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YOUR 2019 AGM UPDATE AND BEYOND

Helpfully, no major changes are required to the form and content of notice of AGM for the 2019 AGM season.

However, with the publication of the updated UK Corporate Governance Code, which applies to financial years starting on or after 1 January 2019, there is much for boards and their company secretariat teams to be addressing now to ensure that companies are ready to report on their compliance – or explain their non-compliance – with the updated Code during the course of the 2019 financial year when they come to prepare their 2019 annual reports.

Although there are no substantive changes required to the content of the annual report for the 2018 financial year, companies will inevitably be focused on their Brexit planning and impact disclosures. In 2018, approximately two thirds of companies referenced Brexit in their principal risks. In addition, the Investment Association is calling on all companies to report their CEO pay ratio in 2019, despite it not being mandatory to do so until 2020. 2018 saw over 30 FTSE 350 companies voluntarily report their CEO pay ratio and there is likely to be investor pressure to do so in 2019.

Separately, companies may wish to highlight changes that they are making in relation to matters such as workforce and wider stakeholder engagement in readiness for reporting against the updated Code in their 2019 annual report. We are already seeing a number of companies describing in their 2018 annual reports work that they are proposing to undertake in these areas.

In this Update, rather than focus simply on the changes introduced by the updated UK Corporate Governance Code (the **2018 Code**) and the new

Key issues

- No substantive changes are required to the form and content of the 2019 AGM notice.
- No major changes are required to the content of the 2018 annual report, although Brexit-related disclosures are likely to be a continued area of focus.
- The Investment Association is calling on companies to voluntarily publish their CEO pay ratio in 2019.
- Boards should be planning ahead now to ensure that they are ready to report against the updated UK Corporate Governance Code for financial years starting on or after 1 January 2019.
- Internal documentation and policies, such as the schedule of matters reserved to the board and board committee terms of reference, should be reviewed to ensure they reflect the recommendations of the updated Code.

narrative reporting regulations[1] (the **Regulations**), we look at some key practical steps that companies may wish to consider taking now to ensure they are ready to report against the 2018 Code. Readers can find additional background material on the requirements of the 2018 Code and the Regulations in our earlier briefings referred to on page 13 of this Update.

THE 2018 CODE

Board leadership, company purpose, values and culture

The 2018 Code clearly states that the board should establish the company's purpose, values and strategy and satisfy itself that these are aligned with the culture. The board is expected to assess and monitor culture and, where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company's purpose, it should seek assurance from management that corrective action has been taken. With this in mind, boards should take the opportunity to clarify what the company's purpose and values are and whether they are clearly articulated and understood throughout the business and externally.

Monitoring culture: Boards should also review the current policies and procedures for assessing culture within the business and how this is being reported back to the board. Any such review should address issues such as:

- Who is responsible for reviewing culture within the business?;
- Are the current mechanisms effective? (Mechanisms might include employee surveys, absenteeism rates, exit interviews, engagement with trade unions, health and safety data, reviewing issues raised through the whistleblowing procedures, etc);
- Is reporting sufficiently regular?;
- Is the outcome of each review clearly articulated to the board?; and
- Is there a record of the board's activities and any actions taken (given the need to report on these issues in the annual report)?

Whistleblowing: The 2018 Code requires companies to establish a means for the workforce to raise concerns in confidence and anonymously. The board is expected to review this procedure and any reports arising from it and ensure that there are arrangements in place for proportionate and independent investigation. Where no such procedures are currently in place, the board will need to ensure these are set up and arrangements put in place for the periodic review by the board of the effectiveness of these procedures and the issues raised in order that the board is able to respond accordingly where areas of concern come to light. Regulated businesses will already have well-developed whistleblowing procedures in place, as will a number of other businesses, but this may be an opportunity to look again at these procedures, in order to ensure they dovetail with the arrangements in place to enable the board to monitor culture within the organisation.

Board composition, succession and diversity

Role of nomination committee: A number of changes to the 2018 Code expand the remit of the nomination committee and should be reflected in the committee's term of reference (and other relevant recruitment procedures and/or documentation), including:

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[1] The Companies (Miscellaneous Reporting) Regulations 2018.

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- the requirement to take the lead on effective succession planning both for the board and senior management and the oversight of the development of a diverse pipeline for succession;
- the requirement for appointment and succession plans to be based on merit and objective criteria and, within this context, to promote diversity of gender, social and ethnic backgrounds and cognitive and personal strengths;
- the need to have regard to other demands on directors' time when making new appointments and to ensure that all significant commitments are disclosed with an indication of time involved prior to appointment; and
- the need for the committee to take an active role in setting and meeting diversity objectives and strategies for the company as a whole and in monitoring the impact of diversity initiatives.

Additional external commitments: Separately, directors should be notified of the requirement that no additional external appointments (whether board directorships or otherwise) should be undertaken without the prior approval of the board and any relevant internal policies should be updated to reflect this. It is worth noting that this prior approval requirement is not expressed to be applicable only to "significant" new appointments. Companies are also reminded that the reasons for permitting significant appointments should be explained in the annual report. Overboarding is a key area of focus for investors and proxy advisers and, with this in mind, directors may want to have regard to the Institutional Shareholder Service (**ISS**) overboarding policy (see box opposite).

Chair tenure: With regard to board composition, the key change is around the tenure of the chair where the best practice recommendation is that he or she should not remain in post beyond nine years from his/her first appointment to the board. This is subject to a limited ability to extend this term where necessary to facilitate effective succession planning. Any such extension must be clearly explained. As such, any company where the chair is approaching (or indeed, beyond) the nine-year mark should consider what succession plans are in place, whether these are likely to result in a need for the chair to have an extended tenure and how this might be articulated to, and received by, shareholders.

Updating role profiles: It would also be advisable to review and, where necessary, update the role descriptions of the chair, CEO, senior independent director and non-executive directors, along with the list of matters reserved to the board and the terms of reference of other board committees to ensure they fully reflect the recommendations of the 2018 Code and, where relevant, the associated guidance set out in the FRC's Guidance on Board Effectiveness, which was updated and published alongside the 2018 Code in July 2018.

Section 172 statement and stakeholder engagement

A new provision in the 2018 Code requires the board to understand the views of its key stakeholders and describe in the annual report how their interests and the matters set out in section 172(1) Companies Act 2006 (directors' duty to promote the success of the company for the benefit of the members as whole) have been considered in board discussions and decision-making. This requirement is reinforced by the requirement in the Regulations to include a statement in the strategic report describing how directors have had regard to the matters set out in section 172(1) during the financial year under review (the **Section 172 Statement**). This is an area that will require careful

Director Overboarding

The 2018 Code states that full-time executive directors should not take on more than one non-executive directorship in a FTSE 100 company or other significant appointment.

The 2018 Code does not propose any specific limit for other directors but does emphasise the need for directors to be able to devote sufficient time to the role. With this in mind, directors should also have regard to the ISS overboarding policy whereby ISS may recommend a vote against a person who holds more than 5 mandates or holds an executive directorship and a non-executive chair role at another company.

For the purposes of calculating the mandate limit:

- a non-executive director position counts as 1;
- a non-executive chair position counts as 2;
- an executive director position counts as 3.

consideration by boards and we would advocate a number of steps in this regard as outlined below.

Stakeholder engagement can broadly be divided into two categories: workforce engagement and engagement with other stakeholders, for example, shareholders, customers, suppliers, the local community and providers of finance, etc.

Workforce engagement: With regard to workforce engagement, we would recommend HR/ER work alongside their boards to map out:

- the identity of the workforce (acknowledging that this may include not only permanent employees, but also those on zero hours contracts, agency workers and/or remote workers);
- what workforce engagement methods are currently in place and how effective they are;
- areas where further engagement may be required;
- which form(s) of engagement would be most effective;
- how the outcome of workforce engagement is fed back to the board in order that it can, where appropriate, respond to issues and concerns.

Despite the 2018 Code recommending three suggested forms of workforce engagement – a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director – we are aware of a number of companies looking to build upon existing engagement methods (such as formalising existing employee forums and/or expanding the remit of existing trade union consultation arrangements), rather than adopting one of the three prescribed methods. Whilst the 2018 Code expressly recognises that a board may adopt different methods of engagement (so long as it explains what methods are in place and why the board considers they are effective) and therefore, strictly speaking, this also amounts to "compliance", there is a risk that the proxy advisor community may view this as de facto non-compliance with the 2018 Code. In this regard, it is worth being aware that the FRC wrote to the proxy advisor community following publication of the 2018 Code calling on them not to adopt a "box-ticking" approach when analysing Code reporting and making their voting recommendations, but, instead, to take into account the quality of the explanations provided by companies in relation to their practical application of the Code.

Wider stakeholder engagement: A similar exercise should be undertaken to identify other key stakeholders, their importance to the organisation, what level of engagement currently exists and whether more needs to be done to ensure that the board is cognisant of the views of these stakeholders and their importance to the success of the business. The board should also be satisfied that the mechanism(s) for ensuring feedback is given to stakeholders will be effective and adequate.

Inevitably, the Section 172 Statement will be a key area of focus for investors when 2019 annual reports begin to be published in 2020. The updated FRC Guidance on the Strategic Report makes clear that the FRC expects the Section 172 Statement to contain meaningful information, and recommends the inclusion of some or all of the following:

- the issues, factors and stakeholders the directors consider relevant in complying with section 172(1) and how they formed that opinion. In this regard, the work undertaken now to identify key stakeholders will be important;

- the main methods the directors have used to engage with stakeholders to understand the issues to which they should have regard; and
- information on the effect of that regard on the company's decisions and strategies during the financial year. Interestingly, the example given on page 60 of the Guidance around disclosure of decision-making indicates an expectation of a level of granularity of disclosure that companies may not have anticipated.

With this in mind, there are a number of practical steps that companies may wish to consider:

- ensuring that senior management and other persons who are involved in preparing papers for the board are clear about who are the company's key stakeholders and their relative importance to different areas of the business, to ensure that the board papers adequately reflect the impact of any decisions on such stakeholders;
- providing additional training for the board and senior management around (i) directors' section 172(1) duties; and (ii) inside information and selective disclosure to ensure that individuals are clear about what information may – and may not – be disclosed in discussions with shareholders and other stakeholders;
- reviewing existing guidelines around minuting board decisions. Whilst we do not expect to see a significant change in board minuting practice, when minuting key decisions taken we would advise including clear cross references to any relevant board papers which set out the key factors to which the board has had regard when reaching its decision; and
- during the course of 2019, preparing a mock-up for discussion of their 2019 annual report reflecting reporting against the 2018 Code and, in particular, the Section 172 Statement in advance of formal reporting in 2020.

Group subsidiaries: implications of new narrative reporting requirements

The Regulations may impact on "large" unlisted UK-incorporated group companies and an assessment will need to be undertaken to determine whether any subsidiary within the group is required to make a Section 172 Statement in its strategic report, along with additional disclosures in its directors' report around engagement with employees, suppliers, customers and others. A "large" company for these purposes is a company that meets two out of the following three tests (i) turnover of more than £36m; (ii) balance sheet total of more than £18m; and (iii) more than 250 employees.

Each qualifying subsidiary will need to make its own Section 172 Statement in its strategic report and publish it on a website (publication on the listed parent company's website will suffice). Given the overlap between the information required to be included in the Section 172 Statement, companies may choose to include the additional disclosures required in the directors' report in their strategic report, so long as they include a statement in the director's report that they have done so.

Boards must also identify if they have any UK-incorporated group companies that will be required, under the Regulations, to provide a statement of their

Significant dissent – implications for shareholder votes held after 1 January 2019

The FRC recommends that companies should start to report, in accordance with the 2018 Code, any significant dissent by shareholders in relation to any recommended resolution on which shareholders vote after 1 January 2019.

Significant dissent is now expressly defined in the Code as 20% or more of votes cast against a recommended resolution, which reflects the current market understanding.

As is the case under the 2016 Code, when announcing the results, the board should disclose what action it intends to take to consult shareholders in order to understand the reasons for the significant dissent. Additionally, the 2018 Code recommends that:

- an update on the views received from shareholders or actions taken should be published no later than 6 months after the shareholder meeting. We anticipate that most companies will include any such update in their half year report; and
- a final summary should be included in the annual report or notice of AGM (as applicable) detailing the impact the feedback has had on decisions the board has taken and any actions or resolutions now proposed.

Companies should ensure that their internal processes are updated to reflect these additional reporting requirements in the event of any significant dissent.

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corporate governance arrangements in their directors' report. A different test applies for this purpose and companies will only be required to comply with this requirement if they have (i) more than 2,000 employees; or (ii) a turnover of more than £200 million and a balance sheet total of more than £2 billion. The listed parent is excluded from this requirement where it is required to make a corporate governance statement under the DTRs.

The relevant statement must include details of the corporate governance code the company has applied for the financial year and, if the company has not applied any such code, the statement must explain the reason why and what corporate governance arrangements were applied instead. The statement must be made available online (publication on a listed parent company's website will suffice).

Boards of affected companies will need to consider now what code (if any) they intend to apply during the coming financial year in order that they are ready to report against it in their 2019 annual report. It is the government's hope that many large subsidiaries will look to adopt the Wates Corporate Governance Principles for Large Private Companies, launched on 11 December 2018. These set out six high-level principles against which companies should report on a comply or explain basis. The BEIS FAQs, which provide practical guidance on the application of the Regulations, state that a subsidiary of a premium listed company which applies the UK Corporate Governance Code could, in principle and if the circumstances warrant it, state that it does not apply a code because the parent applies the UK Corporate Governance Code which is applied throughout the group. The subsidiary would still need to explain however, how the Code applied to governance arrangements in relation to the subsidiary itself. For UK subsidiaries with a listed overseas parent, similar considerations apply. The subsidiary would however also need to ensure that an English language version of the relevant governance code was made available on its website or explain the code's provisions as part of the statement about its corporate governance arrangements.

Where group companies are required to prepare a separate Section 172 Statement and/or a corporate governance statement, it may be helpful to provide training for the boards of those companies to familiarise them with the relevant legislative requirements and, where relevant, the provisions of the Wates Corporate Governance Principles or other applicable code.

Remuneration

The Regulations introduce a number of new mandatory remuneration reporting requirements that apply to quoted companies for financial years starting on or after 1 January 2019[2]:

- the directors' remuneration report (the **DRR**) should include information on the impact of share price growth on share-based executive pay, along with a summary of any discretion that has been exercised on executive remuneration outcomes in respect of share price increases or decreases during the relevant performance periods. Note that the requirement that companies illustrate the impact of share price increases on executive pay outcomes will apply to any new remuneration policies brought forward by companies from 1 January 2019;

The Investment Association updated Principles of Remuneration 2019

Key themes:

- During shareholder consultation, ensure shareholders are provided with details on the whole remuneration structure and not just the proposed changes so investors have the complete picture.
- Pensions contributions for executive directors should be in line with those given to the rest of the workforce. New executive directors or directors moving to a new role should be appointed on this level of pension contribution, with incumbent executives' contribution rates being reduced over time to that available to the majority of the workforce. Compensation should not be awarded for this change.
- New emphasis on director shareholding guidelines in line with the 2018 Code. Post-employment shareholding requirements should apply for at least two years following departure. Such requirements should be established for all new executive directors and for existing executive directors as soon as possible and at a minimum by the company's next policy vote.
- Malus and clawback provisions should include a specific set of trigger events – broadly drawn triggers (such as "gross misconduct") will no longer be viewed as sufficient.

2 For more detailed information about these new reporting requirements, refer to our June 2018 briefing, Government publishes new narrative reporting regulations.

- the remuneration committee chair's annual statement should include a summary of any discretion that has been exercised on executive remuneration outcomes for the year being reported on;
- for those companies with more than 250 UK employees, a requirement to publish, in their DRR, the ratio of their CEO’s total remuneration to the remuneration of their UK employees (for parent companies, the pay ratio information must be on a group basis), along with a statement as to whether the company believes the ratio is consistent with the company's wider policies on employee pay, reward and progression. The Investment Association is calling for all companies to report their CEO pay ratios in 2019, despite it not being mandatory to do so[3]. A number of companies already do so voluntarily – 14 FTSE 100 and 17 FTSE 250 companies reported their CEO pay ratio in the 2018 reporting season[4] - although there are disparities between the methodology used. Whilst the new legislation allows for companies to use one of three prescribed methodologies, both the government and The Investment Association recommend that companies adopt option A, which is considered to be the most statistically robust. Guidance on the practical application of the prescribed methodologies can be found in the BEIS FAQs.

The 2018 Code also includes a series of new remuneration-related recommendations to which companies should have regard, including provisions that:

- the remuneration committee chair should have served at least 12 months on a remuneration committee before his/her appointment as chair;
- the remuneration committee should be responsible for setting remuneration not just for the board chair and executive directors, but also for senior management;
- the remuneration committee should engage with and review workforce remuneration and related policies, to ensure alignment of incentives and rewards with culture;
- deferred awards should have a five-year total vesting plus holding period;
- post-employment shareholding policies should be developed;
- the remuneration committee should have a discretion to override remuneration outcomes, for example where the measurement of a condition does not reflect actual performance.

In light of the changes introduced by both the Regulations and the 2018 Code, we would recommend that companies consider a review of their incentive plans, remuneration policies and remuneration committee terms of reference to ensure compliance.

Finally, it is worth noting the need to ensure that in proposing any significant changes to existing remuneration policies sufficient regard is paid to the views of major shareholders. One theme that comes through strongly in The Investment Association's recent letter to Remuneration Committee Chairs is its members' concerns that some remuneration committees either do not understand or respond to investor concerns or argue that they are operating in "exceptional circumstances", leaving investors feeling their only option is to

[3] See The Investment Association letter to Remuneration Committee Chairs dated 22 November 2018.

[4] Figures taken from Practical Law's "Annual Reporting and AGMs 2018".

vote against remuneration resolutions. The 2018 AGM season saw 63 FTSE 350 companies receive a vote of between 10 - 49.9% against their annual remuneration report, a number which has increased from 54 companies in 2017, with 29 of these companies receiving a vote against in excess of 20%. In addition, during 2018, three companies received insufficient votes to approve their DRR. The Investment Association notes that its members are increasingly voting against the re-election of remuneration committee chairs and individual members of the remuneration committee where they feel that the committee has not adequately addressed their concerns.

ISS and Glass Lewis publish updated proxy voting guidelines for 2019

ISS has published an update to its UK proxy voting guidelines for 2019, which it proposes to apply to shareholder meetings taking place on or after 1 February 2019. Key changes include:

- *External auditor appointment*: an additional exception has been added to the general recommendation to vote in favour of proposals to ratify the external auditors' appointment in circumstances where the lead audit partner has been linked with a significant auditing controversy and, where they are engaged in the audit of other public companies, this track record will be raised for investor attention (even if no issues have been identified at the company itself).
- *Director elections:* ISS will consider recommending a vote against individual directors for certain egregious actions related to service on other boards where such actions raise substantial doubt about that individual's ability to effectively oversee management.
- *Remuneration:* target bonuses should typically be set at no more than 50% of the maximum bonus potential and, in circumstances where there has been a material decline in a company's share price, remuneration committees should consider reducing the size of LTIP grants.
- *Social and environmental issues:* significant controversies, fines, penalties, or litigation will be considered when evaluating social and environmental shareholder proposals.

Glass Lewis, a proxy advisory service which is seen as increasingly influential in the UK, has also published its updated 2019 UK proxy paper guidelines. Changes include amendments to the following policies:

- *Disclosure of CEO pay ratio*: Glass Lewis has clarified that, although it believes the pay ratio has the potential to provide additional insight when assessing a company’s pay practices, it will not be a determinative factor in its voting recommendations.
- *Board and committee responsiveness*: Glass Lewis may, in certain circumstances, hold committee chairs and members accountable by recommending a vote against their re-election where they have failed to adequately address shareholder concerns.
- *Board skills and diversity:* Glass Lewis has clarified that it expects FTSE 100 companies to provide a robust, meaningful disclosure of the board's profile in terms of diversity and skills in order to align with developing best practice standard. Glass Lewis will review both disclosed gender pay gap data and the composition of the executive pipeline when assessing the diversity of the board.
- *Environmental and social risk oversight:* where it is clear a company has not properly managed or mitigated environmental or social risks to the detriment of shareholder value or when such mismanagement has threatened shareholder value, Glass Lewis may consider recommending that shareholders vote against those members of the board with responsibility for oversight of environmental and social risks (or, in the absence of explicit board oversight of such risks, members of the audit committee).

ON THE HORIZON

Ethnicity pay reporting: In October 2018, the government published a consultation on mandatory ethnicity pay reporting. Whilst a small number of both public and private organisations currently publish ethnicity pay information, many do not and feedback on current reporting practices points to inconsistencies in relation to ethnic classifications and levels of data collection. As such, the government favours mandatory ethnicity pay reporting and is seeking views on what information should be reported (and whether employers that identify disparities in their ethnicity pay data should be required to publish an action plan to address such disparities) and by whom. The government's preference is to require organisations that employ more than 250 employees to report ethnicity pay information, mirroring the requirement for gender pay gap reporting. The consultation closed on 11 January 2019.

A new UK corporate energy and carbon reporting framework: New regulations[5] introduce a streamlined UK corporate energy and carbon reporting framework. The reporting changes will take effect for financial years starting on or after 1 April 2019 and the current CRC Energy Efficient Scheme will be abolished as from April 2019.

For UK quoted[6] companies, the mandatory reporting of global greenhouse gas (**GHG**) emissions in the directors' report will continue, subject to some limited changes which are set out in our August 2018 briefing, The future UK corporate energy and carbon reporting framework and the end of the CRC Scheme. In addition to GHG emissions, new reporting requirements will require affected companies to include the total energy use associated with their emissions.

In a change to the current regime, carbon and energy reporting will be extended to certain UK large unquoted companies, as well as to UK large LLPs. However, it is worth noting that no subsidiary (whether quoted, or unquoted, company or LLP) is required to report where it is included in the consolidated group directors' report (in the case of a company) or consolidated group energy and carbon report (in the case of an LLP) of the parent.

Climate change disclosures: Investors are increasingly concerned about the long term environmental and social impact of the companies in which they invest. As referred to above, in its recently published 2019 proxy paper guidelines, Glass Lewis clarified that where a company has not properly managed or mitigated environment or social risks to the detriment of shareholder value, it may recommend a vote against those board members who are responsible for oversight of such risks (or, in the absence of explicit board oversight, the audit committee members). Increasingly, asset managers are receiving mandates that reference climate change.

In October 2018, the FCA published a discussion paper on climate change and green finance which highlights the need for reliable and consistent disclosures by listed companies about climate change in order to assist investors in assessing the risks and making their investment decisions. The FCA will be consulting on guidance for issuers about how the current regulatory disclosure regime might be interpreted to apply to climate change-

The UK Stewardship Code

As part of its consultation on the UK Corporate Governance, the FRC sought some initial views on the role of the Stewardship Code, which was last reviewed in 2012. The FRC has confirmed its intention to publish a consultation on the Stewardship Code on 30 January 2019, with a final version to be published in summer 2019.

5 The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018.

6 A company with its equity share capital included in the FCA's Official List, officially listed in an EEA state or admitted to dealing on either the New York Stock Exchange or the Nasdaq.

related risks and, as part of that exercise, it is seeking views on the level of materiality issuers should apply in making such disclosures and how best to encourage consistent disclosures.

Outcome of independent review of the FRC. In December 2018, Sir John Kingman published his independent "root and branch" review of the FRC, the body responsible for setting corporate governance standards and overseeing the quality of audit work in the UK (the **Review**) . The Review, launched in April 2018, makes 83 recommendations. Most critically, it concludes that the current constraints on the FRC's effectiveness and other weaknesses leave it unfit for purpose and recommends that it be replaced as soon as possible with an independent statutory regulator, to be called the Audit, Reporting and Governance Authority (the **ARGA**), which would be accountable to Parliament and have a new mandate, new clarity of mission, new leadership and new powers. The Review recommends that the new regulator have an overarching duty to promote the interests of consumers of financial information (rather than its producers) and that the ARGA's functions should include setting and applying high corporate governance, reporting and audit standards and regulating and being responsible for the registration of the audit profession. It would also be responsible for maintaining and promoting the UK Corporate Governance Code and the UK Stewardship Code and reporting annually on compliance with the Codes.

Corporate reporting: In relation to corporate reporting, the Review concluded that the FRC's work in reviewing companies' compliance with reporting requirements in the Companies Act 2006 and applicable accounting standards is hindered by various matters, including low levels of review activity, cumbersome enforcement mechanisms and its remit only covering parts of the annual report (areas such as the corporate governance statement and the directors' remuneration report are out of scope). As such, the Review recommends that the new regulator should:

- be required to promote brevity and comprehensibility in accounts and annual reports and to engage meaningfully with users and asset owners about their needs;
- be given powers to direct changes to accounts rather than having to go to court;
- undertake a stronger corporate reporting review process, which should be extended to cover the entire annual report (including corporate governance reporting), adopting a risk-based approach;
- where it has concerns about any reporting matter, be able to require explanations and additional information from a company and to direct it to correct a statement, provide a more detailed explanation or include missing information.

Enforcement powers: With regard to enforcement, the Review noted that the FRC currently has no authority to act against company directors unless they are a member of a professional accountancy body (member directors). The Review highlights that respondents to the call for evidence flagged concerns about the inability for non-member directors to be held properly to account where they have played a part in serious reporting or audit-related failure. The Review finds this inconsistency undesirable and recommends that government, working with the new regulator, should develop proposals for an effective enforcement regime in relation to public interest entities that holds directors to account for their duties to prepare and approve true and fair

A continued focus on diversity

Diversity, both of gender and ethnicity, will continue to be an area of focus for boards in 2019.

The Hampton-Alexander Review, published in November 2018, found that:

- the FTSE 100 are on track to meet the target of 33% women on boards by 2020 (currently 30.2%)
- the FTSE 250 lags behind, with 24.9% representation of women on boards
- in order to meet the 33% target by 2020, 1 in 2 board appointments in the FTSE 350 need to be women
- representation of women on executive committees and direct reports to executive committees also falls some way short of the 33% by 2020 target (FTSE 100 – 27%; FTSE 250 – 24.9%)
- 5 all-male boards remain in FTSE 250.

There is also a call for FTSE 350 companies to increase the number of women in chair, senior independent director and executive roles.

Notwithstanding the 33% target for female representation on boards, directors should note that it is Legal & General Investment Management's policy to vote against chairs of FTSE 350 boards which do not have more than 25% women.

accounts and compliant corporate reports, and to deal openly and honestly with auditors. It recommends that this regime should apply to a company's CEO, CFO, chair and audit committee chair. It is unclear how any such new regime would operate alongside the existing directors' duties regime in the Companies Act 2006 and, in light of the government's stated intention to take forward the Review's recommendations, it is to be hoped that any new regime will be appropriately aligned with the existing regime.

The Review also recommends that the regime for non-member directors should follow the principles of the audit enforcement procedure, with the same threshold for actions to be taken and a graduated range of sanctions. To achieve this, the regulator should set out the relevant requirements or statements of responsibilities in relation to auditing and corporate reporting in order that directors are individually accountable for their roles. Action in relation to director disqualification should remain with the Insolvency Service, but the regulator should have the necessary powers to investigate directors and refer cases to the Insolvency Service.

Accountancy oversight: With regard to accountancy oversight, the Review recognised that the role of the FRC is largely backwards-looking – i.e. its remit is to check whether a company's published accounts are defective and whether its statutory audit is acceptable. The Review considers there is scope for the new regulator to play a more forward-looking role, in particular in acting in response to intelligence or potential warning signs and recommends the regulator should continue to operate its oversight role of the accountancy professional, but with a work programme sufficiently wide and expert to identify any emerging concerns of public interest.

The Review also recommends that government should introduce a "duty of alert" for auditors to report viability or other serious concerns and that the regulator should be able to both require rapid explanations from companies about reasonable concerns raised by the regulator and have powers to commission a "skilled person review", paid for by the company, in certain circumstance (for example, where there are concerns about the accounting treatment of key areas of audit judgement, evidence of significant investor concern or concerns about the credibility of a company's viability statement).

Alongside the Review, Sir John Kingman has published his letter to the Secretary of State for BEIS in response to the request put to him to consider whether there is any case for change in the way in which audits are currently procured, and audit fees and scope are set particularly for major companies of public interest. The letter examines the possibility of a fundamental change to the way in which auditors are appointed – i.e. instead of an auditor being proposed by the company’s board and approved by shareholders, the appointment would be made by an independent body representing the public interest, which would also set the audit fee. However, whilst acknowledging that there is a principled case for at least considering radical change, Kingman concludes that he does not believe it would be right to contemplate a change as major as this, whose purpose is to benefit the users of accounts, when investors are currently so firmly opposed and, as such, he proposes some more limited changes to the audit regime.

Next steps: In response to the publication of the Review, Greg Clark, Secretary of State for BEIS, stated the government's intention to "take forward the recommendations set out in the Review to replace the FRC with a new independent statutory regulator with stronger powers". Given current restrictions on Parliamentary time as a result of Brexit, there is no clear indication of how quickly these changes will be implemented.

FRC Advisory Group to examine the Future of Corporate Reporting: In December 2018, the FRC announced that it had set up an Advisory Group, comprised of representatives from the FRC's major stakeholder groups, including companies, investors, auditors, audit committee chairs, lawyers and others to consider the future of corporate reporting. The Group will provide input and advice to the FRC as it develops the project which will lead to recommendations for changes to regulation and practice.

BEIS announces insolvency and corporate governance reforms*:* In August 2018, BEIS published a response to its March 2018 consultation on insolvency and corporate governance, which had been launched following a number of high-profile company failures. It had sought to seek views on proposals to reduce the risk of major company failures occurring through poor governance or stewardship, and to strengthen the responsibilities of directors of companies which are in, or approaching, insolvency. The response sets out BEIS' proposed actions, which will be subject to further consultation where necessary on the detail:

- *Group structures:* BEIS will consider options to require groups to provide explanations of their corporate and subsidiary company structures in order to bolster transparency. Options could include working with industry to improve guidance or introducing a requirement for corporate groups of a significant size to disclose an organogram of their corporate structures, along with an explanation of how corporate governance is maintained throughout the group.
- *Shareholder stewardship:* BEIS will identify means to incorporate stewardship within the mandates given to asset managers by asset owners and establish safe channels through which institutional investors can escalate concerns about the management of a company by its directors.
- *Dividend payments:* Following a significant number of responses criticising or suggesting improvements to the UK's dividend regime, BEIS will explore further whether a comprehensive review of the dividend regime is needed. BEIS will also take steps to ensure that shareholders of listed companies have an annual say on dividends, if the practice of companies avoiding an annual shareholder vote on dividends by only declaring interim dividends is widespread and investor pressure proves insufficient to change it.
- *Improve boardroom effectiveness:* BEIS has invited ICSA to convene a group to identify further ways of improving the quality and effectiveness of board evaluations, including the development of a code of practice for external board evaluations.
- *Directors' training and guidance:* BEIS will bring forward proposals to strengthen access to training and guidance for directors (including raising awareness of their legal duties when making key decisions), and will consider whether some level of training should be mandatory for directors of large companies.

BEIS also intends to legislate to put in place measures to ensure greater accountability of holding company directors when selling subsidiaries in distress as soon as Parliamentary time permits. It firmly believes that holding company directors should consider whether a distressed subsidiary's stakeholders would be better off in an insolvency proceeding rather than pursuing the sale of the business. BEIS has also proposed a number of wide-ranging restructuring and insolvency reforms. You can find more details about

Review of audit market

In December 2018, the Competition and Market Authority (**CMA**) published an interim market study examining the effectiveness of competition in the audit market. The study identified serious competition concerns in the audit sector and has made three key recommendations:

- splitting the audit and advisory businesses at large accountancy firms, with separate management and accounts;
- regulatory oversight of the appointment of auditors; and
- a joint audit regime for FTSE 350 companies, with a Big Four and a non-Big Four firm working jointly on an audit.

These proposals are out for consultation until 21 January 2019, with a final report and recommendations expected to follow later in the year.

Following publication of the CMA paper, the government announced the launch of a new independent review into standards in the UK audit market, to be led by Donald Brydon. The Brydon Review into UK Audit Standards is tasked with recommending what more can be done to ensure audits meet public, shareholder and investor expectations and will also build on the findings of the Kingman review. Detailed Terms of Reference and a project plan will be published in early 2019.

In November 2018, it was announced that a BEIS Committee Inquiry on the future of audit will kick off with public evidence sessions in early 2019 and will focus on the likely impact of the CMA market study and the Kingman Review in improving quality and competition in the audit market and reducing conflicts of interest. The Committee intends to feed into the CMA study and ensure audit reform is linked to coherent reform of the wider corporate governance agenda.

these reforms in our October 2018 briefing, UK Corporate Insolvency Reforms: Looking beyond Brexit.

As stated above, in light of current restrictions on Parliamentary time as a result of Brexit, it is unclear when BEIS will be able to take these proposals forward.

FURTHER INFORMATION

For further information about any of the issues discussed above, please contact either your usual Clifford Chance contact or any of the authors of this briefing. You can also find additional information on some of the matters referred to above, in the briefings linked to below:

UK announces insolvency and corporate governance reforms (September 2018)

The future UK corporate energy and carbon reporting framework and the end of the CRC Scheme (August 2018)

A 'shorter, sharper' UK Corporate Governance Code (July 2018)

Government publishes new narrative reporting regulations (June 2018)

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