

## Hogan Lovells

### UK Corporate Governance Code published

### Hogan Lovells Corporate Governance Unit views: Corporate Governance in the UK strengthened

The FRC could not have foreseen the strength of feeling and engagement which has emerged over what started as a regular review of the Combined Code. However, they have managed an extended and quite heated review process to produce the new UK Corporate Governance Code which apply to reporting periods starting on or after 29 June 2010.

#### Directors' re-election

The issue that has been the most hotly fought over in the last few weeks has been board re-election. Sir David Walker came down clearly in favour of annual re-election for all directors (at the Tomorrow's 'Good Governance Forum' lecture: Stewardship in practice, in which we participated), but the GC 100 and The Hundred Group of Finance Directors were opposed. Sir David is the winner here, but with a sop for smaller companies (the requirement relates only to the FTSE 350) and a reminder that the regime is 'comply or explain' (so an explanation of non-compliance may be appropriate). The concern remains that this proposal will lead to short-termism, which is ironic when in general the Code is being amended to emphasise long-term success as a goal. The FRC emphasise that, in the nine year period which they reviewed, only 19 directors on the FTSE All Share lost a re-appointment vote.

#### Board Balance

The change in emphasis from 50% independence to 'the appropriate balance of skills, experience, independence and knowledge' has been made. Serving on a board for more than nine years will still raise a presumption of non-independence, but perhaps the ability to rebut that in the annual report and the overall change in emphasis away from the overriding importance of independence leaves a more satisfactory position.

#### Boardroom diversity

Interestingly the FRC are classifying their increased emphasis on boardroom diversity as a main issue, over that of boardroom balance. The Code makes specific reference to the benefits of diversity, including gender. Clever women everywhere should be polishing their CVs....

#### External facilitation of board reviews

FTSE 350 companies will now need to have externally facilitated board reviews every three years. There has been much scepticism over this proposal and not least because an industry will need to be created around it and that industry is not currently established. Sir David is evangelical about the input he received from behavioural psychologists in particular, so potentially this requirement could, in the long term, assist in policing corporate culture.

#### Reporting on business model

Companies will now be required to explain in their annual report 'the basis on which the company generates or preserves value over the longer term (the business model)'. We queried this extension to financial reporting requirements via the Code. However, the FRC have stated that companies that are properly applying the ASB's voluntary Reporting Statement on the Operating and Financial Review will already be providing the required information. As the Coalition Government have stated in their Programme for Government that they intend to "reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting, and investigate further ways of improving corporate accountability and transparency" it appears that the FRC are only slightly in advance of a legislative change in this area.

#### Stewardship

The FRC are expecting to publish the Stewardship Code by the end of June, setting out a framework for good shareholder engagement.

#### Remuneration

As expected, a reference to requiring companies to 'give consideration to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct' has been inserted in Schedule A. This reflects the 'clawback' debate surrounding those thought to have been excessive risk-takers. Clawback can of course take different forms. This is not a requirement to obtain repayment of remuneration which has been received. It will be appropriate to consider deferring delivery of cash or share incentives with the ability of the company to reduce or take away the award where appropriate.

Schedule A now also states that remuneration incentives should be compatible with risk policies and systems. In our view, this codifies existing good practice, but remuneration committees which do not currently sit down and consider whether incentives may drive bad as well as good behaviour should now certainly do so, preferably with their audit/risk committee.

The Supporting Principle to D.1 is amended to require the performance-related elements of executive directors' remuneration to promote the long-term success of the company. This is appropriate in terms of driving good behaviour when setting performance targets and structuring cash and share incentives generally. To an extent this was already implicit in setting a responsible remuneration policy and many companies approached remuneration in this way.

The restriction on NEDs being rewarded by way of share options has been widened to include 'other performance-related elements' of remuneration. Again, this codifies existing good practice.

#### **Website disclosure**

The FRC has not made changes to strip out elements of corporate governance reporting from annual reports and all website disclosure as was discussed. It seems right that those changes would be part of a wider review of reporting.

#### **Conclusion**

The new Code strengthens the hands of shareholders who want to engage. They will be served by more finely balanced, appropriately experienced and better trained boards; they will have more information about the company's business model and appetite for risk; and they will have a better ability to remove directors who they feel are underperforming. What we wait to see is how the Stewardship Code - promised for end of June - will define the engagement of shareholders.

**28 May 2010**