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Changes to UK Corporate Governance Code

FRC Publishes UK Corporate Governance Code 2024 and Consolidates Existing Guidance

SUMMARY

On January 22, 2024, the Financial Reporting Council ("FRC") published the 2024 edition of the UK Corporate Governance Code (the "Code"). This was followed on January 29 by publication of new, non-mandatory Corporate Governance Code Guidance, which consolidates and updates the FRC's existing guidance on applying the Code.

The Code currently applies to all companies, whether incorporated in the UK or elsewhere, with a premium listing on the London Stock Exchange. When the Financial Conduct Authority's proposed reforms of the UK listing regime for equity shares come into effect later this year, the Code will apply to all companies listed in the single "commercial companies" listing category that will be introduced to remove the distinction between a premium and a standard listing. (Our recent memorandum on the proposed reforms to the UK listing regime is available here.)

Rather than being a rigid set of rules, the Code operates on a "comply or explain" basis (which means that, if they have not complied with any provisions of the Code, companies must disclose their non-compliance in their annual reports and explain the reason(s) for such non-compliance). It is divided into sections covering the following five areas: board leadership and company purpose; division of responsibilities; composition, succession and evaluation; audit, risk and internal control; and remuneration, and sets out within those sections 18 general governance principles (Principles A to R) that companies should apply and a further 41 detailed provisions (Provisions 1 to 41) against which companies must "comply or explain".

The 2024 revision of the Code introduces a relatively limited number of changes compared to the previous 2018 edition. The most significant of these changes introduce new disclosure requirements for the annual

report on the effectiveness of a company's internal controls (backed by a board declaration of effectiveness) and on malus and clawback provisions in directors' remuneration.

The FRC has also published a key changes document and a "mythbuster".

The 2024 edition of the Code will apply to financial years beginning on or after January 1, 2025. As an exception, the new reporting obligations on the effectiveness of internal controls will apply to financial years beginning on or after January 1, 2026.

BACKGROUND

Proposals to amend the Code have been discussed for some time. Following several, high-profile corporate failures in the late 2010s, the UK Government published in March 2021 the first in a series of consultations on strengthening the UK's audit and corporate governance frameworks. Its final proposals, published in May 2022, included new reporting requirements for the UK's largest listed and unlisted companies, and the replacement of the FRC with a new regulator with enhanced powers. The Government also invited the FRC to strengthen the Code in a number of areas, and in May 2023 the FRC consulted on revisions to the Code.

In October 2023, following further consultation with businesses, the Government withdrew the proposed legislation that would have introduced the new reporting requirements for the UK's largest listed and unlisted companies and gave no definite timeframe for delivering wider audit and corporate governance reform. In that context, in November 2023, the FRC confirmed that it would take forward only a small number of the revisions to the Code it had consulted on in May 2023 and that it would stop development of the remainder. As a result, the changes made by the 2024 edition of the Code are more limited than originally anticipated.

KEY POINTS FROM THE 2024 CHANGES TO THE CODE

The key points arising from the 2024 edition of the Code are summarised below.

A. RISK MANAGEMENT AND INTERNAL CONTROLS

Several of the most recent amendments seek to strengthen board accountability for a company's management of risk and its internal controls.

The Code previously stated in Principle O that the board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

This principle has been revised to underline the board's responsibility not only for establishing, but also for maintaining, an effective risk management and internal control framework.

Provision 29 of the Code previously provided that the board should monitor the company's risk management and internal controls, carry out at least annually a review of their effectiveness, and report on that review in the annual report. It also provided that the board's monitoring and review should cover all material controls, including financial, operational and compliance controls.

In order to set clearer reporting expectations, Provision 29 has now been amended to make clear that the board's monitoring and review should also cover reporting controls, and to introduce specific disclosure requirements for the annual report in relation to the board's review of the material controls, backed by a board declaration of effectiveness. For financial years beginning January 1, 2026, companies should now provide the following in their annual reports:

- a description of how the board has monitored and reviewed the effectiveness of the company's risk management and internal control framework;
- a declaration from the board of the effectiveness of the company's material controls as at the balance sheet date; and
- a description of any material controls which have not operated effectively as at the balance sheet date, the action taken, or proposed, to improve them and any action taken to address previously reported issues.

The FRC has provided guidance on how boards should prepare the new declaration of effectiveness. In determining which controls are 'material', the guidance encourages the board to consider how a deficiency in the control could impact the interests of the company and its shareholders and other stakeholders. Material controls will be company-specific, and will depend on the company's features and circumstances. The board's view on the effectiveness of the material controls should be based on the evidence it obtains, exercising the standard of care generally applicable to directors in the exercise of their duties (which under UK company law, includes a duty to exercise independent judgment and reasonable care, skill and diligence). Where a control system is less established, or its effectiveness has not yet been proven, the board may wish to adopt a "comply or explain" approach to describe this.

As noted above, the amendments to Provision 29 will not apply until January 1, 2026. This is one year later than the rest of the amendments contained in the 2024 edition of the Code, to allow boards more time to develop their approaches to the new reporting requirements.

B. MALUS AND CLAWBACK IN DIRECTORS' REMUNERATION

The 2024 edition of the Code aims to improve transparency around companies' malus and clawback arrangements applicable to directors' remuneration. These sorts of arrangements enable pay and share awards to be withheld or recovered from directors in certain circumstances.

The previous edition of the Code did not set out specific expectations in relation to the disclosure of malus and clawback arrangements. Although the FRC notes that many companies already make disclosures, particularly in relation to the minimum circumstances and period in which malus and clawback may apply, it is concerned with improving the consistency of reporting—and a new Provision 38 has been introduced which provides that companies should describe their malus and clawback provisions in their annual remuneration report, including:

- the circumstances in which the malus and clawback provisions could be used;
- a description of the period for malus and clawback and why the selected period is best suited to the organisation; and
- whether the provisions were used in the last reporting period and, if so, a clear explanation of the reason.

In a Technical Q&A published on the FRC's website, the FRC explains that new Provision 38 should focus on executive directors rather than all persons subject to the company's malus and clawback provisions.

Provision 37 in the previous edition of the Code stated that remuneration schemes and policies should include provisions enabling directors' remuneration to be withheld or recovered. In the 2024 edition of the Code, it has been rephrased to expressly state that malus and clawback provisions should be included in directors' contracts (and/or other agreements or documents which cover directors' remuneration). This change may encourage companies to consider how established schemes and policies interact with directors' underlying service contracts.

The FRC's updated, consolidated guidance on applying the Code leaves the indicative list of circumstances in which malus and clawback might apply unchanged. It continues to include payments based on erroneous or misleading data, misconduct, misstatement of accounts, serious reputational damage and corporate failure.

C. EMPHASIS ON FLEXIBILITY AND IMPROVING THE QUALITY OF REPORTING

The UK listing rules require companies subject to the Code to make a statement of how they have applied the Principles in a manner that enables shareholders to assess how those Principles have been applied, and to set out their reasons for any non-compliance with the Code's Provisions.

The introduction to the 2024 edition of the Code places an increased emphasis on how the UK listing rules provide a flexible framework for corporate governance. It explains that there is no single way for companies to apply the Principles or comply with the Provisions, and that companies may depart from the Code for a number of reasons, including their stage of maturity. The FRC's mythbuster further highlights that there is no one size fits all approach for governance reporting, and that there are instances when strict adherence with the Code's Provisions might not be the right approach for the Company.

Accordingly, the 2024 edition of the Code introduces a new Principle C which sets out a new expectation that companies should, when reporting on governance, focus on board decisions and their outcomes in the context of the company's strategy and objectives. The FRC expects that this will help companies to streamline and focus reporting on the Code, avoiding unduly long explanations of policy.

Recent FRC reviews of UK corporate reporting have identified shortcomings in disclosure where companies explain non-compliance with the Provisions of the Code. To address this, new Principle C also requires boards to provide a clear explanation when reporting on departures from the Code's Provisions.

To reduce boilerplate reporting, the FRC's updated, consolidated guidance on applying the Code provides that focus should be placed on the quality of disclosures, rather than quantity. It also notes that some companies may choose to move more routine or process-based disclosures onto their corporate websites, with appropriate signposting in their annual reports.

D. CULTURE, DIVERSITY AND INCLUSION

Principle J of the previous edition of the Code provided that board appointments and succession plans should promote diversity, as defined by a list of diversity characteristics. To indicate that diversity policies can be wide-ranging, that list has been removed in the 2024 edition of the Code. In addition, board appointments and succession plans should now also promote inclusion and opportunity.

The 2024 edition of the Code provides that the board's assessment and monitoring of culture, which is encouraged by Provision 2, should be extended to encompass how the desired culture has been embedded.

Provision 23 has been revised such that the annual report's description of the work of the nomination committee should also include disclosures relating to the company's diversity and inclusion initiatives (as well as its diversity and inclusion policy).

The FRC's updated, consolidated guidance on applying the Code encourages companies to reference in their disclosures their relationships with independent initiatives, accreditations and charter schemes, such as the FTSE Women Leaders Review or the Parker Review on ethnic diversity.

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