2

The regulatory framework

Accessing information on corporate governance

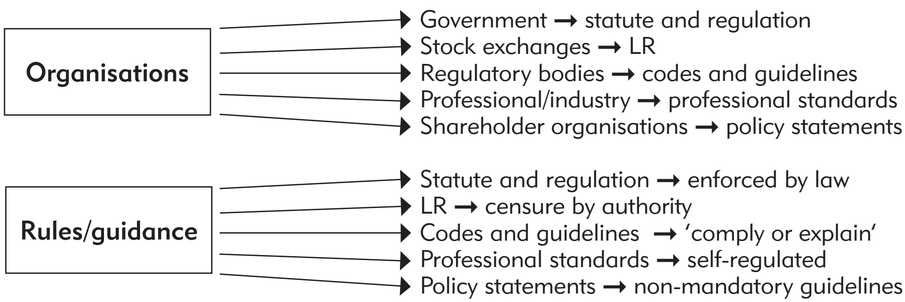
The volume of information relating to corporate governance is already vast and is likely to continue to grow. An internet search using 'corporate governance' as the key words can prove this point. This will highlight the interested organisations with considerable resources, such as government bodies, non-governmental organisations (NGOs), shareholder organisations and regulators of professional service providers, as well as less well-resourced commentators like academics and enthusiastic lobbyists for small interest groups. An additional challenge is the inconsistency of approach. While it has relevance across the economically developed world, there is no single gold standard for governance which has universal application. The standards of good governance are, for the most part, set out in guidance and policy documents that assume voluntary adherence by companies and other organisations. Such voluntarism is widely perceived to be meritorious, as it allows for flexibility both between and within jurisdictions. Conversely, a highly regulated approach has been perceived as a drag on enterprise and, ultimately, unworkable. However, given the focus on corporate governance reform, the prospect of corporate governance becoming more regulated in the future cannot be ruled out. The typical business, particularly one operating globally, is presently faced with a plethora of governance requirements.

Gateways to governance information

As a result of the volume of information that is available, directors, company secretaries and other governance professionals face a challenge if they are to identify, when setting priorities, those aspects that are most relevant to their particular business and its markets. At its simplest, there are two gateways for accessing and understanding the information. These are (1) the *organisations* which seek to shape governance, and (2) *the rules or guidance* that they issue. Figure 2.1 illustrates the point.

For those who must apply corporate governance in practice, such as company secretaries and directors, it is important to hold this type of framework in mind. A helpful feature of this approach is that it draws out the

Figure 2.1 Gateways to governance information



distinction between what is regulatory and therefore mandatory, and what is non-regulatory and therefore voluntary.

The regulatory framework

The regulatory framework for companies is broadly composed of the following main parts:

- governance-related legislation and regulation;
- accounting standards and narrative reporting requirements; and
- corporate governance best practice codes.

Each of these elements is now examined.

Governance-related legislation and regulation

In the UK there is no single coherent body of legislation that is expressly focused on corporate governance. That is not to say, however, that there are not both statutes and regulations which play a significant role in shaping UK governance. Reflecting the wide scope of corporate activities that are of relevance to the governance of companies, such legislation is diverse in both its origin and its impact. Table 2.1 contains a list of a number of the statutes which are commonly cited in the governance context, and provides a brief indication of their governance impact.

Additionally, there is a major body of legislation which imposes compliance requirements on the board, covering such areas as employment rights, health and safety, product liability, environmental risks and competition law. Although such legislation may not prescribe expressly the manner in which companies are to be governed, because the sanctions for non-compliance can be very significant, it will figure prominently in the board's efforts to maintain effective internal controls and risk management generally.

Table 2.1 Corporate governance statutes

Legislation	Governance impact
CA 2006	■ maintenance of statutory books and records ■ filing returns at Companies House ■ preparation of annual report and accounts including narrative reporting ■ remuneration reporting ■ shareholder vote on remuneration policy ■ audit and auditor liability ■ directors' interests, duties and liabilities ■ shareholder communications, meetings and voting ■ share capital and capital maintenance ■ Takeover Panel
Insolvency Act 1986 (IA 1986)	■ wrongful/fraudulent trading
Company Directors Disqualification Act 1986 (CDDA 1986)	■ directors' misconduct ■ directors' unfitness
Criminal Justice Act 1993	■ insider dealing
Financial Services and Markets Act 2000 (FSMA 2000)	■ constitution and powers of the FCA ■ market manipulation ■ financial promotions ■ LR, Prospectus Rules (PR), DTR
Market Abuse Regulation (596/2014) (MAR)	■ market abuse and insider dealing
Bribery Act 2010	■ anti-corruption, both in the UK and overseas
Public Interest Disclosure Act 1998	■ whistleblowing
The Equality Act 2010 (Gender Pay Gap Information) Regulations 2017	■ gender pay reporting

Listed companies

The LR, PR and DTR

The provisions of Part VI of the FSMA 2000 prescribe the FCA's regulatory functions as the 'competent authority' for the listing of securities in the UK.

The UK Listing Authority (UKLA) is the body through which the FCA exercises these functions and, in particular, it maintains the Official List. The regulatory objectives of the UKLA are focused around the need to maintain the competitiveness of the UK market in listed securities, and the desirability of facilitating competition in such securities and the confidence of investors generally.

The Rules and Guidance, referred to above, impose requirements on issuers, sponsors, directors and others in relation to the listing of securities on the LSE. They are designed to ensure that the LSE works fairly and efficiently for the benefit of shareholders, ensuring in particular that they enjoy generous and equal access to information. Listed companies must observe continuing obligations during the period their securities remain listed on the Official List. These include obligations with respect to major transactions, disclosure of financial information, directors' remuneration and shareholder circulars. All of these obligations have a significant governance application. The Rules also contain important requirements to be satisfied when a company's shares or other securities are to be admitted to the Official List, either on the occasion of its initial flotation or in connection with a subsequent new share issue.

Alternative Investment Market (AIM) Rules

The LSE established the AIM as a market designed primarily for smaller and growing companies, to which higher investment risks may be attached than is the case for larger and more established public companies. It is an exchange-regulated market, and as such is not subject to the same level of EU legislation as a regulated market. This status enables the AIM Rules to be less onerous than those for companies with a main market LSE listing. For example, there is no requirement for a company seeking admission to AIM to have a previous trading record, and the requirements for prior shareholder approval of transactions are very modest, being restricted to reverse takeovers, fundamental disposals or cancellation of listing.

However, the AIM Rules do contain important governance provisions relating to disclosures (rules 10 to 17), financial reporting (rules 18 and 19) and the requirement for a share-dealing policy for directors and applicable employees (rule 21), supplementing the provisions in the MAR, which are directly applicable.

Additionally, the key role given to an AIM company's 'nominated adviser' (Nomad) has important governance implications. A Nomad has significant obligations under the AIM Rules, the broad objectives of which are to secure compliance by the company, to guide its directors and to keep the LSE informed. The independence of the Nomad is a central and necessary part of the assurance given to investors who choose to invest in AIM. The importance of the Nomad is emphasised by the fact that an AIM-listed company which ceases to have a Nomad will have its securities suspended from trading.

In practice, when Nomads bring new companies to AIM, they will pay close attention to governance matters, often going beyond the strict requirements of the AIM Rules. Also, more established AIM companies will work with their Nomad to ensure that best governance practice is observed, taking into account the size and profile of their business. As an example, although AIM companies are not required to comply with the UK Corporate Governance Code, many will seek to achieve compliance to a greater or lesser degree, not least because in time they may want to move up to the Official List. The Quoted Companies Alliance representing smaller listed companies has published the 'Corporate Governance Code for Small and Mid-sized Quoted Companies 2013'. This useful publication identifies 12 essential guidelines which represent good practice and need to be considered. The objective of the guidelines is to apply key elements of the UK Corporate Governance Code in a way which is relevant to the needs of smaller quoted companies. The importance of directors doing what is right for their individual company is emphasised even if those actions appear contrary to best practice. Building up a relationship of trust between a company's directors and its shareholders is clearly relevant if shareholder support is to be relied upon by directors who opt to deviate in some circumstances from generally accepted best practice.

MAR

MAR, which came into force in July 2016, applies to share dealings by directors and others discharging managerial responsibilities of both listed and AIM companies. This has replaced the Model Code Provisions in the LR and the AIM Rules now place an obligation on AIM companies to have in place an effective policy for share dealings by directors and other applicable employees (rule 21). A more detailed discussion of MAR is contained in Chapter 15.

The City Code on Takeovers and Mergers (the Takeover Code)

The Takeovers and Mergers Panel (the Takeover Panel) is the body responsible for the contents of and compliance with the Takeover Code. Its statutory functions are established under the CA 2006. The Takeover Code is mainly concerned with regulating the conduct of parties involved in takeovers or mergers, ensuring that there is a 'level playing field' and that all shareholders in a public company subject to a takeover or merger are treated equally. It is based on six general principles, from which more detailed rules are derived.

The Takeover Panel expects both the spirit of the principles and detailed rules to be observed as well as their letter. Amongst other things, it lays down strict rules as to how companies, their directors and their advisers should conduct themselves prior to and following the announcement of a takeover, and it imposes restrictions on dealings by persons with unpublished price-sensitive information during an offer period. It also imposes requirements in respect of the contents of documentation prepared in connection with a takeover. It is worth noting that the remit of the Takeover Code means that it also applies to unlisted companies in some circumstances. The detail of the Takeover Code is discussed in greater detail in Chapter 15.

Accounting standards and narrative reporting

The fundamental purpose of financial reporting was expressed by the Chief Executive of the FRC, at a conference on 7 November 2016, as being to:

> 'tell the story of your business, its position, performance and prospects. It should do so in a way that is fair, balanced and understandable. Those are the requirements of the regulations and the Corporate Governance Code'.

The governance ramifications are self-evident, and it is unsurprising that the relevant financial reporting and auditing practice standards attract immense scrutiny, both within and outside the accountancy and auditing professions. For example, all companies whose shares are listed on either the main LSE or AIM markets are required to report their results under specified IFRS. Convergence on IFRS reporting is intended to ensure consistency in reporting standards across different jurisdictions – an important corporate governance goal, particularly for listed entities. All companies must also include in their annual report and accounts certain narrative elements. Company auditors and the accounting profession generally have a significant role to play in the implementation of these governance developments.

Narrative reporting

As regards narrative reporting standards, these have been undergoing an extensive period of review in recent years in an effort to make such reporting clearer and more meaningful. There has been a plethora of consultations, guidance notes and regulations designed to improve the standard and clarity of reporting over recent years. For accounting periods ending after September 2013, companies have been required to produce a strategic report. In addition, companies must report on environmental issues, human rights and gender diversity as well as publish an annual tax strategy.

These developments and other issues of financial and narrative reporting, regulation and practice are discussed more fully in Chapter 8.

Corporate governance best practice codes

While there is a vast body of legislation and mandatory requirements relevant to corporate governance, equally there are many voluntary standards devised by regulatory bodies and others with an interest in the development of corporate governance best practice. Although adoption of these standards may not be compulsory, the organisations to which they apply are increasingly judged and measured against them and failure to comply with these standards can attract criticism. Some of these are examined below.

Listed companies

The UK Corporate Governance Code

The UK Corporate Governance Code and associated guidance is the main source of governance best practice for UK premium-listed companies. Standard list companies are subject to less rigorous standards and the Code does not extend to AIM-listed companies although such companies may aspire to comply with the Code.

The Code has gone through a number of iterations but despite these many changes, the Code has remained loyal to its 'comply or explain' approach. The FRC's February 2012 report *What Constitutes an Explanation Under 'Comply or Explain'* provides some useful insight into this issue. When the Code was updated in 2014, the central changes related to the adoption of the going concern basis of accounting, company risk management, internal control systems, remuneration and shareholder engagement. In particular, the remuneration provisions emphasised how policies should be designed with the long-term success of the company in mind and enable the recovery or withholding of variable pay when appropriate. Minor changes, principally relating to audit committees' requirements, have been made to the Code in its latest edition which applies to companies with reporting periods beginning on or after 17 June 2016. The FRC has indicated that it expects to consult on possible further changes to the Code in 2017, following on from the Business, Energy and Industrial Strategy (BEIS) Select Committee Inquiry and the BEIS Green Paper on *Corporate Governance Reform*.

The Code's associated guidance comprises:

- FRC *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* (September 2014);
- FRC *Guidance on Audit Committees* (April 2016); and
- FRC *Guidance on Board Effectiveness* (March 2011).

The structure of the UK Corporate Governance Code is illustrated in Figure 2.2.

Figure 2.2 UK Corporate Governance Code

Code Principles

A. Leadership	A.1 The role of the board A.2 Division of responsibilities A.3 The chairman A.4 NEDs
B. Effectiveness	B.1 The composition of the board B.2 Appointments to the board B.3 Commitment B.4 Development B.5 Information and support B.6 Evaluation B.7 Re-election
C. Accountability	C.1 Financial and business reporting C.2 Risk management and internal control C.3 Audit committee and auditors
D. Remuneration	D.1 The level and components of remuneration D.2 Procedure
E. Relations with shareholders	E.1 Dialogue with shareholders E.2 Constructive use of General Meetings

Code Schedules

Schedule A	The design of performance-related remuneration for executive directors
Schedule B	Disclosure of corporate governance arrangements

Associated Guidance

FRC *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*	Risk management, internal controls and reporting
FRC *Guidance on Audit Committees*	Audit committees
FRC *Guidance on Board Effectiveness*	Board leadership and effectiveness