Financial Reporting Council

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Corporate Governance: Fit for the future?

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Saddlers' Hall, 40 Gutter Lane, EC2V 6BR

Good afternoon and thank you for joining us today.

I am very pleased to welcome you to this event to mark the publication of the new UK Corporate Governance Code, which we launched on Monday. With over 270 responses to the consultation, support from Government and many long hours put in by colleagues at the FRC, the new Code is very much the result of a significant collaboration and should set UK business on the path to meeting investor and public expectations and facing up to the challenges ahead. Establishing higher standards of corporate governance will not only promote transparency and integrity in business but attract investment into UK companies for the long term, benefitting the economy and wider society.

The new Code emphasises the importance of four key areas of governance:

- building a positive relationship between companies, their shareholders and stakeholders, particularly its workforce;
- aligning the company's purpose and strategy with a healthy corporate culture;
- ensuring board membership is of a high quality and focussed on diversity, and
- remuneration that is proportionate and supports long-term success.

I will say more about these in a moment.

The Code began life in 1992 as a response to corporate scandals at the time involving BCCI, Polly Peck and Maxwell. Over the years UK corporate governance, underpinned by the Code, has become highly respected internationally. But times change and after 25 years we decided it was time for a comprehensive review of the UK Corporate Governance Code. This was

stimulated in part by concerns about trust in business, and in particular, whether business took sufficient account of employees, customers and suppliers as well as shareholders' interests.

STAKEHOLDERS

The new Code encourages the boards of companies to focus on their wider impact over the longer term.

In the UK, there has been widespread debate on the requirements of section 172 of the Companies Act 2006 and the duty it places on directors to promote the success of a company for shareholders, with due regard for other shareholders. The new Code promotes and builds on this responsibility.

In addition, the Government has introduced secondary legislation to require all companies of a significant size (private as well as public) to explain their actions in relation to section 172.

A key aspect of wider engagement is with the workforce. The new Code puts forward three ways for boards to do this. A director appointed from the workforce, a formal workforce advisory panel and a designated non-executive director, but it also is open to other arrangements which meet the circumstances of the company and the workforce.

PURPOSE, STRATEGY AND CULTURE

Corporate Culture is a new addition to the Code. Its inclusion follows the 2016 report produced by the Culture Coalition, which was led by the FRC and in which we called on boards to "assess how effective they are at establishing company culture and practices, and at embedding good corporate behaviour."

Establishing a company specific corporate culture involves asking questions and making choices about:

- how to align values and purpose to the company's strategy;
- how to integrate new leaders into that culture, particularly at times of a merger or acquisition;
- how to maintain a healthy governance under pressure;
- how to decide whether separate parts of the business should operate different cultures; and
- how actively to communicate values, purpose and behaviours in order for shareholders to engage in constructive discussion.

The role of the board is to establish not only the right culture and behaviours but also the right incentives and disincentives. In doing so, the board must be credible in the eyes of employees and stakeholders. The new Code therefore states that boards are responsible for workforce policies and practices which reinforce a healthy culture. Employees are expected to display the right behaviours, and the board should set the standards, observe those behaviours and critique them if necessary.

Careful thought must also be given to how culture is measured and reported. While corporate culture is often seen as complex and intangible, it can be measured through looking at outcomes, and much information should be available to a board to enable it to do so. What you choose to measure and how you analyse and interpret is important. Culture is company specific and there is no one-size-fits-all. The indicators selected for assessment should therefore, be tailored to each company's circumstances.

BOARD COMPOSITION, DIVERSITY, SUCCESSION

The ongoing success of the company and its culture are also rooted in diversity and succession planning. Boards should therefore take time to consider and understand how diversity and effective succession plans will achieve the strategy and promote success and value. In the new Code, succession planning and the promotion of diversity are key elements in the Code. Boards and investors should consider how these matters benefit the company.

The new Code emphasises the importance of independence and constructive challenge in the boardroom, strengthens considerations of 'overboarding' where members may be unable to devote sufficient time to their responsibilities and focusses on diversity, board refreshment and lengths of service of directors.

To fulfil these expectations a board should:

- determine the balance of skills, background and experience required by the senior executives and non-executive directors.
- champion the benefits of a diverse workforce including senior management. More progress is needed on diversity in the pipeline to senior positions.
- establish succession plans that recognise the value of recruiting talent from a wide pool. A diverse board avoids the dangers of group think and encourages wide ranging ideas and views.

REMUNERATION

Public confidence in business has been damaged by examples of excessive executive pay, which has sometimes been perceived as incentivising poor or short-term business decisions, supporting policies which do not distribute profits wisely or simply rewarding failure.

The new Code deals with these issues by calling on companies and remuneration committees to:

- set more demanding criteria for remuneration policies and practices;
- report more clearly on remuneration and how it delivers company strategy, long-term success and its alignment with workforce remuneration;
- give remuneration committees broader responsibility for understanding how remuneration policies align with strategic objectives and support long-term success, and to use their discretion wherever appropriate;
- extend recommended minimum vesting and post-vesting holding periods for executive share awards from 3 years to 5 years; and
- require the chair of the remuneration committee to have served on such a committee for at least 12 months.

STEWARDSHIP

While the Code puts more emphasis on wider stakeholders, effective reporting to and engagement with shareholders is, of course, of the greatest importance. We are therefore reviewing investor stewardship and the UK Stewardship Code. And the UK Corporate Governance Code asks boards to take effective action when there are significant shareholder votes against resolutions and to report back on those actions more promptly.

We have a strong framework in the UK but it depends on companies and shareholders playing their part fully. A 'comply or explain' system will be most effective if the explanations are detailed, meaningful, truthful; and substantive. If shareholders do not engage or do not fully understand the purpose, culture and business plan of the company, then the role of the Code will be diminished. Governance is therefore underpinned by directors ensuring that their annual report as a whole is a true reflection of the company and is fair and balanced.

Despite the challenges the UK remains in a good position globally, and our professions have significant strengths. But, we must not stand still. We need to work together so that business in the UK regains respect, integrity and trust by delivering fair outcomes in the long term for all investors and wider society as a whole.

Codes put forward principles that make bad behaviour less likely to occur; and public reporting makes it harder to conceal. The new Code is a strong blueprint for strong governance.

But, by itself, a code does not prevent inappropriate behaviour, strategies or decisions. Only people, particularly the leaders within a business, can do that. We look to boards, investors and other stakeholders to embrace the new Code and make great governance and truly great companies a reality in Britain.