purpose

### Principles

- A. A successful company is led by an effective and entrepreneurial board, whose function is to promote the long-term sustainable success of the company, generate value for shareholders and contribute to wider society. The board should establish the company’s purpose, strategy and values, and satisfy itself that these and its culture are aligned.**
- B. The board should ensure that the necessary resources are in place for the company to meet its objectives and measure performance against them. The board should also establish a framework of prudent and effective controls, which enable risk to be assessed and managed.**
- C. In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties.**
- D. All directors must act with integrity and lead by example in the best interests of the company. The workforce should be able to raise concerns in relation to management and colleagues where they consider that conduct is not consistent with the company’s values and responsibilities.**

### Provisions

- 1. The board should assess the basis on which the company generates and preserves value over the long-term. It should describe in the annual report how opportunities and risks to the future success of the business have been considered and addressed, the sustainability of the company’s business model and how its governance contributes to the delivery of its strategy.
- 2. Directors should embody and promote the desired culture of the company. The board should monitor and assess the culture to satisfy itself that behaviour throughout the business is aligned with the company’s values. Where it finds misalignment it should take corrective action. The annual report should explain the board’s activities and any action taken.
- 3. The board should establish a method for gathering the views of the workforce. This would normally be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. There should also be a means for the workforce to raise concerns in confidence and (if they wish) anonymously. The board should review this and ensure that arrangements are in place for the proportionate and independent investigation of such matters and for follow-up action.

4. The board should explain in the annual report how it has engaged with the workforce and other stakeholders, and how their interests and the matters set out in section 172 of the Companies Act 2006 influenced the board's decision-making.<sup>1</sup>
5. In addition to formal general meetings, the chair should seek regular engagement with major shareholders in order to understand their views on governance and performance against the strategy. Committee chairs should engage with shareholders on significant matters related to their areas of responsibility. The chair should ensure that the board has a clear understanding of the views of shareholders.
6. When more than 20 per cent of votes have been cast against a resolution, the company should explain, when announcing voting results, what actions it intends to take to consult shareholders in order to understand the reasons behind the result. An update should be published no later than six months after the vote. The board should then provide a final summary in the annual report, or in the explanatory notes to resolutions at the next meeting, on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed.<sup>2</sup>
7. The board should take action to identify and eliminate conflicts of interest, including those resulting from significant shareholdings, and ensure that the influence of third parties does not compromise or override independent judgement.
8. Where directors have concerns about the operation of the board or the management of the company that cannot be resolved, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chair, for circulation to the board, if they have any such concerns.

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<sup>1</sup> [Reference to section 172 stakeholders to be added]

<sup>2</sup> [Cross-reference to the IA's new public register to be added]

## Section 2 – Division of responsibilities

### Principles

- E. The chair leads the board and is responsible for its overall effectiveness in directing the company. The chair should demonstrate independent and objective judgement, and promote a culture of openness and debate by facilitating constructive relations between directors; in particular, the chair should ensure the effective contribution of all non-executive directors.**
- F. The board should include an appropriate combination of executive and non-executive (and, in particular, independent non-executive) directors, such that no one individual or small group of individuals dominates the board's decision-making. There should be a clear division of responsibilities between the leadership of the board and the executive leadership of the company's business.**
- G. Non-executive directors should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account.**
- H. The board, supported by the company secretary, should ensure that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.**

### Provisions

- 9. The roles of chair and chief executive should not be exercised by the same individual. The responsibilities of the chair, chief executive, senior independent director, board, committees and management should be clear, set out in writing, agreed by the board and made publicly available. The annual report should set out the number of meetings of the board and its committees, and the individual attendance by directors.
- 10. The chief executive is responsible for proposing strategy to the board, delivering it as agreed, and ensuring timely and balanced information is presented in order for the board to make decisions effectively.
- 11. Independent non-executive directors, including the chair, should constitute the majority of the board. With reference to Provision 15, the board should identify in the annual report each director considered to be independent. The chair should hold meetings with the non-executive directors without the executives present.
- 12. The board should appoint one of the independent non-executive directors to be the senior independent director to provide a sounding board for the chair and serve as an intermediary for the other directors and shareholders. Led by the senior independent director, the non-executive directors should meet without the chair present at least annually to appraise the chair's performance, and on other occasions as necessary.

13. Non-executive directors are responsible for appointing and, where necessary, removing executive directors. Non-executive directors should scrutinise and hold to account the performance of management and individual directors against agreed performance objectives.
14. All directors should ensure that they have sufficient time to meet their board responsibilities. External appointments should not be undertaken without prior approval of the board, with the reasons explained in the annual report. Full-time executive directors should not take on more than one non-executive directorship in a FTSE 100 company or equivalent.
15. Individual non-executive directors, including the chair, should not be considered independent for the purposes of board and committee composition if any one of them:
  - is or has been an employee of the company or group within the last five years;
  - has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
  - has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
  - has close family ties with any of the company's advisers, directors or senior employees;
  - holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
  - represents a significant shareholder; or
  - has served on the board for more than nine years from the date of their first election.
16. All directors should have access to the advice of the company secretary, who is responsible for advising the board on all governance matters. Both the appointment and removal of the company secretary should be a matter for the board as a whole.



## Section 3 – Composition, succession and evaluation

### Principles

- I. **The board and its committees should have a balance of skills, experience, independence and knowledge. Board membership should be regularly refreshed.**
- J. **Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be in place for board and senior management.<sup>3</sup> Both appointments and succession plans should be based on merit and objective criteria,<sup>4</sup> and promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.**
- K. **Regular evaluation of the board should consider the balance of skills, experience, independence and knowledge, its diversity and how effectively members work together to achieve objectives. Individual evaluation should demonstrate whether each director continues to contribute effectively.**

### Provisions

- 17. The board should establish a nomination committee that should lead the process for appointments, ensure plans are in place for orderly succession to both the board and senior management positions, and oversee the development of a diverse pipeline for succession. A majority of members of the committee should be independent non-executive directors, with a minimum membership of three. The chair of the board should not chair the committee when it is dealing with the appointment of their successor.
- 18. All directors should be subject to annual re-election. The board should set out in the papers accompanying the resolutions to elect each director, specific reasons why their contribution is and continues to be important for the company's long-term success.
- 19. A chief executive should not go on to be chair of the same company. If, exceptionally, this is proposed by the board, major shareholders should be consulted ahead of appointment. The board should set out its reasons to all shareholders at the time of the appointment and also publish these on the company website.
- 20. Open advertising or an external search consultancy should generally be used for the appointment of the chair and non-executive directors. If an external search consultancy is engaged it should be identified in the annual report alongside a statement as to whether it has any other connection with the company or individual directors.

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<sup>3</sup> The definition of 'senior management' for this purpose should be the executive committee or the first layer of management below board level, including the company secretary.

<sup>4</sup> Which protect against discrimination for those with protected characteristics within the meaning of the Equalities Act 2010.

21. There should be a formal and rigorous annual evaluation on the performance of the board, the chair and individual directors. Companies should have an externally facilitated board evaluation at least every three years. The external facilitator should be identified in the annual report and a statement made as to whether they have any other connection with the company or individual directors.
22. The chair should act on the results of the evaluation by recognising the strengths and addressing any weaknesses of the board. Each director should engage with the process and take appropriate action when development needs have been identified.
23. The annual report should describe the work of the nomination committee and should include:
  - a description of how the board evaluation has been conducted, detailing the outcomes, actions taken and how it has influenced board composition;
  - the process used in relation to appointments, its approach to succession planning and how both support building a diverse pipeline with reference to Principle J;
  - what other actions it has taken to oversee the development of a diverse pipeline for future succession to board and senior management appointments;
  - an explanation of how diversity supports the company in meeting its strategic objectives; and
  - the gender balance of those in the senior management<sup>5</sup> and their direct reports.

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<sup>5</sup> See footnote 3 for a definition of senior management.

## Section 4 – Audit, risk and internal control

### Principles

- L. The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions.**
- M. The board should present a fair, balanced and understandable assessment of the company's position and prospects, and satisfy itself on the integrity of financial information.<sup>6</sup>**
- N. The board should establish the risk and internal control framework and determine the nature and extent of the principal risks it is willing to take in order to achieve its strategic objectives. The board should satisfy itself that the company's internal controls are robust, and allow for prudent and effective risk assessment and management.**

### Provisions

- 24. The board should establish an audit committee of independent non-executive directors, with a minimum membership of three. The chair of the board should not be a member. The board should satisfy itself that at least one member has recent and relevant financial experience. The committee as a whole shall have competence relevant to the sector in which the company operates.
- 25. The main roles and responsibilities of the audit committee should include:
  - monitoring the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgements contained in them;
  - reviewing the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, reviewing the company's internal control and risk management systems;
  - monitoring and reviewing the effectiveness of the company's internal audit function, or where there is not one, considering annually whether there is a need for one and making a recommendation to the board;

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<sup>6</sup> The board's responsibility to present a fair, balanced and understandable assessment extends to interim and other price-sensitive public records and reports to regulators, as well as to information required to be presented by statutory instruments.

- making recommendations to the board, in relation to the appointment, reappointment and removal of the external auditor,<sup>7</sup> and approving the remuneration and terms of engagement of the external auditor;
  - reviewing and monitoring the external auditor's independence and objectivity, and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
  - developing and implementing policy on the engagement of the external auditor to supply non-audit services, taking into account the regulations and ethical guidance in this regard, and reporting to the board on any improvement or action required; and
  - reporting to the board on how it has discharged its responsibilities.
26. The annual report should describe the work of the audit committee and should include:
- the significant issues that the audit committee considered in relation to the financial statements, and how these issues were addressed;
  - an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of any retendering plans;
  - in the case of a board not accepting the audit committee's recommendation on the external auditor appointment, reappointment or removal, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different position (this should also be supplied in any papers recommending appointment or reappointment);
  - an explanation for the absence of an internal audit function if there is none; and
  - an explanation of how auditor objectivity and independence are safeguarded, if the external auditor provides non-audit services.
27. The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's position, performance, business model and strategy.
28. The board should monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report. The monitoring and review should cover all material controls, including financial, operational and compliance controls.

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<sup>7</sup> This overlaps with Part 3 of The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 and the requirements of Chapter 2 of Part 16 of the Companies Act 2006, as inserted by the Statutory Auditors and Third Country Auditors Regulations 2016 on the appointment of auditors to public companies that are Public Interest Entities.

29. The board should carry out a robust assessment of the principal risks (financial and non-financial) facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The board should confirm in the annual report that it has completed this assessment, describe its principal risks and explain how they are being managed or mitigated.
30. In annual and half-yearly financial statements, the board should state whether it considers it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.
31. Taking account of the company's current position and principal risks, the board should explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board should state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

## Section 5 – Remuneration

### Principles

- O. The board should satisfy itself that company remuneration and workforce policies and practices promote its long-term success and are aligned with its strategy and values.**
- P. A formal and transparent procedure for determining director and senior management<sup>8</sup> remuneration should be established. Performance-related elements should be clear, stretching, rigorously applied and aligned to the successful delivery of the strategy.**
- Q. The board should exercise independent judgement and discretion when approving remuneration outcomes, taking account of company and individual performance, and wider circumstances. No director should be involved in deciding his or her own remuneration outcome.**

### Provisions

- 32. The board should establish a remuneration committee of independent non-executive directors with a minimum membership of three. The chair of the board should not chair the committee and can only be a member if independent. Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months.
- 33. The remuneration committee should have delegated responsibility for determining the policy for director remuneration and setting remuneration for the board and senior management.<sup>9</sup> It should oversee remuneration and workforce policies and practices, taking these into account when setting the policy for director remuneration.
- 34. Levels of remuneration for the chair and all non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for all non-executive directors should not include share options or other performance-related elements.
- 35. Where remuneration consultants are appointed, this should be the responsibility of the remuneration committee. The consultants should be identified in the annual report alongside a statement as to whether they have any other connection with the company or individual directors. Independent judgement should be exercised when evaluating the advice of external third parties and receiving views internally.
- 36. Remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. In normal circumstances, shares granted or other forms of long-term incentives should be subject to a vesting and holding period of at least five years. Longer periods, including post-employment periods, may be appropriate.

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<sup>8</sup> See footnote 3 for a definition of senior management.

<sup>9</sup> Ibid.

37. Remuneration schemes and policies should provide boards with discretion to override formulaic outcomes. They should also include provisions that would enable the company to recover and/or withhold sums or share awards, and specify the circumstances in which it would be appropriate to do so.
38. Only basic salary should be pensionable. The pension consequences and associated costs of basic salary increases and any other changes in pensionable remuneration, or contribution rates, particularly for directors close to retirement, should be carefully considered and be aligned to the pension arrangements for the workforce as a whole.
39. Notice or contract periods should be one year or less. If it is necessary to offer longer periods to new directors recruited from outside the company, such periods should reduce to one year or less after the initial period.
40. Executive remuneration should support long-term company performance and value generation. When determining executive director remuneration policy and practices, the remuneration committee should address the following:
  - clarity – remuneration arrangements should be transparent and facilitate effective engagement;
  - simplicity – remuneration structures should avoid complexity; their rationale and operation should be easy to understand;
  - predictability – the range of possible values of rewards to individual directors should be identified and explained at the time of approving the policy;
  - proportionality and reward for individual performance – there should be a demonstrable link between individual awards and the long-term performance of the company. Outcomes should not reward poor performance and total rewards available should not be excessive; and
  - alignment to culture – incentives should drive behaviours consistent with company purpose, strategy and values.
41. There should be a description of the work of the remuneration committee in the annual report which should include:
  - an explanation of the strategic rationale for executive directors' remuneration policies, structures and performance metrics;
  - reasons why the remuneration is appropriate using internal and external measures;
  - whether the remuneration policy operated as intended in terms of company performance and quantum, and, if not, what changes are necessary;
  - what engagement has taken place with shareholders and the impact this has had on remuneration policy and outcomes;
  - an explanation of the company's approach to investing in, developing and rewarding the workforce, and what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company policy; and
  - to what extent remuneration outcomes have been affected by board discretion.



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