London
Stock Exchange

Corporate Governance

For main market and AIM companies

London
Stock Exchange Group

The London Stock Exchange would like to thank the following organisations for their contributions to this guide:

Bank of America Merrill Lynch

pwc

ROTHSCHILD

BoardroomReview Limited

SLAUGHTER AND MAY

HILL+KNOWLTON STRATEGIES

PATTERSON ASSOCIATES
A PEARL MEYER & PARTNERS PRACTICE

CHARTIS

BAKER & McKENZIE

Davis Polk

SHEPHERD+WEDDERBURN

Pinsent Masons

Herbert Smith

COVINGTON
COVINGTON & BURLING LLP

Linklaters

GLASS LEWIS & Co.

THE ZYGOS PARTNERSHIP

cobbetts

F&C Investments

Freshfields Bruckhaus Deringer

ENVIRON
environcorp.com

Corporate Governance for Main Market and AIM Companies

Published in association with London Stock Exchange plc

Consulting editors:
Padraig Cronin and Frances Murphy,
Slaughter and May

Published by White Page Ltd

whitepage

Corporate Governance for Main Market and AIM companies

Consulting editors Padraig Cronin and Frances Murphy, Slaughter and May

Publishing editor Nigel Page

Publisher Tim Dempsey

Production editor Matt Rowan

Design London Stock Exchange plc

Printing and binding Argent Litho Ltd

Corporate Governance for Main Market and AIM Companies
is published by:

White Page Ltd, 17 Bolton Street
London W1J 8BH
United Kingdom
Phone: + 44 20 7408 0268
Fax: + 44 20 7408 0168
Email: mail@whitepage.co.uk
Web: www.whitepage.co.uk

First published: September 2012
ISBN: 978-0-9565842-4-3

Corporate Governance for Main Market and AIM Companies
© September 2012
London Stock Exchange plc, 10 Paternoster Square, London EC4M 7LS

Copyright in individual chapters rests with the authors. No photocopying: copyright licences do not apply.

The information in this publication is not offered as advice on any particular matter and must not be treated as a substitute for specific advice. In particular, information in this publication does not constitute legal, professional, financial or investment advice. Advice from a suitably qualified professional should always be sought in relation to any particular matter or circumstances. The chapters provided by the contributors are not the opinions of the London Stock Exchange plc or any of its group undertakings ('group undertakings' shall be construed in accordance with Section 1161 of the United Kingdom Companies Act 2006). This publication is provided for information and educational purposes only. While all information contained herein is obtained from sources believed to be accurate and reliable, neither the London Stock Exchange plc nor any of its group undertakings accepts responsibility for any errors, omissions, or inaccurate information. All information in this document is provided 'as is' without warranty of any kind. Neither the London Stock Exchange nor any of its group undertakings make any representations and disclaims all express, implied and statutory warranties of any kind in relation to this publication, including warranties as to accuracy, timeliness, completeness, performance or fitness for a particular purpose.

The London Stock Exchange crest and logo, AIM, RNS and SETS are registered trade marks of London Stock Exchange plc. No part of these trade marks or any other trade mark owned by the London Stock Exchange or any of its group undertakings can be used, reproduced or transmitted in any form without express written consent by the owner of the trade mark.

Foreword

Alastair Walmsley, Head of Primary Markets, London Stock Exchange Group

The relationship between companies and their shareholders has never been more important. With an ever-increasing range of global investment options, companies need to focus on building long-term relationships with investors, founded on trust and regular communications. In doing so, companies will maximise the full benefits of being publicly listed.

Corporate governance is central to this process. At the London Stock Exchange Group, we firmly believe that high standards of corporate governance make an important contribution to companies' long-term performance. By regularly reviewing and developing appropriate corporate governance practices, both UK and international companies on our markets can ensure they are better placed to execute their strategy, manage their growth and drive value, whatever the prevailing macro-economic conditions.

The UK Corporate Governance Code (the Code) is maintained by the Financial Reporting Council; it applies to all Main Market companies, both UK and international, with a Premium Listing of equity shares in London. Companies with a Standard Listing, which are required to meet EU minimum admission criteria, are subject to less comprehensive standards of disclosure and shareholder rights.

Although companies on the London Stock Exchange's long-established growth market, AIM, are not mandated under the AIM Rules to adhere to the provisions of the Code, they are encouraged to develop strong governance procedures and are advised to aspire to achieve the key elements set out in the Code as they grow. As a minimum, all AIM companies are encouraged to adhere to the Quoted Companies Alliance (QCA) Guidelines, which are based on the Code but specifically tailored to the needs of growth companies and their investors.

The UK's principles-based approach to corporate governance, and the ability for companies to 'comply or explain', continues to deliver strong and effective governance and ensures the UK governance regime is valued and respected, importantly by both companies and investors.

Corporate governance is the responsibility of both companies and investors: companies are required to demonstrate they are acting in the interests of their shareholders; and investors need to demonstrate they are acting in the interests of their clients. Under the framework of the Code for companies and the Stewardship Code for investors, the UK is a world leader. But governance is not simply about codes or regulations; it is about relationships and trust. This is embodied in the non-prescriptive nature of the UK's flexible and strong governance framework, ensuring that the corporate governance regime in the UK supports companies of all sizes.

It is never too early for companies, even those that remain privately held, to begin establishing appropriate corporate governance policies and procedures. For example, meeting investors' expectations early in an IPO process, engaging with the investment community on corporate governance related decisions and maintaining open dialogue only serves to enhance investors' and other stakeholders' confidence. Good governance standards are a central premise of the London market's attractiveness to issuers and investors.

The equity markets in the UK are underpinned by experienced and dedicated intermediaries, and we have produced this guide in conjunction with a number of these organisations. We are grateful for their contributions. This guide is designed to assist companies in understanding all aspects of governance and the nuances of its application — whether they are aspiring to the highest standards of operation, preparing for an IPO or as part of best practice once listed as a public company.

Good governance and strong management have never been more important to the continued health of the UK's capital markets. This guide aims to encourage companies and executives to consider corporate governance in the widest sense, including board efficiency, transparency, reporting requirements, investor communications and sustainability. We hope you find it useful and informative.

Alastair Walmsley, September 2012

Contents

PART I: INTRODUCTION

Chapter 1 The development of the UK corporate governance regime 8
Financial Reporting Council

Chapter 2 Corporate governance and smaller businesses 11
The Quoted Companies Alliance

Chapter 3 Why is corporate governance so important? 14
The International Corporate Governance Network

PART II: SETTING THE SCENE

Chapter 4 The UK regulatory framework 17
Slaughter and May

Chapter 5 Corporate governance in the EU context 25
Freshfields Bruckhaus Deringer LLP

PART III: PRE-IPO CONSIDERATIONS

Chapter 6 Preparations for an initial public offering 33
Bank of America Merrill Lynch

Chapter 7 Good governance and shareholder expectations — an investor's perspective 41
Glass, Lewis & Co LLC

Chapter 8 Does corporate governance matter for shareholder value? 47
F&C Investments

Chapter 9 Corporate governance — requirements for a UK issuer: Premium Listing, Main Market 53
Linklaters LLP

Chapter 10 Requirements and challenges for non-UK companies listing in London 59
Davis Polk & Wardwell London LLP

Chapter 11 Structuring an effective board 65
The Zygos Partnership

Chapter 12 The prospective non-executive director 75
Pinsent Masons LLP

PART IV: POST-IPO CONSIDERATIONS

Chapter 13 Corporate governance and the Main Market 85
Slaughter and May

Chapter 14 Corporate governance and AIM 93
Cobbetts LLP

Chapter 15 The role of the board in effective risk management and oversight 103
PricewaterhouseCoopers LLP

Chapter 16 Inside information 117
Herbert Smith LLP

Chapter 17 The UK Bribery Act 2010 and its implications for businesses 126
Covington & Burling LLP

Chapter 18 Managing directors' conflicts 137
Shepherd and Wedderburn LLP

Chapter 19 The role of the independent adviser 145
Rothschild

Chapter 20 **Executive remuneration** 151
Patterson Associates LLP

Chapter 21 **Sustainability governance: taking corporate social responsibility on board** 161
ENVIRON International Corporation

Chapter 22 **The relationship between directors and shareholders: financial communications and investor relations** 169
Hill + Knowlton Strategies

Chapter 23 **Corporate governance — towards best-practice corporate reporting** 177
PricewaterhouseCoopers LLP

Chapter 24 **Protection for directors and their companies** 189
Chartis Europe Limited

Chapter 25 **Board evaluation** 193
Boardroom Review Limited

PART V: AN INTERNATIONAL PERSPECTIVE

Chapter 26 **Comparison of UK and US corporate governance considerations** 203
Baker & McKenzie LLP

Chapter 27 **Comparison of UK and Hong Kong corporate governance considerations** 213
Slaughter and May

AUTHOR BIOGRAPHIES 220

Glossary of terms and useful sources 238

Part I: Introduction

Chapter 1	The development of the UK corporate governance regime	Page 8
Chapter 2	Corporate governance and smaller businesses	Page 11
Chapter 3	Why is corporate governance so important?	Page 14

1. The development of the UK corporate governance regime

Chris Hodge, the Financial Reporting Council

2012 marks the 20th anniversary of the Cadbury Code, the first corporate governance code in the UK.

That code — named after Sir Adrian Cadbury who chaired the committee that wrote it — was developed by the business community in response to a series of corporate scandals in the late 1980s and early 1990s.

The London Stock Exchange played an important role in establishing the immediate credibility of the code by adding a requirement to its Listing Rules that all companies had either to comply with the code or explain to their shareholders why they had not done so.

There have been many changes to this framework since 1992; for example, responsibility for the Listing Rules transferred to the UK Listing Authority (UKLA) in 2000, while in 2003 the Financial Reporting Council (FRC) took responsibility for the content of what is now called the UK Corporate Governance Code (the Code). As a result of the new listing regime introduced by the UKLA in April 2010, the Code applies to all companies with a Premium Listing of equity shares, including those which are incorporated outside the UK. But the basic approach is unchanged. It is an approach that has stood the UK market in good stead over the last 20 years.

The foundation stone of that approach is the concept of 'comply or explain', a concept that was revolutionary at the time but has since been widely adopted elsewhere.

'Comply or explain' is based on two premises. The first is that, when it comes to effective governance, there is no 'one size fits all'. While it may be possible to identify processes and structures that will be best practice for the majority of companies, there will always be cases where it is in the best interest of a company and its shareholders to adopt different practices.

The second premise is that if the purpose of corporate governance is to ensure the company is run in the long-term interests of the shareholders, it should be those shareholders rather than regulators who decide whether that is actually the case. For this reason, when companies choose not to follow the code, the explanation is given to the shareholders.

The inherent flexibility of the 'comply or explain' concept means that corporate governance codes can challenge companies to improve their standards more quickly — and, the FRC believes, more effectively — than strict rules with which all companies must comply immediately.

Because they need to be capable of being complied with by all companies regardless of their size and circumstances, rules usually set out what is the minimum acceptable standard. While this is important to establish basic benchmarks of appropriate behaviour, it does not encourage companies to do more than the minimum. 'Comply or explain' codes complement rules by setting out higher and more aspirational standards, recognising that not all companies will achieve them immediately and that for some companies it may be more appropriate to take a different approach to protecting the long-term interests of their owners.

The effectiveness of this approach is self-evident if you look at the improvements in governance in the UK listed sector over the last 20 years. Inevitably

there are still governance failings at individual companies — no system can provide a guarantee against poor decision-making or inappropriate behaviour — but general standards in the UK are consistently ranked as being among the highest in the world, and compliance with the Code is very high.

Many of the features of good governance that are now taken as read have been developed through the code-based approach, starting with the original Cadbury Code in 1992 which recommended the separation of the roles of chairman and chief executive and the establishment of independent audit committees. In 2003 the Code first recommended regular evaluation of the board's effectiveness, something that ruffled many feathers at the time but is now universally seen as good practice, in the UK at least. As recently as 2010, the Code recommended annual election for all directors of FTSE 350 companies. Again this was controversial when first proposed, but within 12 months over 80 per cent of those companies had introduced annual elections.

Codes are sometimes incorrectly characterised as 'self-regulation'. As will already be clear, they do not operate in isolation, but are only part of a broader regulatory framework.

Some minimum standards of behaviour are set out in company law and the Listing Rules, as are disclosure requirements intended to ensure that investors have the information they need to assess the performance and prospects of the company. One example is the Listing Rule requirement for companies to report on how they have applied the UK Corporate Governance Code. Importantly, both the law and the Listing Rules give shareholders rights that enable them to hold the board to account.

While the specific governance arrangements of individual companies are a matter for the board and shareholders, regulators or market authorities do play a role in monitoring the overall impact of codes and taking action to improve their effectiveness where necessary. In the UK this function is performed by the FRC.

As well as updating the content of the Code when necessary, following consultation with the market, the FRC publishes an annual report on its impact and takes steps to improve its effectiveness. For example, in 2012 the FRC published a paper describing the sort of information that should be provided when companies choose to explain rather than follow the Code. This helps companies to know what is expected of them, and provides a benchmark for shareholders when assessing explanations.

The effectiveness of the 'comply or explain' approach, and the appropriate balance between codes, regulations and supervision, will be significantly influenced by the structure of the market in which it is applied.

Looking back at the UK market in 1992, there were three specific features of the market that persuaded those involved in producing the Cadbury Code that the then novel concept of 'comply or explain' could be made to work. Without them, it is arguable whether that approach could have been contemplated.

The first feature, as has already been mentioned, was the relatively strong rights that shareholders had in comparison to other markets at that time. A system that makes boards nominally accountable to their shareholders but gives the shareholders no ability actually to hold boards to account has little credibility.

The second feature was the dispersed nature of the shareholder base in most UK listed companies. While 'comply or explain' has been made to work in markets where ownership is more concentrated,

it can be difficult for minority shareholders to provide a meaningful check and balance to the interests of a block holder. In such cases the balance between codes and hard rules, and the roles of shareholders and regulators, may need to be different. The FRC has recognised that the existence of companies with concentrated ownership structures on the London market raises challenges to a 'comply or explain' approach designed for a market where dispersed ownership is standard.

The final feature of the UK market 20 years ago that gave the Cadbury Committee confidence in 'comply or explain' was the significant presence of institutional investors seeking a long-term return on their assets — most specifically UK insurance companies and pension funds, which at that time owned 50 per cent of the market. While individually they owned only a small percentage of shares in any company, collectively they had both the motivation and ability to demand high standards of governance of the companies in which they invested, and the willingness to engage with the boards of those companies about their specific circumstances.

It is this feature that has changed most dramatically since 1992. UK insurance companies and pension funds now own less than 15 per cent of the market. There has been a significant increase in investment from overseas. Those investors naturally find it more difficult to engage directly with UK boards even when they have a desire to do so.

In order to ensure that 'comply or explain' can continue to operate effectively in the future, there is a need to rebuild the critical mass of investors with a long-term perspective who are willing and able to monitor and engage with the boards of UK listed companies.

That is the reason why the FRC issued the UK Stewardship Code in 2010. This set out for the first time what is expected of institutional investors in terms of monitoring and engagement and reporting back to their clients or beneficiaries. The initial response has been very positive, with over 250 institutions to date having committed to applying the code, but it is too early to say whether the code will achieve its objective of increasing the quantity and quality of engagement.

If it does not, then there is a risk that the 'comply or explain' approach will be perceived by sceptics to have failed. This would be wholly unfair given its track record in the UK over the last 20 years, but in the continuing aftermath of the financial crisis nothing can be taken for granted.

So there is a need to demonstrate that 'comply or explain' continues to deliver strong and effective governance, and is taken seriously by companies and investors. Failure to do so could result in an approach that is more prescriptive about the way companies organise themselves, and could give more power to regulators at the expense of shareholders.

2. Corporate governance and smaller businesses

Tim Ward, the Quoted Companies Alliance

One size does not fit all quoted companies and this is particularly true in the area of corporate governance. Premium Listed companies have a prescribed corporate governance code, while Standard Listed and AIM-quoted companies have more flexibility about the corporate governance regime that they can choose to adopt.

The Quoted Companies Alliance sees corporate governance as a code of behaviour expressing how management teams in companies should act and be organised (governed) both to create and protect value on behalf of shareholders.

We believe that the purpose of corporate governance is to create and maintain a flexible, efficient and effective framework for entrepreneurial management that delivers growth in shareholder value over the longer term.

Any aspect of a company's behaviour, structure and organisation should be capable of being tested against the question: "How is this designed to deliver growth in shareholder value over the longer term?"

The London Stock Exchange has said that the UK Corporate Governance Code (the Code) serves as a standard to which public companies should aspire, but full adherence should not necessarily be the expectation for all AIM companies.

The Quoted Companies Alliance's 'Corporate Governance Guidelines for Smaller Quoted Companies' (the QCA Guidelines) apply key elements from the Code and other relevant guidance to the needs of small and mid-size quoted companies for which the Code may not be entirely or directly relevant due to their size or relative lack of complexity.

The QCA Guidelines

These 12 guidelines endorse the 'comply or explain' approach and represent minimum best practice for smaller quoted companies. Boards should therefore consider each one carefully, and provide a reasoned explanation for any deviations.

Flexible, efficient and effective management

- **(1) Structure and process**. A company should put in place the most appropriate governance methods, based on its corporate culture, size and business complexity. There should be clarity on how it intends to fulfil its objectives, and, as the company evolves, so should its governance
- **(2) Responsibility and accountability**. It should be clear where responsibility lies for the management of the company and for the achievement of key tasks. The board has a collective responsibility for the long-term success of the company, and the roles of the chairman and the chief executive should not be exercised by the same individual
- **(3) Board balance and size**. The board must not be so large as to prevent efficient operation. A company should have at least two independent non-executive directors (one of whom may be the chairman, provided he or she was deemed independent at the time of appointment) and the board should not be dominated by one person or a group of people
- **(4) Board skills and capabilities**. The board must have an appropriate balance of functional and sector skills and experience in order to make the key decisions expected of it and to plan for the future. The board should be supported by committees (audit, remuneration and nomination) that have the necessary character, skills and knowledge to discharge their duties and responsibilities effectively

- **(5) Performance and development**. The board should periodically review its performance, its committees' performance and that of individual board members. This review should lead to updates of induction evaluation and succession plans. Ineffective directors (both executive and non-executive) must be identified and either helped to become effective, or replaced. The board should ensure that it has the skills and experience it needs for its present and future business needs. Membership of the board should be periodically refreshed
- **(6) Information and support**. The whole board, and its committees, should be provided with the best possible information (accurate, sufficient, timely and clear) so that they can constructively challenge recommendations to them before making their decisions. Non-executive directors should be provided with access to external advice when necessary
- **(7) Cost-effective and value-added.** There will be a cost in achieving efficient and effective governance, but this should be offset by increases in value. There should be a clear understanding between boards and shareholders of how this value has been added. This will normally involve the publication of key performance indicators, which align with strategy, and feedback through regular meetings between shareholders and directors.

Entrepreneurial management

- **(8) Vision and strategy**. There should be a shared vision of what the company is trying to achieve and over what period, as well as an understanding of what is required to achieve it. This vision and direction must be well communicated, both internally and externally
- **(9) Risk management and internal control**. The board is responsible for maintaining a sound system of risk management and internal control. It should define and communicate the company's risk appetite, and how it manages the key risks, while maintaining an appropriate balance between risk management and entrepreneurship. Remuneration policy should help the company to meet its objectives while encouraging behaviour that is consistent with the agreed risk profile of the company.

Delivering growth in shareholder value over the longer term

- **(10) Shareholders' needs and objectives**. A dialogue should exist between shareholders and the board so that the board understands shareholders' needs and objectives and their views on the company's performance. Vested interests should not be able to act in a manner contrary to the common good of all shareholders
- **(11) Investor relations and communication**. A communication and reporting framework should exist between the board and all shareholders such that the shareholders' views are communicated to the board, and shareholders in turn understand the unique circumstances of, and any constraints on, the company
- **(12) Stakeholder and social responsibilities**. Good governance includes a response to the demands of corporate social responsibility (CSR). This will require the management of social and environmental opportunities and risks. A proactive CSR policy, as an integral part of the company's strategy, can help create long-term value and reduce risk for shareholders and other stakeholders.

As well as setting out these guidelines, the QCA Guidelines include examples of governance structures as well as minimum disclosures.

Conclusion

One size does not fit all. While best practice should be a guide to company governance and organisation, it is not always the case that such practice should be rigidly adhered to. Directors need to do what is right for the company in its own unique circumstances and maintain an open and full dialogue with the company's shareholders.

The full version of 'Corporate Governance Guidelines for Smaller Quoted Companies' (September 2010) is available online at www.theqca.com/shop/guides/

3. Why is corporate governance so important?

Michelle Edkins, International Corporate Governance Network

Whether you consider corporate governance to be important or not will in part depend on how you think about it. If you consider it a compliance issue for the company secretary to handle and the board to sign off on, then you probably do not give it much weight. If, on the other hand, you consider it a framework within which to set operational and behavioural standards for the board, the executive management and the wider staff, then it will be an essential part of your business planning and execution.

If corporate governance practices are focused on quality leadership and management, companies are better positioned to be able to protect and enhance economic value for their long-term shareholders. The International Corporate Governance Network (ICGN) believes that there are global principles that should apply to most situations where companies seek capital from the markets. Accountability of management and boards for their actions, and transparency through timely and good-quality reporting, are widely accepted as good practice. There are more nuanced, but equally widely expected, practices articulated in many global governance principles covering the board of directors, corporate culture, risk management, remuneration, audit, and shareholders' rights and responsibilities.

In practice, global corporate governance principles provide a framework within which local codes can address the unique characteristics of each market. Flexibility — or 'comply or explain' — is important because there is no proven ideal model for corporate governance. The framework that achieves the desired behaviour at a company will be shaped by company-specific circumstances as well as wider legal and societal factors. It is important that companies and their shareholders are thoughtful about what constitutes good corporate governance in that context.

The importance of good governance practices is evidenced in strong leadership, a positive culture and robust risk management. These all encourage and reinforce behaviours that ensure company representatives act to protect the long-term interests of the company and its shareholders. The corollary is the loss of shareholder value attributable to poor governance and poor decision-making that we see reported in the media. Good governance can help companies pre-empt and prevent adverse situations.

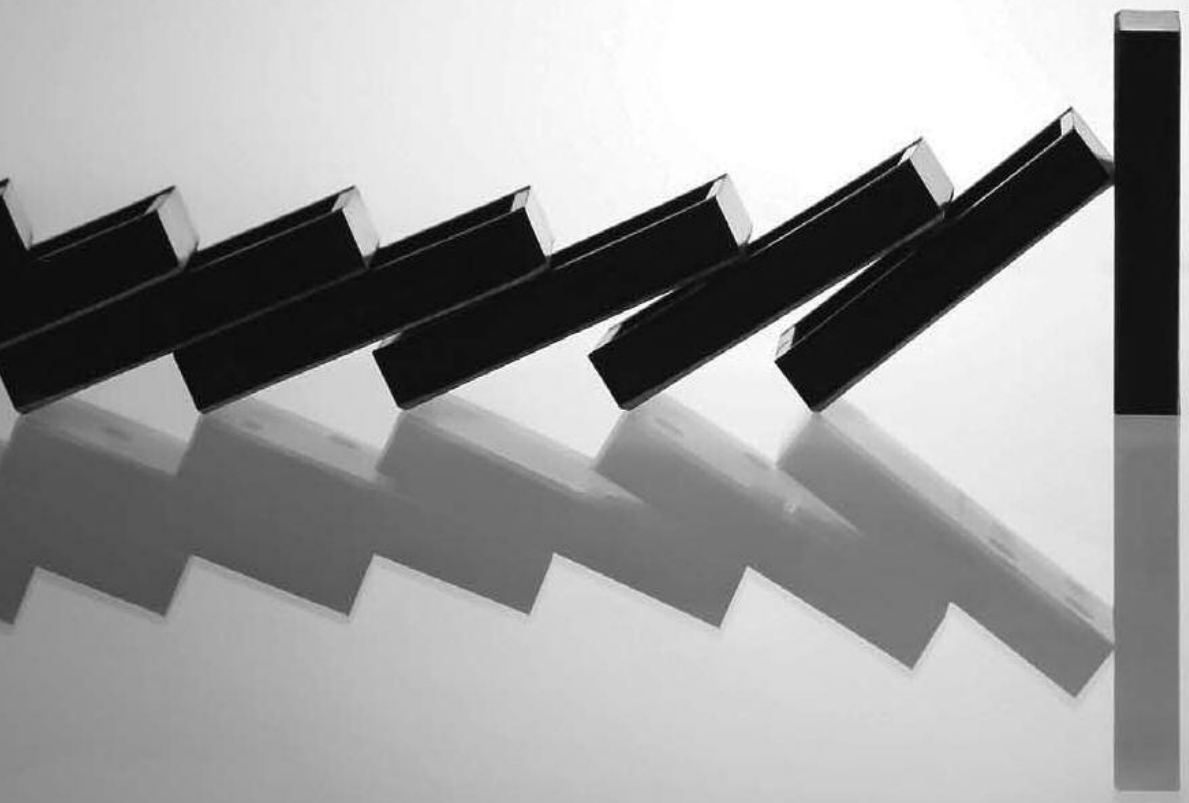
As the trend to globally diversified investing continues, it seems likely that the attention paid to corporate governance standards at a market level will increase. International investors who are less familiar with the nuances of a particular market will look to the relevant stock exchange to provide a quality mark for the companies listed by it. Similarly, international companies seeking to raise capital will be drawn to those markets where high standards attract investors and premiums. Sound corporate governance practices underpin investor confidence in a market and trust in individual company management.

Part II: Setting the scene

Chapter 4 The UK regulatory framework Page 17

Chapter 5 Corporate governance in the EU context Page 25

Accountability.



Our work for a wide range of listed companies, regulators and stock exchanges means we are ideally placed to advise on best practice and trends in corporate governance.

"The firm is praised for its depth of expertise: 'Quality is a given' while 'the extra commercial and strategic thinking adds another dimension'"

CHAMBERS UK, 2011

SLAUGHTER AND MAY

www.slaughterandmay.com

4. The UK regulatory framework

Frances Murphy and Padraig Cronin, Slaughter and May

The UK regulatory framework for corporate governance comprises a number of sources: legislation, particularly the Companies Act 2006; the Listing Rules (the LR), the Disclosure and Transparency Rules (the DTR) and the Prospectus Rules (the PR), which are made and enforced by the Financial Services Authority as the UK Listing Authority (UKLA); the UK Corporate Governance Code (the Code) and the UK Stewardship Code for institutional shareholders, which are the responsibility of the Financial Reporting Council (FRC); and the Takeover Code, which is issued and administered by the Takeover Panel.

The legislation and regulations establish basic standards of conduct and transparency, while the non-statutory codes of practice use self-regulation as a means of maintaining good corporate governance.

As described in the FRC's 'Effective Corporate Governance' guidelines, the overall effect of this regulatory framework is to create a principles-based system of corporate governance, based on proportionality, flexibility and targeting, that cannot be achieved through a 'one size fits all' approach.

The 'comply or explain' approach to corporate governance

Under the LR and DTR, a listed company must report to its shareholders on how it has applied corporate governance guidance and, where it has not applied the guidance as envisaged, provide an explanation as to why it has not done so. Shareholders can then decide whether they are satisfied with the company's corporate governance practices.

The 'comply or explain' approach is the FRC's alternative to a strict rules-based system of corporate governance. The FRC recognises that a company may prefer not to adopt a provision of the Code, or other guidance, if good governance can be achieved by means more suited to the culture and organisation of the individual company. The advantage of this approach is that when making decisions on governance practices, the board can make judgements on a case-by-case basis, taking into account the size and complexity of the company and the nature of the risks and challenges it faces.

'Comply or explain' relies on shareholders and boards to scrutinise their companies. Accountability to shareholders in particular underpins the UK corporate governance system. The regulatory framework described above is designed to ensure that shareholders have the requisite information to judge the governance practices of the company, and the rights necessary to hold the board to account if such practices are found wanting.

In order to satisfy the information requirement, companies must explain their reasons for not following guidance clearly and carefully to shareholders. The FRC states in the Preface to the Code that, in providing an explanation, companies should aim to illustrate how their actual practices are both consistent with the principle to which the particular provision relates and contribute to good governance.

Shareholders can then discuss the position with the company and may take action to influence the board using their voting powers. Section 168 of the Companies Act gives shareholders the ability to appoint and dismiss individual directors, while Sections 303 to 305 give them the right to call a general meeting of the company. The Code states that companies included in the FTSE 350 index must put all their directors forward for re-election each year, or explain why they have not done so. Shareholders of companies with securities listed

on a regulated market, such as the Main Market of the London Stock Exchange, also have an advisory vote on directors' remuneration and will, from late 2013, have a binding vote on pay policy and exit payments.

The UK Corporate Governance Code

The Code consists of five sections: Leadership, Effectiveness, Accountability, Remuneration and Relations with Shareholders. Each section contains Main Principles, Supporting Principles and Code provisions. The Main Principles set out broad tenets of good corporate governance practice; the Supporting Principles and more detailed Code provisions expand on the Main Principles.

The current edition of the Code was published in May 2010. A revised version of the Code is scheduled to apply from October 1, 2012.

Summary of the Main Principles

Leadership
Every company should be headed by an effective board that is collectively responsible for the long-term success of the company. The chairman is responsible for leadership of the board and the chief executive for the running of the company's business. The board should include non-executive directors whose role it is to constructively challenge and help develop proposals on strategy.

Effectiveness
The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.

The updated Code will incorporate a requirement that the board consider board diversity, including gender, when making new appointments.

Accountability
The board is responsible for maintaining sound risk management and internal control systems. The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditor.

Remuneration
Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully. A company should avoid paying more than is necessary and a significant proportion of executive directors' remuneration should be linked to performance. There should be a formal and transparent procedure for developing policy on executive remuneration.

Relations with Shareholders
There should be a dialogue with shareholders based on the mutual understanding of objectives. The board should use the annual general meeting to communicate with investors and encourage their participation.

In the 'comply or explain' section of the Preface to the Code, the FRC states that the Main Principles are the core of the Code and that the way they are applied should be the central question for a board as it determines how it is to operate according to the Code.

The Code is not a rigid set of rules, and the FRC has drafted the Supporting Principles broadly to give companies the flexibility of deciding their own method of implementation. In addition, the Code reflects the fact that some provisions are more applicable to companies of a certain size than others. For example, B.7.1 on the annual re-election of directors applies only to companies in the FTSE 350, and B.1.2 on the composition of the

board and C.3.1 on the audit committee distinguish between companies that are in the FTSE 350 and those that are not.

Meaningful explanations

The FRC is proposing to set out in the Preface to the Code those features that it regards as characteristics of an informative explanation. Although the Preface serves only as guidance to the Code, the FRC intends that identifying these features will help companies understand what is expected of them when they choose to deviate from the Code, and will provide shareholders with a benchmark against which to judge explanations. An FRC February 2012 consultation paper — 'What constitutes an explanation under "comply or explain"?' — identified that an explanation should:

- set out the context and historical background
- give a convincing rationale for the action the company is taking
- describe mitigating action to address any additional risk and maintain conformity with the relevant Principle
- indicate whether the deviation from the Code is limited in time and when the company intends to return to conformity with the Code.

In addition, participants in the consultation felt that explanations should be specific to a company's position, and not generic or 'off the shelf'. Explanation should apply to deviations from the provisions of the Code, and not just to deviations from its Main Principles.

Reporting obligations for Premium, Standard and AIM companies

The extent of a company's obligation to 'comply or explain' depends on the nature of the listing of that company's securities.

Companies applying to admit securities to trading on the Main Market of the London Stock Exchange must have their securities admitted to the UKLA Official List. Since April 6, 2010, there have been eight 'listing categories' on the UKLA Official List. The listing categories set out distinct listing obligations for specific security types and issuer types. Each category falls into one of two high-level 'segments', Premium or Standard. A Premium Listing is only available to equity shares issued by trading companies and by closed and open-ended investment entities. Standard Listings cover shares, global depositary receipts (GDRs), debt and securitised derivatives. In order to be eligible for the FTSE UK Index Series, which includes the FTSE 100 index, a company must have a Premium Listing.

Companies with a Standard Listing must comply with EU minimum requirements on corporate governance disclosure, namely the Statutory Audit Directive and the Company Reporting Directive. These directives were implemented in the UK through the DTR. Companies with Premium Listed equity shares are subject to more stringent UK disclosure standards in addition to the EU minimum requirements.

There is no 'comply or explain' obligation on companies admitted to AIM. However, the London Stock Exchange's 'A Guide to AIM' states that companies seeking admission to the market must publish an admission document that includes a statement on whether or not the company complies with its home country's corporate governance regime, and if not, an explanation as to why. The guide goes on to state that compliance with the Code by AIM companies is widely regarded as good practice and has become expected of larger AIM companies. Many investing institutions expect their investee AIM companies to comply with the Code or set out the reasons for non-compliance in much the same way as Main Market companies.

DTR 7.2: 'Comply or explain' for Premium and Standard Listings

DTR 7.2 sets out the 'comply or explain' obligation for companies whose securities are admitted to

trading on a regulated market. This includes all companies with a Premium or Standard Listing of securities on the Main Market of the London Stock Exchange. (Overseas companies issuing GDRs and companies issuing convertible bonds are subject to the same corporate governance reporting requirements as a company with a Standard Listing of equity shares. Debt issuers are not required to adhere to the Code or make the corporate governance statements specified under DTR 7.2.)

Under DTR 7.2, such companies must make a corporate governance statement in the directors' report, in a separate report published with the annual report, or on the company website. If the governance statement is published on the website, the directors' report must include a cross-reference to the statement.

Where the corporate governance statement is set out separately from the directors' report, the statement must, under Sections 419A and 447 of the Companies Act, be approved by the board and signed on its behalf and filed with the Registrar of Companies.

The company's corporate governance statement must identify the governance code to which the company is subject. LR 9.8.6R (5) and (6) provide that Premium Listed companies are subject to the Code. Standard Listed companies are not subject to the Code but must refer to any corporate governance code with which they have voluntarily decided to comply.

Premium Listed companies and those Standard Listed companies voluntarily applying a corporate governance code must state the extent to which they depart from the relevant corporate governance guidance and their reasons for doing so. If a company decides not to apply any provision of a code, it must explain its reasons for that decision.

LR 9.8.6R (5) and (6): Premium Listed companies

Under LR 9.8.6R (5), a UK incorporated company with a Premium Listing of equity shares must include a 'comply or explain' statement in its annual financial report setting out how the company has applied the Main Principles of the Code. LR 9.8.7R and LR 9.8.7AR make the same provision for Premium Listed companies incorporated outside the UK. There is no prescribed form for this statement; as is clear from the examples in the panels on the right and over the page, companies tend to report on their governance policies by exception, specifying any special circumstances that have led them to divert from the Code approach.

The Preface to the Code encourages chairmen to report personally in their annual statements on how the principles relating to the leadership and effectiveness of the board have been applied. The FRC believes that this may make investors more willing to accept explanations when a company chooses to explain rather than to comply, and may reduce "the fungus of boiler-plate" that the FRC regards as dead communication.

LR 9.8.6R (6) provides that the statement must set out whether the company has complied during the accounting period with all the relevant provisions of the Code, and if it has not, describe:

- those provisions that the company has not complied with
- for provisions of a continuing nature, the period within which the company did not comply with those provisions
- the company's reasons for non-compliance.

This must be done in a manner that enables shareholders to evaluate how the Main Principles have been applied.

DTR 7.2.4G provides that a Premium Listed

company complying with LR 9.8.6R (6) will satisfy the requirements of DTR 7.2.2R and DTR 7.2.3R.

LR 9.8.6R (6) does not require Premium Listed companies to comply with the Code. In accordance with the UK's principles-based system of regulation, it requires companies to state whether they have complied with the Code, and explain and justify any non-compliance. Smaller listed companies may judge that certain provisions of the Code, such as those on re-election of directors, are disproportionate or less relevant in their case. However, such companies may adopt provisions of the Code if they consider it appropriate.

AIM companies

The obligations to 'comply or explain' under DTR 7.2, LR 9.8.6R (5) and (6) and LR 9.8.7 apply to companies whose shares are listed on a regulated market. AIM is not a regulated market for this purpose.

The AIM Rules for Companies do not require adherence to a particular set of corporate governance rules. The London Stock Exchange believes that a blanket requirement to 'comply or explain' by reference to a particular code would not be appropriate for the predominantly smaller, growth-stage companies that make up AIM's constituent members. The London Stock Exchange's 'Inside AIM' newsletter (issue 2, July 2010) stated: "Such a step may simply be seen as 'more regulation' rather than as a beneficial set of practices to improve the running of a company and the interaction between board and shareholders." For many AIM companies, according to a 'A Guide to AIM', the costs of full compliance with the Code would outweigh the benefits to the average shareholder.

Instead, the AIM regulatory framework relies on the 'Nomad system' to assist companies with the application of corporate governance guidance. A company seeking to join AIM must appoint a nominated adviser (Nomad), who will help the company come to market.

Under the current AIM Rules for Nominated Advisers, a Nomad should "consider, with the

Company examples

Premium Listed companies frequently report by exception on their compliance with the Code. For example, on one company website, under 'Governance code compliance', it is stated that "[the company] complied throughout 2011 with the provisions of the UK Corporate Governance Code, except in the following aspects ..."

One major UK food retailer stated in its annual report for 2010-11 that it did not comply with Provision B.6.2 of the Code, which requires that every three years there should be an externally led evaluation of the board's performance. Although an externally facilitated evaluation was due in 2010, the chairman's statement explained that, given the extensive board and senior management changes that had taken place in 2010, it was decided to defer the external evaluation for a year.

An international oil and gas company states on its website that it did not comply in 2011 with Provision D.2.2 of the Code, since the remuneration of the chairman is not set by the remuneration committee. Instead, the chairman's remuneration is reviewed by the remuneration committee, which makes a recommendation to the board as a whole for final approval, within the limits set by shareholders. The company explains the reasoning behind this wider process, namely that it permits all board members to discuss and approve the chairman's remuneration, rather than solely the members of the remuneration committee.

Company examples

In its 2011 annual report, an AIM company reports by exception on compliance with the QCA Guidelines. For example, it states that the board does not, contrary to the recommendation in QCA Guideline 5, undertake performance evaluation of the board, its committees and its individual directors. The company does not explain why this is so.

The website of another AIM company states that it is committed to a level of compliance with the main provisions of the Code, in so far as they are considered to be appropriate for a smaller quoted AIM company.

The 2011 annual report for a further AIM company states that it intends to adopt policies and procedures that reflect the Code so far as the Code is consistent with the QCA Guidelines.

The examples of compliance with the Code by companies on the Main Market and AIM highlight the application of the Code in practice. Whether the approach a particular company is taking is considered appropriate is, consistent with the philosophy underpinning this aspect of UK regulation, left to the investors in the company to decide.

directors of an applicant, the adoption of appropriate corporate governance measures". Nomads are expected to work with their AIM company clients to establish the corporate governance standards with which the company will comply by reference to size, stage of development, business sector, jurisdiction and so on. The London Stock Exchange encourages companies to use the Code or the 'Corporate Governance Guidelines for AIM Companies' from the Quoted Companies Alliance. The QCA Guidelines are based on the provisions of the Code but are less prescriptive.

& who, when, where whatever it takes

When it matters most, you need a firm you can rely on to deliver.

At Freshfields we've worked on more cross-border M&A in the last five years than any other law firm. In recent years we've advised on over half the in-depth merger investigations by the European Commission. And we're currently handling more high-value arbitration cases than any other firm, worth over $80bn.

With over 2,500 lawyers around the world, we give you the absolute commitment to solve problems and achieve your goals.

Freshfields

freshfields.com

Freshfields Bruckhaus Deringer LLP

5. Corporate governance in the EU context

Vanessa Knapp OBE, Freshfields Bruckhaus Deringer LLP

Historically, the European Union has taken a rather piecemeal approach to corporate governance. There have been some initiatives on individual issues but member states have largely been left to put their own governance frameworks in place.

Good corporate governance needs to take account of a particular country's company laws (which, for example, influence board structures and shareholder rights) and shareholder profiles (from widely dispersed ownership to controlling shareholders). This has led to some differences in the corporate governance rules of the various member states, and, particularly in the wake of the financial crisis, there have been calls for a more harmonised approach across the EU.

Developments at EU level

2003 Action Plan

The first steps towards such an approach came in 2003 when the European Commission released an Action Plan (the Plan) on company law and corporate governance for consultation. The main objectives of the Plan included strengthening shareholders' rights and increasing the efficiency and competitiveness of businesses, partly by adopting a common view within the EU on corporate governance rules.

The Commission made it clear that it did not intend to introduce a European Corporate Governance Code but rather wanted to co-ordinate the national corporate governance codes through initiatives in a few key areas, including:

- directors' remuneration, where the focus was on encouraging member states to put regulations in place to increase transparency and give shareholders more influence over directors' compensation packages
- requiring listed companies to publish an annual corporate governance statement, to disclose the key elements of their governance structures and practices
- common minimum standards for nomination, remuneration and audit committees
- the creation of a European Corporate Governance Forum to encourage further co-ordination of the national codes and their enforcement.

Recommendations on directors' remuneration

In 2004 the Commission adopted a recommendation on the remuneration of directors of listed companies. EU recommendations are not binding on member states, but may be a precursor to legislation.

This recommendation proposed disclosure of detailed remuneration information for individual directors, that a policy on directors' remuneration for the following year should be submitted to a binding or advisory vote at the annual general meeting, and that there should be prior shareholder approval of share and share option schemes. The information that the Commission proposed should be disclosed is similar to the details that quoted companies (in other words, UK companies whose equity shares are listed in the European Economic Area or admitted to dealing on the New York Stock Exchange or Nasdaq) must include in their directors' remuneration report, in accordance with the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

A Commission report in 2007 found that a large majority of member states had introduced high disclosure standards for the remuneration of individual directors. However, disclosure of the remuneration policy had not been widely adopted and few member states had recommended a shareholder vote on remuneration criteria,

although most had either recommended or required shareholder votes on share-based incentive schemes.

In 2009 the Commission adopted a recommendation on the structure of directors' compensation designed to encourage focus on the long-term performance of the company, to link compensation to performance and to prohibit severance pay for directors in the event of inadequate performance. It also proposed strengthening the role of remuneration committees and called for an increase in the monitoring of the system by shareholders. A separate recommendation set out principles on the remuneration of risk-taking staff in financial institutions.

In June 2010 an evaluation report from the Commission on the member states' implementation of the 2009 recommendations found that a relatively high number had either not taken up any of the measures or had taken measures that were unsatisfactory.

Board composition

In 2005, the Commission published a recommendation to encourage member states to reinforce the presence of independent non-executive directors on listed companies' boards. The recommendation included minimum standards for the creation, composition and role of nomination, remuneration and audit committees. It also set out when a director should be considered to be independent. A report in 2007 noted that most member states had complied almost fully or to a large extent with the recommendation.

Audit committees

In 2006, provisions in relation to the audit committees of public interest entities (which include EU entities whose securities are traded on an EU-regulated market) formed part of a Directive on statutory audits of annual accounts and consolidated accounts. Among the provisions was a requirement for at least one member of the audit committee to be both independent and competent in accounting or auditing. The provisions also set out various responsibilities for audit committees, including monitoring the effectiveness of internal control and risk management systems. These provisions have been implemented in Chapter 7 of the Disclosure and Transparency Rules for UK-listed issuers.

Corporate governance statements and internal control rules

Under the Fourth and Seventh Company Law Directives (the Accounting Directives), all listed companies in the EU must publish a corporate governance statement annually, either in their annual reports or on their website (with a reference in the annual report). Companies must set out whether they comply with their national corporate governance code or explain if they do not. They must also describe their internal control and risk management procedures. In the UK, Chapter 7 of the Disclosure and Transparency Rules implements these requirements and allows listed companies to choose whether to publish their corporate governance statement in the directors' report or in a separate statement, and also allows the directors' report to cross-refer to a statement on the issuer's website.

European Corporate Governance Forum

This was established in 2004 with representatives from member states, European regulators, issuers, investors and academics. It published statements, recommendations and annual reports on a range of topics from related-party transactions and shareholders' voting rights to the 'comply or explain' principle. Its mandate expired in 2011.

Green Papers on corporate governance: 2010 and 2011

2010 Green Paper

In response to the financial crisis, the Commission committed itself to improving corporate

governance in financial institutions. In 2010, it published a Green Paper on both this subject and remuneration policies, which included proposals on:

- how to enhance the involvement of shareholders, financial supervisors and external auditors in corporate governance matters
- how to encourage companies to establish a risk culture that promotes the long-term performance of the company
- how to improve the functioning and composition of boards to enhance their supervision of senior management
- how to change remuneration policies to discourage excessive risk-taking.

It was accompanied by a Commission Staff Working Document, which described and analysed weaknesses in corporate governance revealed by the financial crisis.

Responses to the Green Paper showed there was a broad consensus that the Commission should focus on establishing general principles and desired results for corporate governance, but leave the detailed regulations and implementation to the member states.

The Commission has also addressed the corporate governance of credit institutions in proposals to revise the Capital Requirements Directive. These include provisions dealing with the responsibilities of the board for risk and remuneration — including the need in some companies for risk and remuneration committees and an independent risk management function — and provisions aimed at ensuring that the directors are competent and dedicate adequate time to company business. Similar provisions for non-bank investment firms have been included in the proposed changes to the Markets in Financial Instruments Directive.

The revised Capital Requirements Directive is due to be implemented in member states on January 1, 2013.

2011 Green Paper

Recognising that the solutions for financial institutions put forward in 2010 might not be relevant to EU companies in general, the Commission published a second Green Paper on the effectiveness of the framework of EU corporate governance principles. This focused on:

- boards, including the diversity of their composition, the time devoted by directors to their roles, external board evaluation, directors' remuneration, the chairman's role and the board's responsibility for risk management
- shareholder involvement in corporate governance issues — and how to encourage them to be more active and take an interest in long-term performance — the role of proxy advisers and whether more minority protection was needed
- how to improve the 'comply and explain' approach and increase the monitoring and enforcement of the national corporate governance codes.

A feedback statement published by the Commission in November 2011 showed that most respondents recognised the importance of diversity in boards but rejected compulsory quotas to ensure a better gender balance. A majority were also in favour of encouraging external evaluations on a 'comply or explain' basis. Almost three quarters of respondents supported mandatory disclosure of the policy for directors' remuneration, an annual remuneration report and details of individual directors' remuneration, while a small majority favoured a mandatory vote on remuneration policy and the remuneration report.

Although most respondents agreed that the board should take responsibility for risk and ensure risk

management arrangements were effective, many felt that no further EU action was needed on this.

To promote shareholder focus on long-term performance, respondents suggested that the requirement for quarterly financial reporting be removed (now proposed in a change to the Transparency Directive). Views on more effective monitoring of asset managers and their incentive structures were more mixed. There was, however, support for clarifying provisions on acting in concert, which were thought to cause problems for shareholders. There was also support for requiring proxy advisers to be more transparent, and a small majority wanted further measures to address proxy advisers' conflicts of interest. The European Securities and Markets Authority (ESMA) issued a consultation on proxy advisers in March 2012 and published the responses in June 2012.

On the subject of extra protection for minority shareholders, most respondents thought they were already sufficiently protected and that there was no need for regulatory intervention on related-party transactions.

There was a large majority in favour of companies providing meaningful and informative explanations if they departed from a corporate governance code, but most respondents were against having a monitoring body to check the quality of those explanations.

The 2011 Green Paper also asked whether it was appropriate to have a 'one size fits all' approach for listed companies, or if there should be different codes for different-sized companies (see, for example, the French codes discussed below). A large number of respondents were opposed to this idea, many referring to the flexibility already offered by the 'comply or explain' principle and the risk of creating a 'sub-standard' category of companies. Most respondents also rejected corporate governance measures at EU level for unlisted companies.

At the time of writing, the Commission had not announced any proposals for new legislation or changes to existing legislation based on the 2011 Green Paper. These were expected late in 2012.

2012 European Parliament resolution
In March 2012 the European Parliament adopted a non-legislative resolution on corporate governance. It expressed disappointment that certain issues it considered especially important, such as directors' responsibility, independence from the company's shareholders and conflicts of interest, had not been included in the 2011 Green Paper.

The Parliament believes a basic set of corporate governance measures should apply to all companies listed in the EU, and it requested that the Commission present a proposal for the type of information to be released to shareholders in annual company reports. It believes a European Stewardship Code could be developed in collaboration with national authorities.

The Parliament supports diversity in boards and called on the Commission to report on measures taken by member states and the business sector to increase female representation on boards. If these measures are inadequate, the Parliament takes the view that mandatory rules and quotas should be imposed at EU level to raise female representation to 30 per cent by 2015 and 40 per cent by 2020.

Corporate governance approaches in the larger EU markets

France

Regulatory framework
The French Commercial Code provides that all companies whose registered offices are in France and whose financial securities are admitted to trading on a regulated market are legally required

to apply a corporate governance code — such as that published by the French Association of Private Sector Companies and the French Business Confederation, or the Middlenext code for small and mid-cap companies — and explain in their annual report which, if any, of the code's provisions have not been applied by the company and the reasons. Non-adherence to a code is permitted as long as the chairman's report (included in the company's annual report) contains an explanation and sets out the rules that the company has applied instead.

Monitoring
There is no specific body under French law responsible for monitoring adherence to the 'comply or explain' regime and there are no legal provisions granting the French markets regulator (AMF) any disciplinary power over non-compliance with the corporate governance rules. However, pursuant to the French Monetary and Financial Code, the AMF must publish an annual report on the general application of governance rules and issue recommendations for companies as to how better to apply them. This is a detailed report that analyses the implementation of the different recommendations and rules contained in the various governance codes. As a result, the recommendations are now strictly adhered to by companies listed on the CAC40 and SBF120 indices.

Germany

Regulatory framework
The German Stock Corporation Act requires listed corporations, partnerships limited by shares and European companies incorporated in Germany to comply with the recommendations and suggestions contained in the German Corporate Governance Code, or explain their non-compliance. Non-listed German incorporated companies that have issued financial instruments other than shares for trading on a regulated market within the European Economic Area, or have their shares traded on a multilateral trading facility (MTF), must also comply or explain.

Monitoring
Monitoring compliance with the rules and the contents of a company's explanatory statements is mainly the responsibility of the shareholders of the company. Neither the Government Commission on Corporate Governance nor the Federal Financial Supervisory Authority has the power to formally review a company's individual declarations of compliance.

Netherlands

Regulatory framework
The Dutch Civil Code requires all listed companies with their statutory seat in the Netherlands, whose shares or depositary receipts for shares are admitted to an MTF in the European Union or any similar system outside the EU, to state in their annual report and accounts that they have complied with the relevant sections of the Dutch Corporate Governance Code, or otherwise explain their non-compliance.

Monitoring
The Dutch Corporate Governance Code Monitoring Committee, established by the Dutch government, monitors whether a listed company has complied with the code, or explained if it has not. The Dutch Financial Markets Authority verifies whether a company has made a statement in its annual report and accounts about its compliance and may give recommendations to the relevant company as to its adherence. The contents of a company's explanatory statements are, however, only monitored by shareholders.

Italy

Regulatory framework
The Italian Consolidated Financial Act requires all issuers of securities that are admitted to trading

on a regulated market to disclose in their annual report – or in a separate report published with the annual report – the key elements of their governance structure and practices. If there is a voluntary adoption of the Italian Corporate Governance Code (ie, the code of best practices approved by the Corporate Governance Committee and promoted, inter alia, by Borsa Italiana, the Italian Stock Exchange), the companies must specify which recommendations of the code have actually been implemented, or explain the reason for any non-compliance with one or more of the recommendations.

Further, any listed companies that aim to be admitted to the STAR segment of the MTA market organised and managed by Borsa Italiana (a market segment for mid-sized companies with a share capital of less than €1 billion) are obliged to comply with certain recommendations contained in the code — in relation, for example, to independent directors, internal committees and the remuneration of directors.

Monitoring
In Italy the monitoring of corporate governance reports is provided for at several levels. In the first place, the board of statutory auditors of each issuer that adopts the code must check the arrangements for implementing the recommendations of the code that the company declares it complies with. Furthermore, the Italian Securities and Exchange Commission (Consob) verifies whether listed issuers have annually disclosed the information regarding their governance structure and practices, as well as – if the code has been adopted – the fulfilment of the 'comply or explain' disclosure obligations.

Although the Italian Association of Joint Stock Companies (Assonime, which is represented in the Corporate Governance Committee) has no official responsibility, it produces an analysis of the general degree of compliance of listed issuers with the recommendations of the Corporate Governance Code every year.

Spain

Regulatory framework
The Spanish Securities Market Act provides that all companies domiciled and listed in Spain must prepare and publish a corporate governance report on an annual basis, providing detailed information on the company's governance structure and how it functions in practice. Companies must state whether or not they comply (fully or partially) with each of the recommendations laid out in the Spanish Corporate Governance Code issued by the Institute of Directors-Administrators, and provide an explanation for each recommendation with which they do not comply fully.

In addition, following the introduction of new regulations in 2011, financial entities bailed out by the Fund for Orderly Bank Restructuring must also meet the corporate governance standards applicable to listed companies.

Monitoring
The Spanish Stock Exchange Commission monitors the fulfilment of the 'comply or explain' obligation and also monitors and analyses the explanatory statements made by the relevant companies.

Part III: Pre-IPO considerations

Chapter 6	Preparations for an initial public offering	Page 33
Chapter 7	Good governance and shareholder expectations — an investor's perspective	Page 41
Chapter 8	Does corporate governance matter for shareholder value?	Page 47
Chapter 9	Corporate governance — requirements for a UK issuer: Premium Listing, Main Market	Page 53
Chapter 10	Requirements and challenges for non-UK companies listing in London	Page 59
Chapter 11	Structuring an effective board	Page 65
Chapter 12	The prospective non-executive director	Page 75

Across tables.

Across companies.

Across continents.

Taking your opportunity further.

That's return on relationship.

baml.com/relationship

Bank of America Merrill Lynch

"Bank of America Merrill Lynch" is the marketing name for the global banking and global markets businesses of Bank of America Corporation. Lending, derivatives, and other commercial banking activities are performed globally by banking affiliates of Bank of America Corporation, including Bank of America, N.A., member FDIC. Securities, strategic advisory, and other investment banking activities are performed globally by investment banking affiliates of Bank of America Corporation ("Investment Banking Affiliates"), including, in the United States, Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch Professional Clearing Corp., both of which are registered broker-dealers and members of FINRA and SIPC, and, in other jurisdictions, by locally registered entities. Investment products offered by Investment Banking Affiliates: Are Not FDIC Insured • May Lose Value • Are Not Bank Guaranteed. TAKING YOUR OPPORTUNITY FURTHER is a trademark of Bank of America Corporation, registered in the U.S. Patent and Trademark Office. ©2012 Bank of America Corporation

6. Preparations for an initial public offering

Craig Coben and Oliver Holbourn, Bank of America Merrill Lynch

An initial public offering (IPO) is more than just a milestone for a company. A stock market listing enshrines a relationship between the company and a range of institutional and retail shareholders. Admission to trading imposes a set of regulatory obligations and responsibilities to a broad group of stakeholders and exposes a company to unprecedented public scrutiny.

When a company joins a public market, its owners are a diverse and dispersed group of investors relying upon the directors and the management to represent and further their interests. Such an arrangement creates a series of challenges, to which the solutions may be tentative and delicate. A robust corporate governance framework enables any problems to be mitigated by ensuring that the interests of shareholders are properly mediated and represented through a board of directors.

Following several aborted and disappointing flotations, corporate governance has been highlighted as an area on which companies should focus more — particularly in the run-up to an IPO, as well as once on the market. In general terms there should be alignment between investors on the one hand and the issuer/sponsor on the other in relation to corporate governance expectations at IPO.

This chapter outlines recommendations for best practice in relation to corporate governance in the build-up to an IPO. These recommendations are designed to enhance transparency and to allow the right balance to be found between accountability to shareholders and the management's necessary discretion to run the business.

As discussed elsewhere in this guide, companies with a Premium Listing on the London Stock Exchange are subject to the principles set out in the UK Corporate Governance Code (the Code) issued by the Financial Reporting Council (www.frc.org.uk). While the Code is not mandatory, it states that companies must either 'comply' with its governance guidelines or 'explain' any deviations. The details of such compliance or any relevant explanations will typically need to be included in the IPO prospectus.

The Code includes five key areas of focus — leadership, effectiveness, accountability, remuneration and relations with shareholders — in promoting disclosure, transparency and fairness, and so enabling third parties to make informed investment decisions.

Why does corporate governance matter in an IPO?

Effective corporate governance is not simply window-dressing or a public relations exercise. Rather, it informs investors about the way in which the company will be managed on their behalf and seeks to align the interests of investors and management, enhancing the overall level of trust. Good corporate governance aims to ensure that the management on the 'inside' acts in the interests of the owners on the 'outside' and that the latter can hold the former to account. In the case of a company where at IPO institutional investors are in a minority, governance is aimed at protecting those investors while still recognising the principle of 'one share, one vote'.

At IPO, institutional fund managers have the opportunity to commit capital to a company that may well have no track record in the public markets and with which they may not be overly familiar. In some instances, the directors may not have run public companies before and their abilities and reputation may not be well known.

The challenges for a company considering an IPO are significant — not just to convince a potential

investor of the merits of the company, but to do so in the context of a portfolio decision where an investor may have to sell an existing holding in order to raise funds to back that IPO. Put simply, strong corporate governance reassures investors that the company will be managed in a way that takes their interests into account.

Corporate governance is particularly important where the IPO involves the sale of less than 50 per cent of the company's issued share capital. New shareholders will be in a minority position versus, potentially, one or two large major shareholders. Through an effective corporate governance framework and communication of the company's approach, directors can reassure minority investors that their interests will be protected.

High standards of governance are clearly also in companies' interests. The transparency afforded by clear governance enables investors to appreciate how the risks of their investment might be mitigated. Naturally, this lowering of risk should be met by a commensurate increase in valuation.

How important is corporate governance for investors at the IPO stage?

Institutional investors have a wide range of views on the subject, but several leading UK institutions have told us that they are unlikely to invest in IPOs of companies where the standard of corporate governance is not satisfactory. In particular for larger companies, having a fully independent board at IPO is seen as an important investment benchmark. The view of many larger institutions is that the 'spirit' behind the 'comply or explain' framework is to comply where possible and explain where not (rather than being a choice between the two).

For other investors, weak corporate governance — for example, where there is a controlling shareholder post IPO, and the board is not seen as a strong enough counterbalance — may not be a bar to investment, but they will demand a discount to the 'fair value' of the company as compensation. In this way, good corporate governance can and should decrease the 'risk premium' associated with an IPO investment.

An often cited concern is that corporate governance is often not given enough 'air time' during the IPO process, and that it can be seen as an afterthought in the marketing. The appointment of board members typically happens later in the IPO process than investors would like, and there is also a feeling among investors that they are often not given enough time with members of the board outside the executive management team. Companies considering an IPO are encouraged to take this investor feedback on board.

The 'comply or explain' regime, meanwhile, only allows for an assessment of the company at the point of listing, and investors believe that such a 'snapshot' creates the temptation to comply with the 'letter' but crucially not the 'spirit' of the Code, exalting form over substance and defeating the overall purpose of the Code.

There have been some high-profile IPO cases where the 'letter' of the Code was complied with but arguably the 'spirit' was not. Sometimes these have involved companies whose business is conducted in countries where corporate governance thinking and practice is less developed than in the UK. In one instance the company put in place a full review of governance standards post IPO to address concerns from shareholders. This highlights the importance that the UK investment community places on corporate governance.

Where a company has explained a situation in which it has not complied with the principles of the Code, the prospectus should, for example, articulate the intentions of the company to comply in the future, with management setting out a roadmap to compliance. The company should also

monitor its progress against its stated intentions and communicate this progress to investors — particularly if the company has not fully complied with the Code guidelines at the time of the IPO.

We are not advocating a strict approach to governance. Compliance with the Code entails significant time and expense and this burden explains why some investors do not make full compliance a condition of supporting an IPO. On the other hand, a listing often requires many months or indeed years of preparation, and so most issuers should be able to address corporate governance if they make it a key priority.

Several investors have commented that when they meet an IPO candidate, even at an early stage, they expect that company to have already appointed senior board members who are demonstrably and unimpeachably independent, and who have a track record in the public markets.

Ensuring strong corporate governance at IPO — where does the responsibility lie?

Several parties play an integral part in ensuring that a company seeking a listing has a framework in place to uphold good corporate governance.

This framework, and the disclosure of the company's governance arrangements, should be contained in the IPO prospectus. The content of the prospectus — which is set out in the Listing and Prospectus Rules — is overseen by the Financial Services Authority, which will only approve the prospectus once it is comfortable that the disclosure is satisfactory.

The FRC oversees the Code, which sets out the level of governance expected in a listed company. The FRC has no role in scrutinising disclosure at IPO, however.

Companies seeking a Premium Listing on the London Stock Exchange are required to appoint a sponsor, which is usually an investment bank acting as a bookrunner on the offering. While the responsibility for prospectus disclosure and complying with the Listing Rules lies with the company, the sponsor's ongoing connection to listed markets means that it faces reputational risk and potential actions should the disclosure prove materially incomplete. Prior to the listing, sponsors must write an eligibility letter to the UK Listing Authority, following review and analysis, setting out how they believe the company satisfies eligibility criteria in the Listing Rules. Sponsors can also play a key role in helping the company to understand the importance of good governance when board appointments are being made, and in putting the best overall governance structure in place.

Investors also have the power to express dissatisfaction with the governance structure. By not participating in an IPO or demanding a valuation discount, investors can show their unease with corporate governance standards in a powerful and direct way, reinforcing the voluntary Code and 'comply or explain' regime.

Applying the principles of the Code — what is best practice?

The Code is aimed at ensuring that shareholders' interests are properly represented within the governance of a company. While issuers may develop a framework that is in formal compliance with the Code but at odds with its 'spirit', our research shows that the market gives equal weight to complying with both the 'spirit' and the 'letter' of the Code.

Although there are only five areas of focus, adopting the Code can be a daunting prospect for companies. As discussed elsewhere in this guide, there are several facets to the Code requiring a degree of interpretation. It is laid out as a set of principles to offer flexibility to issuers, while the

option of explanation serves to balance any non-compliance.

Section A: leadership

Ensuring an effectively functioning board ahead of an IPO may seem obvious to any issuer, but it is the balance of leadership and structuring of the board that is important. The structure of the board will also have the biggest influence on the way in which corporate governance will be adopted on an ongoing basis.

There should be a split of control, and no subset of individuals on the board should dominate. The chairman should lead the board and there should be a clear division of responsibilities between the chairman and the chief executive. The chairman should take responsibility for ensuring effective communication with the shareholders.

To ensure he acts in an independent manner, the Code states that the chairman should not have previously been the chief executive of the company. In most cases, this is the most prudent structure and the preference of the market.

However, there are certain circumstances where it is understandable, and beneficial to the company, if the chairman has had a previous involvement in its operations. This is most common in businesses where the chairman is the major shareholder and founder but no longer wishes to be chief executive. Investors can accept this type of non-compliance with the Code, although in situations like this it is advisable to have a strong pool of independent non-executive directors to maintain a balance in the boardroom. In these cases, the senior independent non-executive director will often act as the de facto point of contact for the shareholder community.

Alongside a chairman, the senior independent non-executive director is a role that should be filled as early as possible in order to provide a sound platform for taking the company public and to ensure the right corporate governance structure is put in place.

While a company may not have appointed all of the independent board members at the stage of early meetings with investors, the company should have commenced plans to recruit such personnel, and investors will expect some of the most important roles to have been filled. Often, senior fund managers with extensive experience of UK plcs may be able to provide suggestions as to who may be available, suitable and worth approaching to join the board.

In recent IPOs, a degree of criticism has been levelled at companies for the appointment of so-called independent non-executives where there is an existing relationship with company management and this is seen as being too close. It is recommended that companies seek to avoid this association.

Section B: effectiveness

Closely linked to the leadership of the company, the Code outlines the balance of skills required by the board, recommending that for companies in the FTSE 350 at least half the board should be independent, and that below the FTSE 350 threshold there should be at least two independent directors. The board is expected to identify those members it considers independent in the IPO prospectus.

For companies seeking a Premium Listing on the London Stock Exchange, the Code states that non-executive members of the board should not hold their role for a long duration — “any term beyond six years … should be subject to particularly rigorous review” — but rather be regularly refreshed in order to maintain their independence and impartial oversight of the company.

While we believe that full adoption of corporate

governance standards should be the focus in an IPO, there has been a degree of understanding among investors where a clear intention to make the transition to a majority independent board is stated at IPO but not fully achieved by that time. A good recent example of this was the IPO of Jupiter Fund Management in 2010 which stated that: "As the shareholding of the TA Funds (Private Equity Owner) reduces over time … the Company would intend, unless it had already done so, to appoint new independent non-executive directors at that point so that at least half of the Board (excluding the Chairman) will be independent and non-executive in compliance with the UK Corporate Governance Code."

Given the relatively short tenure of a non-executive's role, the Code suggests that companies should have a clear succession plan in place to find new non-executives. This process should include a majority independent committee led by the chairman or senior independent non-executive.

Clearly, the inaugural selection of non-executives cannot be conducted in this way. A senior non-executive and chairman, appointed at an early stage, will be best placed to lead the process of recruiting additional non-executives. The input of investors and advisers in identifying potential candidates can help the process.

Section C: accountability

While it is not possible to judge the past performance of the board in the same way as for an established public company, the role and skills of each board member should be explained within the prospectus so that the performance against these criteria can be reported upon in the financial reports. The audit committee, which should consist of a majority of independent members, should provide a key function in monitoring the boards' performance against these specifications and report back to investors.

In terms of preparing for an IPO, it is important to ensure that the objectives of the board and expectations of specific board members are agreed and can be articulated. This will be beneficial in attracting the best-quality investors to the company and delivering a clear strategy. The chief executive, chairman and senior independent non-executive should take the lead in these discussions in the run-up to admission to the market.

Section D: remuneration

It is expected that remuneration will be fair, linked to the long-term performance of the company and set at the right level to attract talent to the company board. Companies should operate a transparent policy and decisions should be driven by the remuneration committee.

During the listing preparation, recruiting new non-executives will be a key area of focus and remuneration will naturally play an important role in this. We would recommend, as a minimum, that rewards for board members are benchmarked against peer groups and discussed with potential investors to ensure a fair rate is being paid. See chapter 20 for more detail on executive pay.

Given the increased political and media attention on the compensation of board members, we believe remuneration should also be clearly linked to a combination of tangible factors such as long-term total shareholder return and return on capital employed, along with other appropriate measures depending on the business. The head of the remuneration committee should also engage with the company's largest shareholders for regular confirmation of their support for the proposed remuneration strategy.

Section E: relations with shareholders

It is clear that, regardless of jurisdiction, a company's relations with institutional shareholders need to be maintained in an open and transparent way. This is vital to achieving and maintaining a

'healthy' listing. The chief executive, chairman and senior independent non-executives are likely to act as the senior points of contact with investors on substantive issues.

In the listing preparation, it is important to establish a system for communicating with investors both in the short and long term. Corporate brokers provide a day-to-day touchpoint with the market but companies should also be looking to appoint an investor relations expert to ensure there is always someone available when investors need to ask questions. This professional should have a strong understanding of the business and ideally be in place ahead of the listing to take part in the IPO roadshows.

Should there be any differences in governance between Premium, Standard and AIM companies?

A Premium Listing on the London Stock Exchange's Main Market is regarded as the gold standard for companies seeking to list in London and therefore should apply the highest standards of governance. AIM is designed for smaller companies that are often at an earlier stage of their development and looking to expand rapidly, and therefore offer a higher-risk/higher-reward proposition. For companies quoted on AIM, there is no requirement for compliance with the Code, and it is carried out on a voluntary basis.

While smaller companies may find it uneconomical to put in place a board and corporate governance standards akin to those expected of companies in the premium sector, there are certain aspects of the Code that should be adhered to, including reviewing board effectiveness and publishing governance procedures in the annual report. Further, the approach to standards should be conducted in the same way as it is at a company seeking a Premium Listing. It is worth bearing in mind that often it will be the same group of investors looking to make an investment at IPO.

Similarly, Standard Listings on the London Stock Exchange are not required to adhere to the Code, although a company would still be required to make a statement in the annual directors' report as to its governance practices. It is best practice for a company seeking a Standard Listing to work within the framework of the Code where possible.

Conclusion

When a company is making a decision on whether it should list its shares on the London Stock Exchange, corporate governance is a key piece of the puzzle. Running a public company effectively will more often than not require a change of mindset from operating as a private company.

Our recommendations for best practice centre on full disclosure and early planning in order to achieve full compliance with the Code at IPO. Companies and their advisers should:

- work towards having all board members in place prior to announcing an intention to float
- give greater prominence to corporate governance during the IPO marketing process and in IPO documentation
- ensure that board appointments for the purposes of compliance with the Code do not create succession issues
- articulate the intent of the company, in the listing prospectus, to comply with the Code in the future where it is not already doing so
- regardless of whether the company is seeking a Premium or Standard listing, or an admission to AIM, a company should strive to achieve full adoption of the Code over time
- maintain high standards of governance over the life of the public company.

There has been some debate around tightening the corporate governance parameters for companies

seeking to list on the Premium segment where the free float is less then 50 per cent of the issued share capital of the company, to ensure minority shareholders are adequately protected. The remit of this chapter does not allow us to debate this, but the more that companies launching an IPO are able to comply with both the 'letter' and the 'spirit' of the Code, the less discussion there should be around this topic over time.

A listing on the London Stock Exchange is a prestigious achievement. It is the start of a new leg of a company's life cycle and it represents the culmination of a lot of hard work by the company and its advisers. Getting the right corporate governance structure in place at the time of the IPO should help ensure that the company can capitalise on the achievement of listing and grow and prosper in the future.

GLASS
LEWIS & Co.

Making every vote count.

Glass, Lewis & Co. is the leading independent governance analysis and proxy voting firm, serving global institutional investors that collectively manage more than $15 trillion in assets. With research focused on the long-term financial impact of investment and proxy vote decisions, Glass Lewis empowers institutional investors to make sound decisions by uncovering and assessing governance, business, legal, political and accounting risk at more than 23,000 companies in over 100 countries.

Contact us for more information: info@glasslewis.com +1 888.800.7001

GLASSLEWIS.COM

7. Good governance and shareholder expectations — an investor's perspective

Robert McCormick, Glass, Lewis & Co LLC

As companies consider joining a public market for the first time, they should consider shareholder expectations and be responsive to shareholder concerns. These expectations are not confined to company performance, strategy and growth, but also include broad corporate governance issues and the opportunity for shareholders to engage in regular discussions with management and the board. Shareholders are also encouraged to engage with companies under the Stewardship Code, launched by the Financial Reporting Council in July 2010, with the goal of promoting and enhancing engagement between institutional investors and companies to improve long-term returns.

Executives and directors should be prepared to engage with shareholders not just after the company has been admitted to trading but as part of the company's IPO preparation to address any investor concerns before listing. In addition, pre-IPO engagement will foster trust in the company, potentially increasing investor take-up in the company's initial stock offering since shareholders will be more comfortable investing in companies where they have already developed a working relationship with management and the board. Since it takes some time for management and the board to develop a rapport with investors, the relationship-building process is better begun during the period leading up to the IPO to facilitate engagement and build a foundation of trust after going public.

Whereas private companies may have a relatively small number of shareholders — who share goals, perspectives and tolerances to risk — public companies, particularly large companies, often have many thousands of shareholders, with different or even competing aims that could be influenced by everything from time horizons to investment strategy. Companies, then, must understand the diverse expectations of a growing shareholder base, balance and manage these expectations, and then respond appropriately.

The standards sought by shareholders

Shareholders may make some allowances for companies new to the market and give them the time and discretion to meet broad corporate governance standards, codes of best practice and their own expectations. However, shareholders expect immediate compliance with certain standards of corporate governance best practice set out in the Financial Reporting Council's UK Corporate Governance Code (the Code), and with the relevant rules of the London Stock Exchange and the Financial Services Authority (FSA). In particular, shareholders look for high levels of board independence, transparency and prudent remuneration practices.

Shareholders often seek direct discussions with executives and directors both to learn about the company and to share their perspectives and, if necessary, their concerns. Engagement is often focused on company performance, director oversight and remuneration. When engagement fails or significant concerns remain unaddressed, such as when a company fails to comply with the Code and does not provide a thorough explanation, shareholders may sell their shares, agitate for change or try to replace directors.

Directors

Shareholders view directors as their representatives in the boardroom. Therefore, they want directors who will hold management to account and be responsive to investors' concerns, including meeting them when necessary. Shareholders want boards

that not only satisfy the independence thresholds and standards set out in the Code, but are also composed of directors with a track record of high performance and robust oversight at companies where they have previously worked and served as directors. Shareholders rarely unseat board members except in cases of egregious oversight lapses; even then, most directors would choose to resign rather than lose a vote.

Remuneration

Remuneration should be one of the most transparent aspects of a public company's governance and easy to measure against the company's performance. On a basic level, shareholders expect that remuneration will be tied to performance and that the design, structure and implementation of the compensation programmes, particularly for senior executives, will be clearly linked to the long-term strategy of the company. This means shareholders want clear disclosure of the performance metrics selected by the company so that investors may understand not only how the programmes work but also how that remuneration is earned.

Shareholders expect remuneration committees to set performance targets that are stretching, tied to the strategy of the company and linked to the performance of both the company and individual. The preference is for multiple performance targets with a range of goals to reward above-average performance, relative to appropriate peers, rather than excessive focus on a single metric with an 'all or nothing' payout. Shareholders are keen to ensure that risk factors are carefully considered in the design of compensation programmes, in order to eliminate the potential for encouraging actions that threaten the viability of the company.

Since 2003, shareholders in the UK have had the right to cast a non-binding vote each year on the company's remuneration report; the UK government is now proposing a binding remuneration vote as well as a shareholder vote on exit payments above one year's salary. These proposals are still pending, but in the meantime shareholders have used the current, non-binding vote to signal their views to their boards, with majority votes against remuneration packages sometimes revealing broader concerns about the board and executives.

The remuneration vote has encouraged greater dialogue between companies and shareholders about what shareholders expect in terms of compensation design and practice. The vote has also resulted in more direct dialogue between shareholders and directors since shareholders prefer to speak directly to the remuneration committee regarding executive remuneration. If they are not satisfied with the compensation programmes even after these meetings, shareholders will vote against the remuneration report; if their concerns remain unaddressed, they may also vote against members of the remuneration committee.

Shareholder engagement

Of course, companies have always had meetings and discussions with major shareholders to discuss the financial results, business strategy and growth prospects, among other issues. However, as shareholders have broadened their examination of company practices, they have begun to formalise their engagement with companies on issues relating to governance.

More recently, this engagement has broadened further still to encompass a wider area of risk exposures, mainly relating to environmental and social factors in addition to governance issues. These three areas — typically called ESG factors — play a growing part in shareholders' evaluations of the performance of a company, its attractiveness as an investment and, in particular, how shareholders should vote at annual general meetings (AGMs). The shareholder focus on ESG factors — and on seeking evidence that the company has sustainable business practices —

has become sharper in the wake of the environmental and safety disasters experienced by companies such as BP, Massey Energy and Tokyo Electric. Engagement on these issues has therefore grown considerably.

The Stewardship Code sets forth several principles relating to investors' responsibilities, including those that encourage shareholders to meet with boards of investee companies. The Stewardship Code requires that investors publicly disclose how they discharge their stewardship, including how they monitor companies through dialogue with investee companies and when they will escalate their intervention activities including through additional meetings with management and the board. The Stewardship Code, like the UK Corporate Governance Code which it is intended to complement, is implemented on a 'comply or explain' basis; the FSA requires, under Conduct of Business Rule 2.2.3R, that all UK-authorised asset managers disclose whether they apply the Stewardship Code.

In light of the promotion of shareholder responsibilities under the Stewardship Code, there is a growing recognition among shareholders that with rights come responsibilities. Such responsibilities include actively engaging with companies in their portfolios and the exercise of shareholder voting rights in a way that fosters long-term, sustainable performance without jeopardising the viability of the company. Some companies have convened meetings with their largest shareholders or hosted so-called 'fifth analyst calls', pioneered by Railpen Investments and F&C Asset Management, to engage with many shareholders on governance issues at one time. These calls and meetings generally occur prior to the AGM.

The differing expectations of shareholders

Engagement expectations and activities can vary greatly according to the diverse nature and aims of the different shareholders — their investment strategies and timeframes, the personnel involved and the integration of governance analysis with investment decision-making.

The most basic differences stem from active versus passive investment strategies. There are different approaches to engagement between active managers, who elect to buy and sell shares in a company, and passive managers, mainly index funds, which own shares in a company by virtue of its inclusion in an index, limiting the size of their stake and also potentially limiting changes in the size of the holding.

Active managers

Since active managers choose to buy and sell shares in a company, they may hold larger stakes in a smaller number of companies than passive managers. This gives active managers the opportunity to focus their engagement efforts. As large shareholders, they may also have more leverage with management and the board in making their voices heard, since news that an active manager is selling is likely to be viewed negatively by other investors.

On the other hand, active managers may also feel that engagement is less crucial since ultimately they can always sell the shares and buy into a company that they believe offers a better investment opportunity. However, certain active managers may be such large holders of a company's stock that they would not want to sell since it would negatively affect the stock price.

Further, buying an underperforming stock may be part of the investment strategy of the active manager, who may be looking to engage with the board and management to improve the performance of the company, including enhancing its governance. Indeed, some active investors deliberately seek out poorly performing companies on the grounds that there will be higher returns once strategic or

governance problems are addressed. For these investors, engagement is essential to their investment strategy.

To a greater extent than passive managers, active managers employ investment professionals who are very knowledgeable about each company and are therefore likely to be involved in the engagement and proxy voting decisions. Like passive asset managers, however, very large active managers also tend to employ teams of analysts devoted to governance issues. In many cases, the governance analysts make most proxy voting decisions based on guidelines promulgated by the manager's fund board of trustees.

The ability of active managers to invest according to short timeframes may influence the way they engage with companies on some issues. For example, active managers may be less likely to promote certain risk-mitigation investments made by their portfolio companies if the timeframe is overly long for the managers' expected return on these investments. Also, they may feel that they should not remain invested in a company that is performing badly or has poor ESG practices and structures, since as fiduciaries they have a responsibility to invest in companies offering better alternatives for maximising shareholder returns. Active funds may feel compelled to be more engaged with companies on at least some issues since they may be subject to the Stewardship Code or at least feel that it is their responsibility as fiduciaries to engage.

Passive investors

Passive investors include asset managers, such as index fund managers and quantitative investors, as well as asset owners — generally pension funds that use index investing as their preferred strategy. For the latter group of investors, it is likely that the asset manager makes the investment decisions while the asset owner conducts the engagement activities, at least on governance issues, and makes all proxy voting decisions.

While these investors are passive in their investment strategy, they are usually anything but passive in exercising their shareholder rights. They closely monitor their portfolio companies and engage with them when they see problems in performance or in ESG areas. As passive shareholders cannot sell their shares, the only way to improve investment performance is to push for changes at their portfolio companies via engagement.

Also, they may not hold large stakes in companies and those companies will know that the passive investors cannot sell their shares, so management and the board may be less responsive to their concerns. Therefore, passive shareholders may need to be active in seeking support from other shareholders to effect change.

Passive managers have fewer investment professionals conducting fundamental company research (contributing to the low-cost nature of the index fund strategy of some passive investors), and therefore their governance analysts may not be able to leverage the expertise of portfolio analysts or managers. Further, many passive shareholders — asset managers and asset owners alike — do not generally have teams of financial, strategic and industry-specific analysts involved in the engagement process, so they rely on the expertise of the governance analysts who lead the engagement and proxy voting responsibilities.

The Stewardship Code does not distinguish between the responsibilities of passive and active investors to engage with companies, as Principle 4 of the Stewardship Code promotes intervention to protect shareholder value regardless of investment strategy or being underweight.

Engaging with the right people

Many investors prefer to conduct their engagement with board members rather than members of management. This preference is partly philosophical: directors are elected representatives of the shareholders who are appointed to oversee management, and therefore shareholders believe there is no reason why they should be prevented from bringing their concerns directly to their representatives. But there is also a practical purpose: if the concerns are about the executives or executive remuneration, such a conversation with the management team itself is not productive.

The larger the asset manager, the more likely there is to be a group of governance professionals devoted to voting company shares and engaging with companies on governance. The investment decision-makers, portfolio managers and analysts at an investment firm, may be separate from the governance analysts in many ways — geographically, organisationally, even philosophically. The investment professionals may be less focused on certain governance aspects and therefore may be driven primarily by performance over the short term.

Companies should determine the right contact at asset managers for both portfolio analysis and proxy voting governance engagement. Companies may find that the positive view of the investment professionals is not shared by the governance analysts, who, sometimes operating in a compliance or legal function, are charged by the board of trustees with reviewing issues such as remuneration more strictly. Therefore, companies should not only develop relationships with the investment professionals at investment firms, but should also consider engaging with the governance professionals.

Shareholder recourse: when engagement fails

Shareholders have several options when they feel that their efforts to engage with a company have not been successful. Of course, active managers can simply sell their shares. However, shareholders who cannot sell, or who choose not to, have several alternatives. They can publicly announce their concerns and their intention to vote against certain directors or company proposals at the AGM. Aggrieved investors can submit their own proposals for inclusion on the company's agenda at the AGM and then solicit other investors to support these proposals.

Shareholders may also try to elect their own directors in place of incumbent director nominees — a process that is generally known as a control contest or proxy contest.

Shareholder expectations of engagement with companies continue to evolve. Even in periods of good performance and high returns, shareholders expect to play an increasingly active role at their portfolio companies. Directors of companies who actively engage with investors will be better placed to deal with any challenges that may arise.

reo®

Responsible Engagement Overlay

F&C has been a leader in the provision of engagement advisory services since 2000 when we launched our responsible engagement overlay '***reo***®' service to meet institutional investors' stewardship needs.

reo® is a global engagement and proxy voting service which can be applied across a range of asset classes.By encouraging the adoption and development of industry best practice we aim to protect and enhance investor value.

To find out more about ***reo***®, please call +44(0) 207 011 4444 or email institutional.enquiries@fandc.com

www.fandc.com

F&C Investments

8. Does corporate governance matter for shareholder value?

Karina Litvack and Eugenia Unanyants-Jackson, F&C Investments

Corporate governance is a key value driver for investors and an important determinant of investment decision-making. In moving from private to public ownership, companies gain a significantly larger base of shareholders, who, in turn, tend to hold relatively diversified investment portfolios. This means that the new minority shareholders have neither the proximity to company management nor the ability to oversee and influence decisions that can affect the value of their investments. For this reason, minority shareholders must be able to rely on appropriate corporate governance structures, risk management systems and board processes to safeguard their interests and ultimately enhance shareholder value.

Some basic safeguards that help reduce investment risk include confidence that the board and management will: (1) release timely and reliable information about the company, so as to allow shareholders to react to changing circumstances; (2) deliver on the stated strategy and performance targets; (3) take decisions in the interests of all investors — in other words, without favouring insiders and controlling shareholders; (4) ensure that holdings will not be significantly and unexpectedly diluted through non-pre-emptive issues; and (5) guard against shareholder value being destroyed through significant transactions or material related-party transactions that investors have not had a chance to evaluate and approve.

It follows that well-governed, transparent companies that can demonstrate the above safeguards present a lower-risk proposition for investors, and will therefore benefit from a lower cost of capital and a more loyal shareholder base.

What to do in the pre-IPO phase

The key is to demonstrate a clear commitment to good corporate governance from day one. In practice, this means articulating clear positions on ownership structure, shareholder rights, transparency and disclosure, audit and risk management, and board practices. It is essential that such measures be put in place sufficiently in advance of the IPO to enable companies to demonstrate their effectiveness to prospective investors, making adjustments as needed in response to market soundings prior to going public.

Evidence of good governance practices will increase investor confidence in the board and management and lead to more accurate valuations, by reducing the uncertainty that gives rise to the so-called 'corporate governance discount'.

Clearly, corporate governance alone will not make an investment attractive if the business model itself is not convincing or the IPO is overpriced. But all other things being positive, particularly the business acumen and experience of the management team, investor attention will turn to the calibre, expertise and integrity of the non-executive directors, and therefore their ability to oversee, challenge and advise the management in order both to drive value creation and to protect the interests of minority shareholders at all times.

A genuine commitment to substance over form is essential; a perfunctory, 'box ticking' approach will backfire, as investors can see right through this. For example, it is much better to have two qualified independent directors who can bring value to the business than four independent but unsuitable individuals appointed to the board for 'compliance' purposes.

What do investors look for?

F&C sees the following as evidence of good practice:

- **Capital structure**: a single share class
- **Disclosure**: quality corporate reporting and transparency through adoption of international accounting standards; inclusion of non-financial information regarding all significant governance, environmental and social risks; and transparency of ownership structures
- **Board practice**: high-calibre directors; independent board committees; effective board chairing; and prevention of the concentration of power in one individual or a special-influence group — through, for example, an independent chairman, strong independent representation on the board, and shareholder agreements specifying the powers of controlling shareholders
- **Strategic decisions**: effective independent board oversight of significant and related-party transactions; where the board is not majority independent, special powers for independent directors to block transactions that may disadvantage minority shareholders; where material, shareholder approval prior to such transactions; and compliance with the UK Takeover Code
- **Dilution**: pre-emption rights and shareholder approval of significant non-pre-emptive issues
- **Remuneration**: appropriate executive remuneration practices that are clearly communicated, performance-tied, benchmarked to an appropriate peer group and subject to shareholder approval
- **Engagement**: a commitment to shareholder dialogue from the board and management, including engagement and consultation processes to facilitate constructive feedback from investors and build a better market understanding of the management and its strategy.

First-time issuers that fall short of the above standards may wish to consider gaining experience and exposure to the UK public markets through a quotation on AIM or a Standard Listing before progressing in due course to the Premium segment of the London Stock Exchange's Main Market. Companies that choose this route benefit from less prescriptive regulation and listing requirements, as well as greater flexibility in managing investor expectations. It allows them to evolve their governance and disclosure practices to meet the more stringent requirements and higher market expectations associated with a Premium Listing.

What are the benefits of pre-IPO engagement?

From an investor's perspective, an IPO's success depends on it being done at the right price, with the right set of accounts and being benchmarked against the right peer group. Early-stage engagement with investors not only generates timely and valuable feedback on the attractiveness of the investment case (positioning, valuation, investor appetite and potential concerns), but also allows issuers to educate investors about the company, increase confidence in the board and management, and enable informed comparison with sector peers.

Given the constraints of the IPO timeframe, it is important that new issuers and their advisers focus on starting in-depth engagement early in the process to allow time for quality dialogue. We would also advise that companies target investors with significant exposure to, and knowledge of, the sector/market, rather than just those of a large size.

As major contributors to the success or failure of any investment, corporate governance, risk management and shareholder protection mechanisms should be standing items on the agenda of pre-IPO meetings with investors. This is particularly true for companies from jurisdictions with less developed legal regimes and overall corporate governance infrastructures. F&C would therefore advise that, in addition to well-prepared meetings with the chief executive and the finance

director, pre-IPO companies offer investors an opportunity to meet with the board chairman, chairman of the audit committee and, where relevant, controlling shareholders. In addition to increasing investor confidence, such meetings lay the foundation for productive dialogue between the company and investors after the listing.

Life after the IPO: the benefits of having engaged shareholders

A successful IPO is only the beginning of a new set of challenges for newly listed companies. Investor expectations of a listed company, and the accompanying scrutiny, go a long way towards determining a company's success after a listing. In order to reduce share price volatility and build a more loyal following with investors, companies should uphold their IPO commitments and cultivate long-term constructive relationships with investors. This includes:

- fulfilling listing and disclosure obligations
- embracing accountability to a broader shareholder base and other key stakeholders
- maintaining and improving the corporate governance standards and risk management structures established prior to the IPO
- ensuring that corporate conduct does not fall short of investor expectations, which are very high in the UK.

The UK Stewardship Code encourages investors to engage in dialogue with companies to help sustain long-term returns and maintain standards in line with evolving good practice. For example, F&C has a long history of detailed and constructive dialogue with the boards and executives of its investee companies, including voting at all shareholder meetings.

This approach is based on our strong conviction that active ownership enhances long-term sustainable value, and that voting and engagement play an important role in driving down investment risks and enhancing returns. Importantly for issuers, this view is shared by a large proportion of the UK investment community.

Voting is important for both investors and issuers in that, notwithstanding the outcome, dissenting votes send a signal to management about specific concerns and can be an agent of change. By monitoring expressions of minority investor dissatisfaction obtained through the voting process, companies can gain important feedback and engage in more systematic outreach to investors in order to build consensus, resolve concerns and ultimately enhance their standing in the market.

Beyond the voting process, engagement addresses a broad range of issues in order to anticipate and resolve concerns before they become problems. Such dialogue can take many forms, including face-to-face meetings, correspondence, conferences, workshops etc, and can take place with individual investors or in collective discussions. More often than not, it is initiated by investors and prompted by specific concerns. In this regard, companies are well advised to anticipate problems by sounding out investors proactively, inviting comment on practices and building a reservoir of goodwill on which to draw in the event that difficulties arise.

Most institutional investors, particularly in continental Europe and the UK, favour constructive dialogue with companies over more confrontational forms of shareholder activism. However, for engagement to be productive, companies need to demonstrate a genuine willingness to take on board investor views and respond constructively and transparently in their follow-up actions.

How a company responds to engagement has a strong bearing on investor perceptions; in case of disappointment, investors may escalate their

action through votes against the board and management at shareholder meetings, by placing shareholder proposals on the ballot to invite fellow investors to oppose management, or by reducing or divesting their holdings to mitigate investment risks.

How to establish productive engagement with shareholders

Investors value open access to the board and management teams — and in particular, efficient, transparent processes that solicit their views, sound out potential concerns and help them build a better understanding of the company's strategy and culture. In routine cases, professional management, such as the chief executive, finance director, investor relations manager, company secretary and/or sustainability specialist, will serve as the interlocutors. In the event that investors wish to engage directly with the board, however, it is important that companies demonstrate the board's willingness to do so — through contact with relevant non-executive directors.

Strategic, operational, financial and governance issues have historically dominated engagement between company boards and investors. However, more and more attention is now paid to risks related to ethical business conduct, labour relations, environment, health and safety, and community relations because of their potentially significant impact on company performance.

Those companies preparing for an IPO should be aware of this growing area of investor pressure and be prepared to address these risks more systematically by factoring them into strategic planning, operational management, risk management and remuneration incentives.

Linklaters

Top of the list.

Ensuring the highest standards of quality and service across all our relationships.

That's why the leading global corporations and financial institutions trust Linklaters with their most important and challenging legal assignments.

Abu Dhabi | Amsterdam | Antwerp | Bangkok | Beijing | Berlin | Brussels | Dubai | Düsseldorf | Frankfurt
Hong Kong | Lisbon | London | Luxembourg | Madrid | Milan | Moscow | Munich | New York | Paris | Rome
São Paulo | Shanghai | Singapore | Stockholm | Tokyo | Warsaw

linklaters.com

9. Corporate governance — requirements for a UK issuer: Premium Listing, Main Market

John Lane and Lucy Fergusson, Linklaters LLP

An applicant for a Premium Listing of equity securities on the Main Market is likely to need to make changes to its corporate governance structure — including the composition of the board and its committees and internal controls — in the context of its transition to a publicly traded entity. Companies already quoted on other markets such as AIM may, to a greater or lesser extent, have some of the appropriate governance structures in place. However, any company seeking a Premium Listing must ensure that it is in a position to comply with the new obligations that will apply.

These obligations are not only those that stem from the Listing Rules (the LR) of the UK Listing Authority (UKLA) — including the duty to report on compliance with the UK Corporate Governance Code (the Code) and the Disclosure and Transparency Rules (the DTR) — but also the specific provisions of the Companies Act 2006 that apply only to UK companies admitted to listing.

These company law provisions include the requirement for a directors' remuneration report, and the right of shareholders to vote on this report. More detailed disclosures are required in the business review section of the company's annual report, and there are additional rules on the conduct of annual general meetings and making information available to investors. These provisions are part of the corporate governance framework in that they are designed to help balance the relationship between directors, as managers of the company, and shareholders, as its owners, by equipping investors with the information and voting tools they need to ensure directors are accountable.

Compliance with the corporate governance principles and the regulations that apply to a company with a Premium Listing is ultimately the responsibility of the directors. Moreover, many of the new obligations that apply to a company when it has achieved a Premium Listing may result in potential personal liability for directors if breaches occur. Therefore, adequate information and training for directors should be a key part of the issuer's preparation process.

Add to the rules the need to engage with investors and analysts on an ongoing basis, as well as the increased public scrutiny that accompanies listing, and it is clear that a good deal of work will be needed to ensure a smooth transition to the public arena.

Corporate governance structures

Under DTR 7.1, issuers with Premium or Standard Listings are required to have an audit committee with at least one member who is independent and one member who is competent in financial matters.

The first corporate governance disclosure that a company coming to market will need to make will be in its prospectus. It will take the form of a statement as to whether the company complies with the Code, with an explanation, where relevant, of why it does not. The explanation, of course, may be that, as a newcomer to the market, it has not previously had to comply. However, potential investors will expect to see appropriate structures being put in place to comply with the Code unless there is a reasonable justification for not doing so.

Moreover, as discussed elsewhere in this guide, companies are required to explain in their annual reports how they apply the principles of the Code, and specifically how they comply with its more detailed provisions — or to give a reasoned

explanation for any areas in which they are non-compliant. From the outset, therefore, directors must be prepared to meet these enhanced governance principles and market expectations. This will generally mean that, by the time of listing, the company should have at least the main structures in place, including the appointment of independent non-executive directors and, in addition to the audit committee, appropriately constituted remuneration and nomination committees.

In many companies, the former owners will retain significant stakes after listing. It should be noted that any members of management and any directors nominated by key shareholders will not be considered independent in terms of the Code's provision that at least half the board should comprise independent non-executive directors.

Helpful guidance on the establishment of committees is available in the form of model terms of reference published by the Institute of Chartered Secretaries and Administrators. Other documents to consider include a clear set of mandates within the corporate group for decisions on expenditure and other key matters, and a schedule of matters reserved for the board.

Assuming there is to be compliance with the Code's provision that the roles of chairman and chief executive are separate, there should also be a suitable division of responsibilities between them.

AIM companies

As noted above, companies that are already admitted to AIM will normally have met investor expectations by adopting certain levels of corporate governance standards. The London Stock Exchange set out its position on corporate governance for AIM companies in its 'Inside AIM' newsletter in July 2010. It believes that the Code serves as a standard to which companies should aspire, but that full adherence should not necessarily be the expectation for all AIM companies.

The London Stock Exchange also notes that AIM has the benefit of the nominated adviser (Nomad) system. Nomads are in an excellent position to work with their AIM clients to consider and set out the corporate governance standards with which the company is going to comply, by reference to factors including size, stage of development, business sector and jurisdiction. The Exchange also supports the use of the 'Corporate Governance Guidelines for Smaller Quoted Companies' published by the Quoted Companies Alliance (QCA) in September 2010.

How different life is for an AIM company when it moves to a Premium Listing on the Main Market and has to comply or explain against the Code will obviously depend on the extent to which its existing practices have evolved.

Eligibility for listing

A number of formal requirements must be satisfied in order to meet the requirements of the LR. Most importantly, the majority of businesses must have a proven three-year trading record and a sufficient 'free float' (the number of shares held by persons not connected with major shareholders or the management).

The company must appoint a sponsor to confirm to the UKLA that the directors have established procedures to enable compliance with the continuing obligations that apply to listed companies under the LR and DTR, as well as procedures that provide a reasonable basis for the directors to make proper judgements on an ongoing basis as to the financial position and prospects (FPP) of the issuer. The directors must also make a statement in the prospectus that the group has sufficient working capital for at least the next 12 months, and the sponsor must

Document checklist: governance and compliance policies and procedures

This checklist sets out key policies and procedures that a company should consider adopting before Premium Listing in order to ensure compliance with eligibility requirements and continuing obligations, as well as with the UK Corporate Governance Code

Compliance with Listing, Disclosure and Transparency Rules

- Review of processes for reporting on financial position and prospects
- Review of sufficiency of working capital over next 12 (or more) months
- Briefings for board members on their responsibilities and obligations as directors of a Premium Listed company
- Disclosure procedures manual — guidance and procedures for all relevant employees on identifying information that the company may be required to disclose and ensuring it is brought to the attention of the board
- Insider list procedures — processes for maintaining lists of persons with access to inside information
- Inside information guidance for employees — to ensure they are aware of their obligations where they have access to inside information
- Securities dealing code
- Procedures to ensure compliance with share-dealing reporting obligations
- Guidance note on significant transactions under Chapter 10 of Listing Rules
- Guidance note on related-party transactions under Chapter 11 of Listing Rules

Compliance with Corporate Governance Code	Code reference
Code of values and standards	A.1
Schedule of reserved matters for the board	A.1.1
Division of responsibilities between chief executive and chairman	A.2
Terms and conditions of appointment of non-executives	B.3.2
Procedures for board access to independent advice	B.5.1
Insurance cover for directors	A.1.3
Audit committee terms of reference	C.3.2
Remuneration committee terms of reference	D.2.1
Nomination committee terms of reference	B.2.1
Risk committee terms of reference (if appropriate)	
Environment, health & safety committee terms of reference (if appropriate)	
Whistle-blowing arrangements	C.3.4
Design of performance-related remuneration for executive directors	D.1.1

confirm that this statement has been made on a reasonable basis.

In accordance with the duties that the sponsor owes to the UKLA, each of these confirmations by the sponsor must be given "after having made due and careful enquiry". This entails an appropriate due diligence process.

In order to be satisfied it can confirm the

company's ability to meet its continuing obligations, the sponsor will consider the skills and experience of the board and the internal governance structures that the company has in place. It will also seek to ensure that the directors have been fully briefed by advisers on the company's obligations and their own duties.

In relation to the obligation to have proper FPP reporting procedures in place, a firm of accountants will normally be appointed to conduct an independent review of the financial control systems. Their report, which will detail the systems and comment on their effectiveness, will form part of the sponsor's assessment of the adequacy of the issuer's systems. As part of this process, the directors will normally be expected to prepare a memorandum describing the company's FPP reporting procedures.

The outcome of the review will naturally depend on the issuer, the extent of its reporting procedures and any perceived risks or previous failings in those procedures. There will normally need to be a dialogue between the company, the reporting accountants and the sponsor as to how the FPP reporting procedures should be framed, bearing in mind the particular financial and reporting risks that the company is subject to, and the key performance indicators that need to be monitored beyond the requirements of the statutory accounts.

Similarly, the working capital confirmation will require the board to consider in detail the future cash flows and capital requirements of the business against a range of sensitivities. This work will be reviewed by the accountants engaged by the sponsor in order to provide comfort to the sponsor in making its confirmation to the UKLA.

Ongoing compliance with Listing Rules

A company with a Premium Listing must comply with continuing obligations under the LR and DTR. In the course of preparing for a listing, amid all the work involved in proving eligibility, drafting a prospectus and marketing the company to potential investors, directors must not lose sight of the fact that compliance with these obligations will be a fact of life from the day that the company is listed.

The key provisions of these rules are intended to protect existing and potential investors by ensuring proper disclosure of material financial and other information and giving shareholders rights to vote on certain matters. Although there are many detailed rules, which are outside the scope of this chapter, they can be broadly summarised by the Listing Principles, set out in LR 7. These have the same force as rules but are written in general terms with the aim of underpinning the specific obligations set out in the LR and DTR. Under the Listing Principles, a company with a Premium Listing must:

- take reasonable steps to enable its directors to understand their responsibilities and obligations as directors
- take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations
- act with integrity towards holders and potential holders of its listed equity securities
- communicate information to holders and potential holders of its listed equity securities in such a way as to avoid the creation or continuation of a false market in such listed equity shares
- ensure that it treats holders of the same class of its listed equity securities that are in the same position equally, in respect of the rights attaching to such listed equity shares
- deal with the Financial Services Authority in an open and co-operative manner.

Two key aspects of the Listing Principles are the emphasis on directors' understanding of their responsibilities (as the persons ultimately responsible for their company's compliance with the rules) and on the need for adequate procedures, systems and controls. The implication of these principles is that directors will not (unless knowingly at fault) be held accountable for a failure in compliance, but they may be held responsible if the failure results from inadequate systems or procedures.

Inside information

In practice, it is particularly important for companies to focus on being able to identify and deal with material, price-sensitive information that may need to be disclosed promptly to the market, and must, pending disclosure, be kept confidential in accordance with the rules in DTR 2. This includes having procedures for identifying the information and ensuring that it is escalated to the board of directors so that they can consider whether the information needs to be disclosed. It also includes having procedures for training employees and maintaining lists of insiders.

In addition, companies must be able to identify transactions that are significant or involve related parties, and that may be subject to the disclosure and shareholder approval rules contained in LR 10 and 11.

The FPP reporting work carried out by the sponsor and accountants, referred to above, is a critical part of making sure that the company has the necessary systems in place and that they will function as intended in the future.

Dealing codes and training should also be put in place to ensure that directors and other employees with access to price-sensitive information do not deal when prohibited by the UKLA's Model Code and, more broadly, are aware of the risks of market abuse.

Conclusion

Preparation for a Premium Listing is a twofold process of ensuring that the company achieves the milestones required to gain admission to listing, and that the directors and other relevant company employees are prepared, and the systems are in place, to meet the continuing obligations and expectations placed on a company with a Premium Listing. The latter, in particular, will require careful preparation in terms of designing systems and procedures.

Above all, it is important that directors and employees are thoroughly grounded in the rules to which they and their company will be subject.

Davis Polk's multi-disciplinary practices are ranked among the world's best across the board – uniquely broad and deep in scope, consistently excellent in quality and capability, practical in advice and solutions, global in reach and key to the achievement of our clients' goals.

Cross-border, multi-listed IPOs, industry-shifting mergers and acquisitions and sensitive, multi-jurisdictional governance matters, internal investigations and government enforcement actions – year in, year out, leading companies and financial institutions around the world turn to our lawyers for their most critical legal and business matters.

For more about our practices, please contact: paul.kumleben@davispolk.com or simon.witty@davispolk.com or visit www.davispolk.com.

New York
Menlo Park
Washington DC
Beijing
Hong Kong

London
Madrid
Paris
São Paulo
Tokyo

Davis Polk

davispolk.com

10. Requirements and challenges for non-UK companies listing in London

Simon Witty and Sapna Dutta, Davis Polk & Wardwell London LLP

The number and diversity of companies listed on the London Stock Exchange that are incorporated outside the UK continue to grow. Around 33 per cent of London-listed companies are from outside the UK and represent more than 60 countries, including Argentina, Bahrain, Chile, China, Croatia, the Czech Republic, Egypt, Hungary, India, Kazakhstan, Lebanon, Pakistan, Poland, Qatar, Russia, South Korea and the UAE.

This reflects the continuing evolution of today's globalised market, an increasing level of geographical diversification in investor portfolios and the recognition by issuers in both developed and emerging markets of the competitive benefits that a London listing can deliver.

In recent years, however, the range of London-listed non-UK issuers has highlighted what can be significant differences in the governance standards applied across various jurisdictions.

Current requirements for non-UK companies

All companies with a Premium Listing on the Main Market, regardless of their country of incorporation, are required to apply the UK Corporate Governance Code (the Code) and provide their shareholders with anti-dilutive pre-emption rights when new shares are issued.

Companies with a Standard Listing of shares or global depositary receipts have to comply with EU minimum standards, which include a requirement under the EU Company Reporting Directive to provide a corporate governance statement explaining the corporate governance code to which the issuer is subject and a description of the company's internal control and risk management systems.

Principal challenges for non-UK companies

The provisions of the UK Corporate Governance Code are considered to be among the most high-grade governance standards applied in any securities market around the world. Given that, even issuers whose securities are already listed on another exchange may need to make alterations to their governance practices before seeking a Premium Listing.

Compliance with these standards can present challenges for some non-UK issuers whose home country governance regime is less developed. This is often the case for companies from emerging or developing markets where governance practices are less established or less stringent, or both. In particular, corporate ownership structures in many of these markets routinely involve the majority of an entity's shares being closely held, for example by its founders — including family members or other related parties — or by another small group of individuals or corporations, or a foreign government.

Companies whose governance practices have evolved against that background may find it difficult and time-consuming to elevate their practices to the level set by the Code. Leaving aside a variety of other corporate implications of these modifications, an issuer's timetable for listing may be affected. Below we discuss a selection of Code provisions that can be particularly challenging for non-UK issuers.

Board, managerial and operational independence

The Code includes a number of provisions designed specifically to ensure the independence of a company's board, management and operations, which may not be present in the same

way or at all under less developed or stringent regimes and particularly in the context of closely held companies. These include the requirements that at least half of the board is made up of independent non-executive directors (at least two directors must be independent non-executives in smaller companies outside the FTSE 350), that the roles of chairman and chief executive are separate, and that companies follow certain minimum rules for the establishment, composition and responsibilities of board committees.

The concept of independent directors is a consideration for some tightly held and controlled companies, where, for example, an individual is a significant shareholder, has material business relationships or other close ties with the company or its related persons, or has received remuneration from the company other than in his or her capacity as a director. While the Code does not prohibit the appointment of a director with these relationships, a company doing so will need to recruit an increased number of independent non-executives or explain why it considers a director with these relationships to be independent or appropriate.

Board diversity

The Financial Reporting Council (FRC) has announced that, effective for financial years beginning on or after October 1, 2012, the Code will be amended to require companies to publish their policy on gender diversity in the boardroom, to report against it annually and to consider diversity as a factor when evaluating the effectiveness of the board. While there has been an increased focus on diversity and gender equality in Europe and the US in recent years, the use or even existence of such policies remains uncommon in many countries.

Accountability and transparency

Non-UK issuers from certain jurisdictions may also need to carefully consider the Code's procedural requirements for corporate accountability and transparency, many of which reflect governance issues more commonly recognised in developed markets. One of these issues is executive pay, with the Code requiring that a significant proportion of executive directors' remuneration should be performance-linked, that no director should be involved in deciding his own remuneration, and that a formal and transparent procedure should be established for developing policies on executives' and directors' pay.

Additionally, the Code requires the establishment and maintenance of formal, transparent arrangements for corporate reporting, risk management and internal controls, along with an annual board review of the effectiveness of these systems and a corresponding annual disclosure to shareholders that the review has been carried out.

The perils of 'explaining'

The basis of the 'comply or explain' principle is that where a company believes that, due to its individual circumstances, good governance can be achieved by means other than applying the Code, then compliance is not obligatory as long as the company clearly and carefully explains its reasons. For non-UK companies seeking a Premium Listing, that option provides some flexibility in the face of unfamiliar Code standards, although there are certain associated considerations that will continue to be important for non-UK issuers to keep in mind.

The presence of a controlling shareholder, for example, may cause concern among minority shareholders who are not persuaded by the adequacy of the explanations provided by the company or the level of scrutiny applied to them. The FRC continues to express its views in relation to companies with concentrated ownership structures, and the implications this has for 'comply or explain', and has indicated that there is a need to look more broadly at the rights of minority shareholders. As

this issue develops, it may become increasingly prominent for non-UK issuers that are closely owned or controlled. Already, majority-controlled companies must often implement measures to safeguard the independence of the company's board and its operations to ensure investor support.

There are other difficulties with 'comply or explain', which can have practical consequences for non-UK issuers in the face of a lack of familiarity with the Code's provisions and the number of additional requirements imposed. First, rather than using the option to explain, most companies choose to comply with all the provisions of the Code or to limit non-compliance to just one or two provisions. This negates the flexibility that the Code was intended to provide and which can be especially helpful to non-UK companies. It may well be for some companies that thoughtful non-compliance is the better, but unused, approach.

Second, in the midst of ongoing debate in Europe as to the efficacy of 'comply or explain', the FRC has noted that in some cases explanations have been more an assertion of difference than a full explanation of the reasons for departing from agreed best practice. As a result, it is paying "particular attention" to the quality of explanations and has encouraged investors to highlight examples of good and bad explanations. So, where non-UK issuers opt to explain non-compliance, it is likely that they will nonetheless need to demonstrate a thorough understanding of the Code provisions and set out specifically why those provisions are inappropriate for them.

Heightened investor scrutiny

Just the fact that some non-UK companies may require alterations to their governance practices to bring them into line with the standards in the Code can be a reason for increased and continued investor scrutiny of those practices after the listing, and there can be an accompanying pressure to implement refinements over time.

In addition, the tendency for companies to comply with the Code, rather than explain, has triggered more qualitative evaluation by investors of whether these companies are complying with the 'spirit' of the Code as well as the 'letter'.

Pre-emption rights

Premium Listed non-UK issuers are required to provide pre-emption rights to their shareholders in any issue of equity securities for cash or sale of treasury shares that are equity shares for cash, in accordance with the Listing Rules. In countries where these rights are not already required by law or are not otherwise common practice, implementation can require a range of procedural steps — for example, the need to hold a shareholder vote to enshrine such rights as well as to take authority for a limited disapplication and, as is customary in the UK, to renew such authority annually.

How does the UK compare with other regimes for foreign issuers?

Among securities exchanges internationally, there is a wide disparity not only in the approaches taken to ensure that overseas issuers maintain certain minimum governance standards, but also in the views of what those standards should be.

United States

In the US, 'foreign private issuers' (FPIs) listed on the New York Stock Exchange or Nasdaq may generally elect to follow home-country practice in lieu of all NYSE or Nasdaq governance rules, other than those governing audit committees. Since 2009, such companies have been required to disclose any significant differences between the two practices in their 20-F annual report, enabling investors to evaluate those home-country practices against the US domestic standards. However, unlike under the UK regime, FPIs need not undertake the additional burden of explaining why they have chosen to apply home-country practices, nor must they demonstrate

why they consider US standards to be inappropriate for them.

Hong Kong

The Hong Kong Stock Exchange (HKEX) strikes a different balance again. At the outset, an overseas issuer must come from an 'acceptable overseas jurisdiction' in order to list on the HKEX, and prospective issuers from other jurisdictions must show to the HKEX that they are subject to shareholder protections at least equivalent to Hong Kong standards to be eligible for listing. However, once that initial eligibility has been demonstrated, the HKEX takes a more layered and tailored approach to governance — one that applies equally to all companies listed on the Main Board regardless of their country of incorporation, but that varies the level of governance standards depending on their perceived importance.

At the highest level, issuers are required to comply with the selected governance standards in the Listing Rules, which include provisions relating to director responsibilities and competence, and certain board and board committee composition requirements. The second level comprises the provisions of the HK Corporate Governance Code, with which issuers must comply or explain. The third tier consists of 'recommended best practices', with which all issuers are simply encouraged to comply or explain. These recommended best practices, in particular, can limit the number of alterations to home-country practice that an issuer may need to make before listing, which can be beneficial for issuers from emerging markets. In practice, however, the number of issuers able to utilise this flexibility is limited as many emerging markets countries are not on the 'acceptable overseas jurisdictions' list.

The HKEX has announced that it is working closely with the Securities and Futures Commission of Hong Kong with a view to clarifying and streamlining the requirements for overseas companies seeking Hong Kong listings. It remains to be seen whether this results in changes that have an impact on governance requirements.

Europe

There remain some European jurisdictions that continue to apply their governance standards only to domestic issuers, such as the Luxembourg, Frankfurt and Nasdaq OMX Copenhagen stock exchanges. In these cases, overseas issuers are permitted to follow home-country requirements without an associated 'comply or explain' or other disclosure requirement in respect of the listing country's governance standards. While this regime provides significant flexibility for an overseas issuer, there is a risk that such issuers might not be required to apply any regulated governance standards. That situation typically has to be addressed on a case-by-case basis taking into account investor and regulator feedback, and often involves dialogue with the relevant exchange. Some jurisdictions have taken steps to address this. For instance, the Nasdaq OMX Copenhagen provides that if an issuer is not subject to a home-country governance code, it must follow the OMX Copenhagen's governance principles.

Continuing governance concerns over some non-UK issuers

The concerns of market participants over the governance practices of some non-UK issuers are unlikely to go away. Particular scrutiny is likely to be paid to the extent to which companies are complying with the spirit of the Code — and not just the letter — or providing detailed explanations for non-compliance. Specifically, the growing desire to make qualitative assessments of compliance with the Code will be a challenge and, in doing so, investors will be keen to understand the differences in how Premium Listed UK and non-UK issuers apply the Code — particularly in the case of those non-UK companies with closely held or controlled shareholder structures.

While these concerns do not relate solely to non-UK issuers, they illustrate a growing view among UK regulatory authorities – such as the Financial Services Authority, the FRC and the Department for Business, Innovation and Skills, as well as investors.

The benefits of applying the Code

Many non-UK issuers face challenges in complying with the Code, but the advantages of a Premium Listing persuade a large percentage of them to address these challenges. A Premium Listing can increase an issuer's prominence and provide access to a greater range of institutional and retail investors, as well as bringing greater status and recognition among the global investment community. Inclusion in the FTSE UK series of indices is also a possibility for qualifying companies, offering greater potential for liquidity and creating a basis for portfolio trading for both passive and active investors.

Further, there have been examples of issuers whose governance practices have been perceived by the market as unsatisfactory and that have, as a result, suffered from a discounted valuation.

The willingness of prospective shareholders to vote with their feet and their wallets in favour of the higher, more sophisticated and independent governance standards associated with a Premium Listing continues to demonstrate the benefits of those standards. This can lead to a meaningful increase in a company's IPO price and continuing market valuation — and has done so.

The Zygos Partnership

The Zygos Partnership is an international Search firm specialising in finding Chairmen, Chief Executives, Finance Directors and Non-executive Directors.

We advise a wide variety of organisations at every stage of their corporate development, from start up to FTSE 100.

We have worked for 51 of the FTSE 100 and 66 of the FTSE 250, as well as a large number of pre-IPO and AIM-listed companies.

In the last year we advised on half of all FTSE 100 Chairman appointments. 33% of our NED appointees in that period were women.

We offer...

- An experienced, specialist, exclusive focus on Board appointments
- An extensive global network of contacts at the most senior levels, which gives clients access to the very best candidates
- A rigorous and creative search process – each search brings new candidates generated by fresh research tailored to that client

What differentiates us is the dedicated and continuous involvement of the Partners in delivering every aspect of the search, working alongside the same small, high quality team.

More than three quarters of our clients have chosen to work with us repeatedly. We consider this the measure of a great search firm.

Thanks to our reputation, and the strength of our network, we are in a position to enable our clients to access and appoint the most talented business leaders worldwide.

The Zygos Partnership
15 Sloane Square, London SW1W 8ER, UK
Tel: + 44 (0) 20 7881 2900
www.zygos.com

11. Structuring an effective board

Julia Budd and Laura Sanderson, The Zygos Partnership

As a result of the introduction and evolution of the UK Corporate Governance Code (the Code) over the last 20 years, and parallel developments in UK law, the bar has been raised considerably for UK listed companies in terms of the standards that they are expected to achieve in their management and their conduct. Boards have had to raise their game, and constructing a team of directors that is able to fulfil an array of governance requirements is now a complex challenge.

What follows is practical guidance, based on the experience of The Zygos Partnership in advising on senior appointments in FTSE companies and our observations as to how the boards of a large number of our clients are structured and how they function in practice.

In attempting to capture the way in which the Code is applied by boards, there are two challenges. First, the situation is a dynamic one as new Code provisions progressively affect the shape and composition of boards. Second, there is a healthy variety in how boards 'comply or explain' with the Code provisions as they develop the structure that is most effective for their particular business. Nonetheless, at the time of writing some clear norms are established, and this is what we are aiming to capture here.

Not a jury, more a football team

Boards of UK listed companies have changed considerably in the past 20 years. Prior to the 1992 publication of the UK's (and the world's) first corporate governance recommendations (the Cadbury report), and in the absence of a formal shared understanding of their roles, a large number of non-executive directors (NEDs) used to sit alongside the executive directors. Their function was rather akin to the '12 good men and true' of the jury system. Good chaps (and they were almost always chaps), NEDs were there to make a somewhat vague and unspecified contribution to the success of the company while also protecting the shareholders' interests.

Two decades of development in UK corporate governance good practice later, and the function of boards and their chairmen, executive directors and NEDs is well understood and classified. While directors of listed companies have a number of functions in common, each also has a specific combination of other roles to play to enable the board to achieve its purpose.

A board is now a carefully composed team, where each member can cover a different area of the pitch.

The size and structure of boards

Ever since the Code (then the Combined Code) was revised in 2004 in the wake of several high-profile corporate failures, there has been a focus on shrinking the size of boards to ensure that they are small enough to act as an effective decision-making forum. FTSE 350 boards now typically consist of eight to12 people in total. Some of the largest FTSE 100 companies do have larger boards than this, but in these companies the board necessarily spends more time on safeguarding good corporate governance and takes fewer decisions, because there is a greater depth of management. These companies also tend to have more board committees to populate. In this context, having a larger board can add greater range to the governance process without compromising the board's function.

The Code mandates that at least half the board, excluding the chairman, should be composed of independent NEDs (provision B.1.2). Each board also needs a senior independent director, as well as chairmen for the audit, remuneration and nomination committees.

Typical structure of a FTSE 350 board

Executive directors
Chief executive
Chief financial officer
(There could be another executive director if desired, and technically there could be several more — as long as there is one more independent NED than the total number of executive directors. However, it is less usual for a company to have more than three executives on the main board)

Independent non-executive directors
Chairman
Senior independent director and committee member
NED and chairman of audit committee
NED and chairman of remuneration committee
Further two NEDs and committee members

The chief financial officer as board member?

Readers more used to US-style corporate governance may be surprised by the presence on the board of the chief financial officer (CFO), but this is almost universal for companies on the UK Main Market. The expectation is that the CFO should be a highly strategic business person, able to complement the chief executive primarily by bringing a financial perspective to the business's decisions. In the UK system, the CFO and the chairman provide the checks and balances to ensure that the chief executive does not become too dominant in the leadership of the company in a way that could jeopardise its future prosperity. There can also be an advantage from the point of view of chief executive succession planning in having other executives at the top table.

Committee membership and chairmanship

All NEDs typically serve on the nomination committee, alongside the chief executive, and the committee is usually chaired by the chairman of the board. The audit and remuneration committees are usually chaired by one independent NED each, with a further two independent NEDs serving as committee members. The Code requirement is for the involvement of three independent NEDs on each committee (two in the case of companies outside the FTSE 350). The chairman may act as one of these if he/she was considered independent on appointment as chairman, but he/she may not act as chair of the audit or remuneration committees (provisions C.3.1 and D.2.1).

Additional committees

In certain industries, there is a need for further committees, and these tend to cover the following areas:

- **Health and safety and environment**. Committees for HS&E are generally found in companies where workforce fatalities are a real risk, such as in the extractive industries, power and manufacturing
- **Corporate social responsibility**. CSR committees may sit in businesses whose products pose varying degrees of risk to their consumers (including food and drinks businesses, pharmaceutical companies, consumer financial services, tobacco and gambling) or that operate in vulnerable communities, such as companies extracting natural resources in the less developed world
- **Risk and regulation**. A key recommendation of the 2009 Walker review on the corporate governance of UK banks was that financial services businesses must have a risk committee that is separate from the audit committee, with responsibility for monitoring all aspects of group risk, including major transactions, and publishing a risk report annually.

Where an additional committee is needed, more independent NEDs may be required to chair and

populate it, and so the overall size of the board may increase.

Shareholder directors

Given the independence criteria for board balance and committee membership, any directors appointed to the board who represent a major shareholder are simply numerically additional directors who may serve alongside those described in the panel opposite — up to a maximum of one fewer than the number of independent NEDs.

As the independent NEDs are there to represent the interests of 100 per cent of the shareholders, there can be a natural tension between them and any shareholder directors. The chairman, or an independent deputy chairman if the chairman is a significant shareholder or is not independent for another reason, will have an important role in managing this tension and providing 'air cover' for the chief executive.

UK institutional investors favour smaller boards, and the presence of shareholder directors is usually expected to be transitional. If they have been appointed after an IPO, a significant change in strategy, a company turnaround or a major transaction, the expectation tends to be that they will step down within one to two years.

Attributes of effective independent directors

Functional experience

In considering the selection of the chairman and senior NED, two factors should be taken into account. First, prospective directors will need commercial experience that is relevant to the company's business and wider operating environment. Second, they will need the right functional experience to fulfil all necessary board and committee roles. Taking the second point first, the core requirements for each of the main board roles are set out in the panel to the right and on the next two pages.

Attributes of the chairman

Key requirements

The individual appointed should:

- run the board as an effective team
- oversee the process of strategy development
- be accessible to the chief executive and the executive team for support, challenge and counsel
- complement the chief executive in maintaining relationships with shareholders and, as necessary, other stakeholders — customers, suppliers, staff
- ensure that the company has appropriate succession processes in place at board and senior management level
- be skilled in communicating clearly and effectively at all levels and to a range of audiences, both internally and externally
- devote one to three days a week to fulfilling the role of chairman.

Prior experience

The chairman:

- is likely to be an experienced UK plc NED
- may have a successful track record as a chairman who has built and led professional and effective boards, although prior experience as a chairman is not an absolute requirement for the role
- will need to be well respected by the investor community, and will show a clear understanding of the requirements of institutional investors.

It may also be an advantage if the chairman has experience in corporate finance, mergers and acquisitions, and bid defence.

In practice, to fulfil these criteria, the chairman is most likely to have:

- prior experience within a listed company as a chief executive or CFO. This needs to be someone whom the chief executive can look up to, learn from and respect, and who understands the relative isolation of the chief executive's position. Investor communities also respect an individual who has led or been an integral part of a team that has made them money in the past
- previous responsibility for a business equivalent to, or larger in scale than, the company for which the candidate is being considered.

Candidates from alternative backgrounds will usually need to bring a demonstrable record of success, coupled with extensive experience as a NED, to be considered qualified for the chairman role.

Attributes of the senior independent director

To be considered for this role, a candidate will have:

- proven ability as a NED in FTSE companies of similar scale to the company for which he/she is being considered
- the stature to play the key role of senior independent director. He/she will be known to, and respected by, the institutional investor community.

In cases where a company is coming to the market, it is likely the candidate will have prior experience as a senior independent director or chairman, or audit or remuneration committee chairman.

Candidates should be able to act as a *confidant* to the chairman and ensure that he/she is attuned to the thinking of both the executive and non-executive directors. This role assumes particular importance in situations of board stress, where there may be divided views.

Attributes of the chairman of the audit committee

The Code provides that at least one member of the audit committee must have recent and relevant financial experience. The Financial Reporting Council's 'Guidance on Audit Committees' adds that it is desirable that this committee member has a qualification from one of the professional accountancy bodies (paragraph 2.16).

It is usual for this person to act as the chairman of the audit committee, and so the experience criteria for this role mean the individual is typically one of the following:

- a current or former finance director, usually with experience as a finance director of a listed company
- a former audit partner at an accountancy firm
- a financially qualified current or former chief executive of a listed company
- occasionally, a current or former divisional finance director
- occasionally, an individual with corporate finance experience from an advisory background, such as a banker who also has a professional accounting qualification.

Additionally, candidates should:

- possess the intellect and skills to manage the detail of the audit chairman role, plus the ability to challenge, from a broader perspective, the processes by which the company assesses its risk and manages the business
- be able to take a lead and stand their ground
- be available whenever required between board and committee meetings to the chairman, chief executive, CFO, external audit lead partner and the head of internal audit.

Other factors to consider

Executive/non-independent chairman
In cases where a company intends to list on the London Stock Exchange with an executive chairman or a chairman who is not independent, the role of the independent deputy chairman (which usually then replaces the senior independent director role) assumes particular importance. In this scenario, it is important to appoint an individual of chairman calibre, as outlined above, so the market can see that an effective independent counterbalance to the executive chairman is in place, whom the investors can call on to take action on their behalf if necessary.

Currently serving executives as NEDs
Most boards of UK-listed companies have as NEDs both individuals who are serving executives in other companies, and those who have retired from a full-time executive career. The presence of current executives can bring a degree of diversity

Attributes of the chairman of the remuneration committee

The Code does not make specific provisions for the experience required for the chairmanship of the remuneration committee, and so boards can exercise a degree of discretion in deciding who would be best qualified for the role. However, given the tasks of the committee, the experience criteria are usually as follows. Candidates are:

- often serving or retired chief executives, or group HR directors, or others who have held responsibility for the management and motivation of a substantial workforce
- in a position to bring experience of a remuneration committee of a listed company, either as the executive director supporting its activities or as a NED member or chairman
- cognisant of current best practice around compensation and reward structures
- ideally able to bring demonstrable experience of negotiating effective reward structures with investors
- able to show a good track record in investor or media relations.

At the time of writing, the role of chairman of the remuneration committee has become more high profile given political pressure over high levels of reward, together with investors voting down a series of remuneration reports. It may be the case that currently serving executives are in future prevented from serving on remuneration committees, because of their perceived interest in contributing to the ratchet effect of ever-rising remuneration benchmarks. Meanwhile, the structuring of remuneration has become highly complex and in need of better tools to link it to management performance. This is a situation in flux which companies are encouraged to monitor.

to boards in terms of age and experience, as well as currency in a wider operating environment. However, it can be a challenge for them to make sufficient time available for the NED role. Boards

Attributes of non-executive directors

The aim in the appointment of NEDs is to ensure the board has access to the right balance of knowledge, skills and experience. However, the following general points apply to all would-be NEDs. All candidates should:

- be able to contribute to debates on strategic issues, to help the board be effective in weighing options and be decisive in drawing conclusions
- have a strong command of the issues relevant to the business, sufficient to monitor performance, financial information and controls, risk management, remuneration and succession planning
- demonstrate the ability to question, probe and challenge appropriately
- be independent in character and judgement, as well as technically independent as required by the Code (provision B.1.1)
- be able to uphold high standards of integrity and probity
- be in a position to make sufficient time available to discharge their responsibilities effectively
- have a degree of gravitas, together with the personal qualities to play an appropriately complementary and supportive role to the chairman and management.

In addition, experience of corporate financial matters will normally be required for members of the audit committee, and greater financial expertise will be required where the company's activities involve specialised financial activities.

can usually benefit from having one or two currently serving executives as NEDs; more than that may create problems.

Diversity

In the UK, diversity is now commonly agreed to be a characteristic of effective boards as it is believed to be a means of avoiding 'group think' and so mitigating risk, as well as a way to

achieve a board that is truly representative of the scope of the business and its key markets. It is also seen as a way to ensure that the board is tapping into the fullest possible range of talent available.

There are many aspects to diversity, but the three most relevant in this context are age, gender and nationality. As discussed above, a degree of age diversity can be achieved by aiming for a balance of current executives and retirees among the independent board members.

Achieving gender diversity on boards is, at the time of writing, the subject of political focus at both UK and EU level. In the UK, the Davies review (2011) recommended that FTSE 100 boards should aim for a minimum of 25 per cent female representation by 2015. No target has been set for FTSE 250 companies, but the chairmen of all FTSE 350 companies are expected to set out the percentage of women they aim to have on their boards in 2013 and 2015. The government and the business and investor community have broadly supported these recommendations. In practice, what this means for a typical board is that it should aim to appoint two or more female directors (and at least one).

If a company has significant operations in particular countries or regions, it may also be desirable to appoint individuals who both have appropriate operating experience in those areas and are of relevant nationalities.

Personal style
It is important to consider a number of personal attributes among board candidates, including intellect, critical assessment and judgement, creative thinking, courage, openness, honesty and tact, as well as the ability to listen, forge relationships and develop trust. Diversity of psychological type is another way of ensuring that a board is not composed solely of like-minded individuals but is a challenging and effective group.

Formal qualification:
While a raft of formal qualifications are available for those who would like to be considered as company directors, these are not usually given any weight by investors or boards; the primary qualifications for the role of chairman or NED are relevant knowledge, skills and experience. However, in certain sectors that rely heavily on particular professional skills, it can be desirable to appoint a NED with the relevant qualification, such as a Fellow of the Institute of Actuaries for a major insurer.

Prior experience on the board of a listed company
While not all board members will need prior experience of serving on the board of a UK listed company, it will be important to ensure that a sufficient number have done this before in order to provide the necessary guidance on governance and market norms, and particularly in times of major change such as an IPO.

Relevant industry experience
All effective board members will bring a track record of commercial experience in a field that is relevant to the company; each company will be able to create its own list of priorities here. It may also be desirable for individuals to bring other specific operating experience depending on the company's particular circumstances, such as experience in joint ventures, turnaround/change management, mergers and acquisitions, regulation, major contracts and government relations. Again, the priorities here will be different for each company.

Building a board that is future-proof

Given that non-executive directors, once appointed, will typically serve for at least six years,

they need to be appointed with an eye to the future.

NEDs should not replace advisers or consultants

In a new listing, it can be tempting to try to make up for relative inexperience in the management team by appointing specialist non-executive directors who can fill the role otherwise played by consultants or advisers. However, this is short-sighted; the management team will evolve to develop the skills it needs, and can bring in outsiders as necessary in the interim. Taking this route could leave the board with NEDs whose role in providing deep expertise in narrowly confined areas has become redundant but who still have a number of years left to serve on the board. It is better to appoint individuals who can draw on a broad base of commercial experience that will continue to be relevant to the company in the years to come.

NEDs should be 'rightsized' in terms of their experience

If the company expects to grow rapidly, it should appoint some NEDs with operating experience of the scale that the company expects to achieve in five years' time. However, be wary of hiring someone with no experience of the size and stage that the company is at today. Someone with a lot to offer a large company may have little to offer a smaller company and could be a fish out of water.

Board appointments: bringing it all together

Laying the groundwork

The Code sets the requirements for a formal, rigorous and transparent procedure for the appointment of new directors to the board, and makes it clear that it is best practice to use the services of an external search consultancy to ensure independence, thoroughness and transparency in the process (provision B.2). Moreover, given the challenges and limited rewards of the NED role, the supply of strong candidates to undertake these roles does not exceed demand. An appointed search firm should:

- agree structured specifications for each role with the company
- search rigorously for candidates who meet those specifications
- incorporate suggestions of candidates from other sources, such as corporate finance advisers or shareholders, and weigh them against the candidate specifications and other potential candidates
- present a choice of candidates for each role
- interview the most suitable candidates carefully and check their references, in order to be able to advise on who will be the most effective in each role
- advise on and manage the company's own interview process
- act as independent advocates on both sides, for the company and the candidate.

There is a real advantage in using a single search firm for the complete set of appointments, both to avoid confusion in the market about who is representing the company, and to ensure that the board is composed of an effective team rather than a collection of individuals. It may be helpful to work with the search firm to construct a grid or a gap analysis of your board, as part of the process of crafting candidate specifications covering the right mix of skills and experience for forthcoming appointments.

Initiating the search

At the outset, the search firm should work with the company to develop answers to the crucial questions:

- What are the key challenges facing the board over the next three to five years?

- In the light of this, what does the chief executive need from the chairman and non-executive directors?

The individual candidate specifications for each board role can then be shaped accordingly.

Picking a captain

Great teams need great captains, and the captain then wants to pick their team. Start off with the appointment of the chairman (or deputy chairman, in cases where there will be an executive or non-independent chairman). The individual appointed for this role sets the benchmark of quality for the remaining appointments, and then works with the chief executive and shareholder directors to structure the rest of the board.

Agreeing the brief

Getting the stakeholders to agree written specifications at the outset avoids wasting time on the wrong candidates.

Preparing the briefing

Prospective chairmen or NEDs will be hungry for information about the company as they decide on their level of interest in the role. This can be a challenge for a pre-IPO company that may not have produced a detailed company report and accounts before. In this area, however, the prospective board members are effectively acting as a proxy for future investors who will have similar information requests. It is important to make full disclosures of information to them at an early stage, and to recognise that the incoming directors will bring a necessary culture change in this area in the run-up to IPO.

Deciding on the jury

Who will interview prospective candidates, and when? It is usually advisable for the chairman/deputy chairman and chief executive to conduct the first-round interviews, ideally separately. Managing the process carefully and efficiently respects candidates' time and helps maintain their interest in the role.

The seven habits of highly ineffective directors*

- The one-company devotee: "At my [former/current] company we always ..."
- The rock thrower — who often makes a valid point but at the wrong time or in the wrong way, so rendering it less effective or counterproductive
- The didact: "Let me tell you what you really need to do ..."
- The one-trick pony: "I don't have a clue on the dividend policy, but let's bring the discussion back to marketing again"
- The aggressive — watch out for this kind particularly when the company is navigating tricky waters and directors are beginning to feel exposed
- The underprepared: listen for the sound of the board papers being opened for the first time at the meeting
- The silent or timid: "—"

**With thanks, and apologies, to the late author Stephen R Covey*

Not a one-off exercise

The task is not complete once the appointments have been made. The Code states that the board needs to be refreshed progressively (provision B.2). In an IPO situation, a number of the NEDs will have been appointed simultaneously, and their replacement post-IPO will have to be staggered carefully. In every company the chairman will need to plan ahead for the progressive succession of the committee roles, ideally allowing time for new committee chairmen to join as NEDs and committee members prior to the handover. The company may also need to bring in NEDs with different skills and areas of expertise as the company grows.

Chairmen do need to be prepared to tell non-executive directors when it is time for them to step down if their contribution is becoming less useful. It can be helpful to use individual director appraisals to provide feedback and open up this subject.

How to ensure that the board, once appointed, is actually effective?

It takes more than a clean kitchen to produce a good meal. Having individuals with the right skills and experience around the board table is the first step, but the chairman has a key role to play in making the board effective by:

- ensuring thorough induction of both NEDs and executive directors; induction of executives is often missed, but can be very helpful in coaching divisional directors and new CFOs to operate effectively as directors of listed companies
- getting the board agenda and supporting papers right
- chairing the board meeting in a way that enables each director to contribute fully
- communicating with directors outside board meetings and finding opportunities for less formal engagement among board members, including dinners, strategy 'away days' and site visits
- providing individual performance feedback to directors and using the annual board appraisal effectively.

A sectoral approach to:

Infrastructure
Energy & Natural Resources
Financial Services
Advanced Manufacturing & Technology

Providing corporate legal advice on:

Capital markets
Group reorganisations
Joint ventures
Private equity

Governance
Investment funds
M&A

Aberdeen, Belfast, Birmingham, Edinburgh, Glasgow, Leeds, London, Manchester
Beijing, Doha, Dubai, Falklands, Hong Kong, Munich, Paris, Shanghai, Singapore

Please contact:

Andrew Masraf
Group Head, Corporate

T: +44 (0) 207 418 9514
M: +44 (0) 7778 122978
E: andrew.masraf@pinsentmasons.com

www.pinsentmasons.com © Pinsent Masons LLP 2012

Combining the experience, resources and international reach of McGrigors and Pinsent Masons

12. The prospective non-executive director

Martin Webster, Pinsent Masons LLP

The role of a non-executive director is vital to the good governance of a publicly quoted company and there is no shortage of eligible candidates to sit around the boardroom table. Indeed, board appointments can be so keenly sought that would-be non-executive directors (NEDs) are often reluctant to carry out due diligence on the company before accepting an offer, despite the risk of personal liability and reputational harm which can follow when things go wrong.

To ensure that a company is right for them, prospective NEDs should carry out appropriate due diligence, comprising three elements:

- a review of publicly available information and of documentation supplied by the company
- questions for the company and individual directors
- meetings with directors and company advisers.

It is important that candidates do not commit to joining a board until their due diligence is complete and all their questions have been answered satisfactorily. Exposure to personal liability and the potential damage to personal reputation are not the only considerations; prospective NEDs must also have faith in the company's strategy, be sympathetic to its culture and be clear that they are being hired for the right reasons. For the relationship to work, they need to understand the company and the company needs to be clear what it is expecting from the NEDs in return.

Questions to ask before joining the board

Much information on a company will be publicly available, including past annual reports and results, regulatory announcements and media commentary. This will answer many questions and provide a general background. Further enquiries may be directed to the company secretary or raised with individual directors.

The following are some of the questions that a prospective NED might ask before committing to join a board. Some might be included in a formal request for information, while others will be better raised on a one-to-one basis with particular individuals.

Business, objectives and strategy

- Do you have a good overview of the company's business model, particularly the way in which value will be generated and preserved over the longer term?
- Are you clear on the company's objectives and its strategy for achieving them?
- What are the key issues currently on the board's agenda?
- What is the company's financial track record over the last three years, and its current financial position?
- If company performance has not been good, is there a plan to turn things round and can you commit to that?
- Does the company have a distinct culture and set of values? Are you in sympathy with them?

Governance

- Are you comfortable with the company's approach to corporate governance (including remuneration policy) and the explanations given for any non-compliance with the UK Corporate Governance Code (the Code)?
- Is constructive challenge from the NEDs welcomed?
- Is the board sufficiently diverse in its composition, skills and outlook? Are there plans to broaden the diversity of the board?
- Are you being brought on to the board to provide particular skills or experience, and are you confident you can deliver?

- What were the outcomes of the last board evaluation and have changes been made as a result?
- Does the board include representatives of major shareholders and how is that relationship managed? Is there a written agreement in place governing what those investors can and cannot do?
- Are you likely to have any conflicts of interest with the company? Is there a standard questionnaire that may help bring these out?

The board

- What time commitment is expected of you and will you be able to meet it, including emergencies and non-routine meetings? Will scheduled meeting dates fit with your other commitments?
- What are the boardroom dynamics — who wields real influence? Is the quality of chairmanship seen as good?
- Do the chairman and chief executive work well together?
- Have you seen the schedule of matters reserved for board decisions and the terms of reference for any committees you are to join? (Both will help define your role)
- How good is the company secretarial function, both in terms of the quality and timing of board papers and the support available to NEDs?
- Is there an effective induction programme for new directors and a commitment to ongoing training, particularly to bring you up to speed in areas where you lack experience?
- Are you encouraged to be active outside the boardroom, with opportunities to meet management below board level and make site visits so you can become more familiar with the business and the issues it faces?

Investor relations

- Who are the major shareholders and are they long-term investors?
- What major issues have they raised in the last year?
- How good is the dialogue between major shareholders and the board, both collectively and via individual directors?
- Who are the other major stakeholders in the company — employees, customers, suppliers, regulators and outside interest groups — and how good are relations with them?

Risk

- What are the main risks faced by the company and how are these mitigated and managed? What keeps directors awake at night?
- What is the company's risk appetite — are you comfortable with that?
- Does the company have internal controls and risk management systems that have proved effective and are regularly reviewed?
- What insurance cover is available for directors and when was it last reviewed? Does the company also give indemnities to directors? Do you understand the limitations of these protections?

Some of these questions might also be answered by sitting in on a board meeting, provided there is no sensitivity on confidential matters. Alternatively, a dinner or other meeting of the board in a social setting may achieve the same ends.

Face-to-face meetings with key individuals are also likely to provide answers. Even if already seen as part of the selection process, meetings with the chairman, chief executive, senior independent director and company secretary might be arranged. A session with the finance director should be scheduled to go through the last published results and ensure there is a good understanding of the issues they raise. The chairman of the audit committee might also be seen if accounting matters are likely to be high on

the agenda. A visit to the company's brokers can provide an insight into the key concerns regularly raised by major shareholders.

The role of the NED — what is expected?

It is important that a prospective non-executive director is clear as to the role they will be expected to play. Many facets of the post are common to all NEDs but there may also be elements specific to a particular company or individual. Is the director being recruited because of experience in IT or retail, for example, or is their accounting knowledge sought as chairman of the audit committee?

Some detail will be contained in the director's letter of appointment (which will be available for inspection by shareholders), but the following responsibilities, derived from the Code, also need to be taken into account.

Constructive challenge

Investors and regulators alike would probably view constructive challenge of a company's executive management as being the prime task of a non-executive director. Indeed, this questioning role is enshrined in one of the Code's Main Principles, which have to be applied by all Premium Listed companies.

However, NEDs need to show discretion. Negative or persistent questioning and point-scoring can create unwanted tensions in the boardroom and is unlikely to prove effective. Management has to be allowed to run the business on a day-to-day basis without having its decisions continually second-guessed. At the same time, though, proposals put to the board by the executive team must be examined and tested with a degree of healthy scepticism.

That is not always easy and non-executives have to be sensitive to the balance they need to strike, while management has to understand that the NEDs are there precisely to provide this level of challenge.

Much of this work might not be done in the boardroom. Indeed, questioning will often be more effective on a one-to-one basis rather than in the full glare of a formal board or committee meeting. The corollary is that, once the discussion is over and agreement reached, the board needs to give full support to the executives in their implementation of the collective decision.

Strategy

The same Main Principle that highlights this role of challenge for non-executives also requires their help in developing proposals on strategy. Of course, before deciding on a strategy to achieve a company's goals, its objectives must be agreed, even if they are no more than maximising shareholder value. The route taken by the company to that end will usually be developed by the chief executive and the executive team, often in conjunction with the chairman, and then presented to the full board, where it will be debated and subject to constructive challenge. Once approved, strategy should be kept under review and updated as circumstances change, with the NEDs playing a similarly active role.

Management and corporate performance

Performance against the agreed strategy also needs to be monitored by NEDs, which in turn means they must be satisfied they have all the information they need, when they need it, and are confident in its veracity. They must then be ready to use the information in judging management's implementation of strategy and the resulting commercial consequences. Only in that way will they be able to decide whether or not the executives, the strategy, or both, need to change.

Systems and controls

Much, therefore, relies on the systems that a company has in place for reporting information

about the business up to the board. This may sound like a back-office function that is entirely the responsibility of the executives, but the non-executives need to satisfy themselves that the systems are reliable. An internal audit department may give that level of reassurance, or it may be part of the remit of external auditors, but the audit committee (composed solely of NEDs) will also play a key role.

Information reaching the board may also be disclosed to shareholders and the wider market as part of a company's periodic reporting or in one-off announcements of price-sensitive information. Again, non-executives have a role in ensuring that such disclosures are both accurate and timely.

Remuneration

It is a basic principle of good governance that no one should be involved in deciding their own pay and so remuneration policy for all executives, not just directors, should be settled by a remuneration committee made up of independent non-executives. The committee's remit extends to recommending and monitoring the level and structure of senior management pay and setting the reward packages of individual directors.

A key feature of the remuneration committee is that it should have delegated authority from the board to decide these matters. It does not refer recommendations back to the board for a final decision but assumes full responsibility for the proposals it makes. That can place the committee chairman and other members in the line of fire when remuneration proves controversial. With the annual re-election of directors now recommended for companies in the FTSE 350, a NED's tenure on the board may be less secure than in the past.

The non-executives should not, however, decide their own pay. The Code provides that this task should be dealt with by the whole board, which may delegate the responsibility to a committee of executive directors. The articles of association may place an aggregate limit on NED fees.

Appointment and removal of directors

This remains a matter for the full board, although a nomination committee is commonly appointed, as recommended by the Code, to develop proposals on which the board can decide. This committee should be made up of a majority of independent non-executives, with the chairman often leading its deliberations. The chief executive will no doubt have a role in the appointment of the executive team, but the Code requires all board appointments to go through a "formal, rigorous and transparent procedure", and the NEDs on the nomination committee need to ensure that this is the case.

The nomination committee also has a role in ensuring that the board has the right mix of skills, experience, independence and knowledge. And if an individual director's performance is shown to be lacking, perhaps in an annual appraisal, the chairman and committee have to decide whether to recommend re-election at the next AGM or to engineer an earlier removal.

The committee also needs to look forward and plan for the succession to key roles among the executives. That is one reason why the non-executives should get to know the senior managers below board level — to assess their potential as candidates for the top roles. Succession planning also applies to the non-executive directors; a board full of long-serving NEDs can appear stale and even complacent. The Code urges "progressive refreshing" of the board to ensure that the non-executive contribution remains active and avoids the risk of 'group think'.

Shareholder relations

The chief executive and finance director should have regular discussions with major shareholders

to provide progress reports on the company's strategy, while the chairman and senior independent director will also meet investors at regular though less frequent intervals. The non-executive directors also need to maintain a good understanding of investor sentiment, whether through feedback from such meetings, analysts' and brokers' reports or face-to-face dialogue. Meetings between non-executives and major shareholders should be arranged by the company at the request of either side.

Attendance at the AGM offers NEDs the opportunity to meet smaller shareholders. The Code provides that the chairman should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM.

Standard of skill

While the law makes no distinction between executive and non-executive directors, there is a recognition that individuals bring different skills to a board and should be judged by those standards. Everyone will be expected to have a basic level of competence, but if an individual has particular experience or knowledge above and beyond that objective benchmark, they will be judged by their own higher standard.

Non-executive directors will be expected to use their broader general business experience to probe and challenge the executive directors, and to bring their relevant professional qualifications to bear. A chartered accountant chairing the audit committee will be judged by a different standard on financial compliance issues, for example, compared with a NED brought on to the board for their direct marketing experience.

The role of the senior independent director

The Code requires the appointment of a senior independent director (SID) from among a company's independent non-executives (or an explanation as to why no such appointment has been made). The Code identifies six elements to the role:

- to provide a sounding board for the chairman — someone on whom he can test out ideas and seek a second view
- to serve as an intermediary for the other directors — particularly where there is an issue concerning the chairman
- to be available to shareholders if they have concerns that have not been resolved by their regular contact with the chairman, chief executive or finance director, or that would be inappropriate to raise with them
- to attend sufficient meetings with a range of major shareholders to listen to their views and understand their issues and concerns
- to lead the annual evaluation of the chairman's performance, with input from other non-executive directors
- to lead the non-executives at times when it may be necessary for them to meet as a separate group without the chairman, because of his personal involvement with a particular issue.

Recent high-profile examples of SID roles include:

- Marks & Spencer, where chief executive Sir Stuart Rose also became executive chairman and the SID was given an enhanced role as guardian of the company's governance to reassure investors there was a counterweight to the power concentrated in the chairman's hands
- HSBC, where the chief executive, the finance director and a non-executive director were all contenders for the vacant chairmanship, with the prospect of the chief executive leaving if he was not successful. The SID was given the task of finding a solution satisfactory to the board and shareholders

- Prudential, where the chairman and chief executive both faced criticism following the collapse of an attempted acquisition by the insurer, and the SID acted as a liaison point between the board and dissatisfied investors
- BSkyB, where the independent directors were led by the SID in responding to News Corporation's bid to acquire the 61 per cent of the company it did not already own.

To avoid any risk of confusion between the roles of the chairman and the SID, a brief job description for the latter might be agreed by the board and be available on the company website along with other governance documents.

The participation of NEDs in an IPO

When a company is preparing for an initial public offering (IPO), the appointment of new non-executives will be a common requirement as an assurance of good governance standards. The company may have had a purely executive board until that point, or the non-executives may have been family members or other representatives of significant shareholders.

If the aim is to achieve a Premium Listing, at least half the board of directors, excluding the chairman, should be independent NEDs. In other words, the executive directors should be matched by at least an equal number of independent NEDs. It is recommended that Premium Listed companies outside the FTSE 350 have at least two independent NEDs, while Standard Listed and AIM companies will usually want to achieve a similar board composition.

Prospective non-executive directors joining a company before an IPO need to be aware that their presence on the board may be an element in the selling of the company to investors. The market will want to know that proper systems of governance and risk management are in place, and a strong non-executive complement on the board will be seen as an indication of good intent. In particular, NEDs with a grounding in UK corporate governance standards will be sought where an overseas business is being floated on UK markets.

Such directors may find that they are not joining a board with well-developed governance systems or even with a good understanding of what such systems might look like. It will be their task to ensure that the usual committees and governance structures are put in place before the IPO and that there is an acceptance by existing board members that new procedures and principles are to apply. Satisfying oneself that such change is achievable, and is not regarded as mere window dressing, will be a key part of the due diligence process described earlier in this chapter.

The new NEDs need to capitalise on this opportunity and to put in place a schedule of matters reserved for board decisions and committee terms of reference that ensure an appropriate level of governance. Where a major shareholder retains some board representation, a formal agreement may be negotiated to reinforce these governance structures and to ensure that conflicts of interest are recognised and do not prejudice the interests of the incoming investors.

While the NEDs will have a particular interest in the company's corporate governance arrangements, they may feel they can leave the details of the IPO to their executive colleagues and the company's professional advisers. They will, nonetheless, be required by the Listing Rules to accept responsibility for the information appearing in the listing particulars or prospectus and to confirm that:

"To the best of their knowledge and belief (having taken all reasonable care to ensure that such is the case) the information contained in the document is in accordance with the facts and does not omit

anything likely to affect the import of such information."

No distinction is drawn between the executive directors and the NEDs; all carry the same legal and regulatory responsibility for what is said to potential investors.

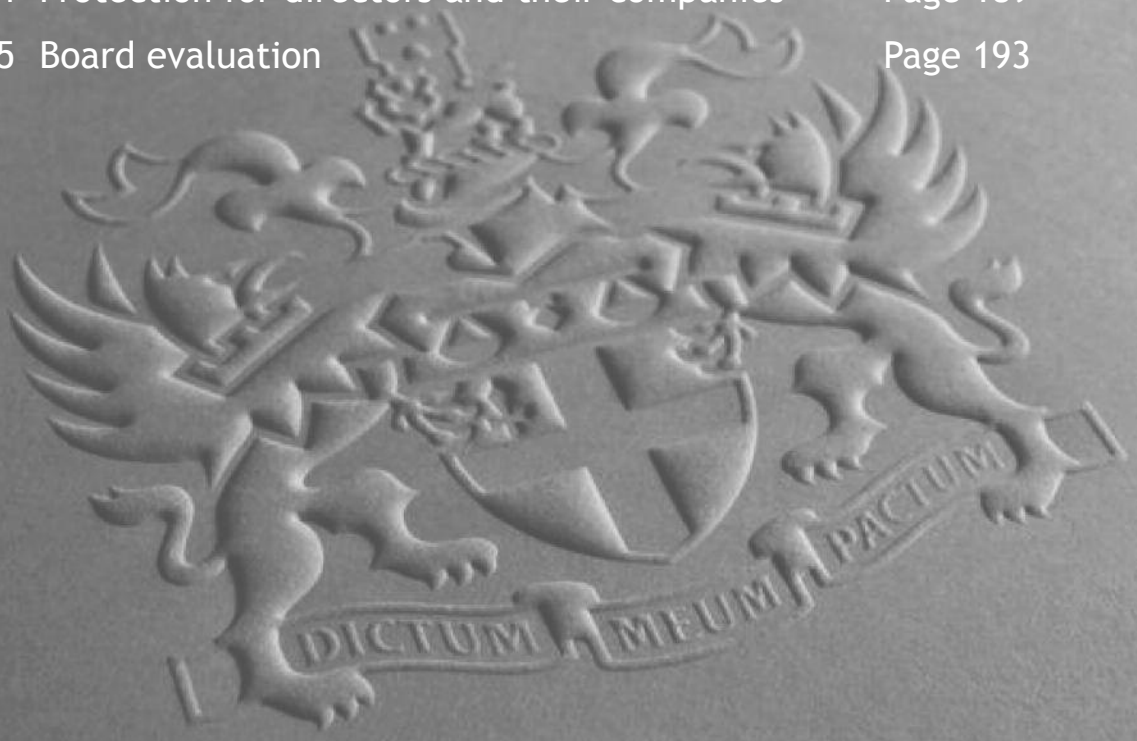
It is important, therefore, that the new NEDs do not abdicate responsibility to the existing directors and instead participate fully in the final meetings at which the IPO documentation is signed off, verification of its terms is confirmed and the share price decided. As with any board meeting, this is their opportunity to question, challenge and debate the issues before reaching a collective decision.

Conclusion

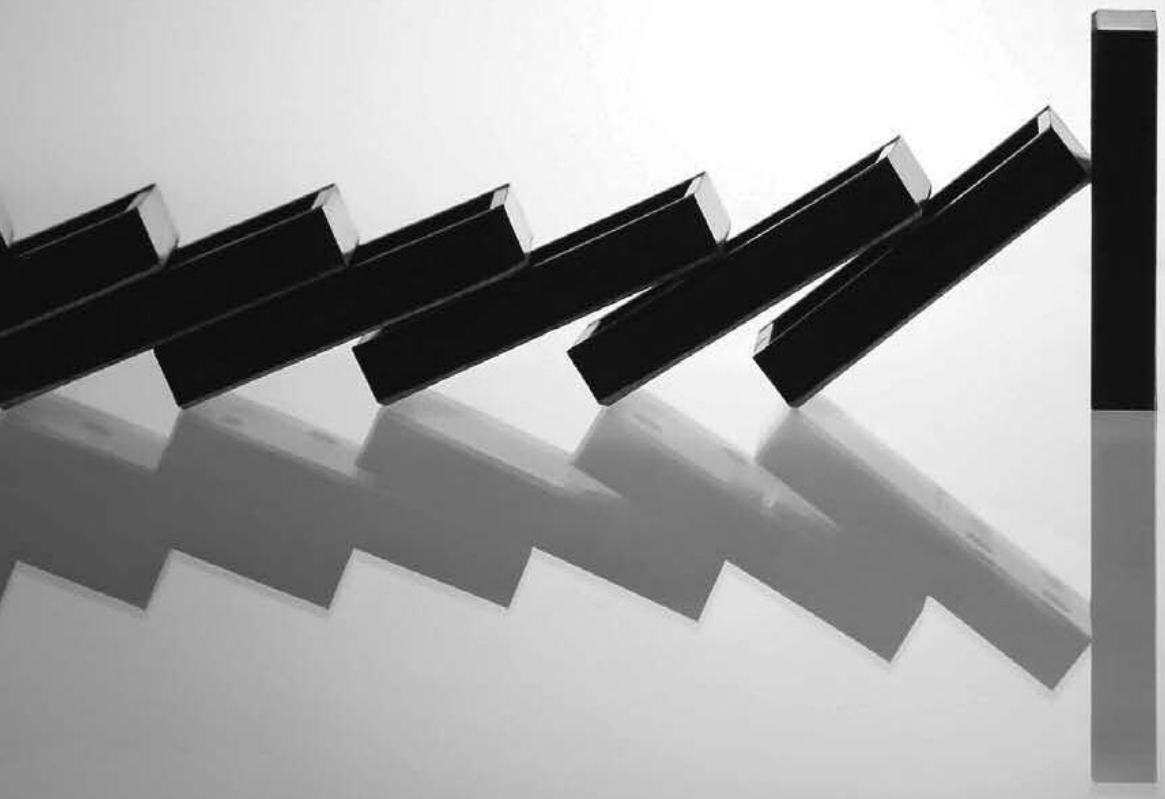
The time commitment required of a non-executive director may not be great but the role remains crucial. NEDs are a necessary check on the executive team, a safeguard and channel of communication for investors, and the guardians of a company's good governance.

Part IV: Post-IPO considerations

Chapter 13	Corporate governance and the Main Market	Page 85
Chapter 14	Corporate governance and AIM	Page 93
Chapter 15	The role of the board in effective risk management and oversight	Page 103
Chapter 16	Inside information	Page 117
Chapter 17	The UK Bribery Act 2010 and its implications for businesses	Page 126
Chapter 18	Managing directors' conflicts	Page 137
Chapter 19	The role of the independent adviser	Page 145
Chapter 20	Executive remuneration	Page 151
Chapter 21	Sustainability governance: taking corporate social responsibility on board	Page 161
Chapter 22	The relationship between directors and shareholders: financial communications and investor relations	Page 169
Chapter 23	Corporate governance — towards best-practice corporate reporting	Page 177
Chapter 24	Protection for directors and their companies	Page 189
Chapter 25	Board evaluation	Page 193



Accountability.



Our work for a wide range of listed companies, regulators and stock exchanges means we are ideally placed to advise on best practice and trends in corporate governance.

"The firm is praised for its depth of expertise: 'Quality is a given' while 'the extra commercial and strategic thinking adds another dimension'"

CHAMBERS UK, 2011

SLAUGHTER AND MAY

www.slaughterandmay.com

13. Corporate governance and the Main Market

Padraig Cronin, Slaughter and May

The basic framework of corporate governance for listed companies is provided by the Companies Act 2006, the Disclosure and Transparency Rules (DTRs) and the Listing Rules (LRs). For a company with a Premium Listing of equity shares, LR 9.8.6R (5) and (6) require the company to state how it applies the Main Principles of the UK Corporate Governance Code, and either to confirm that it complies with the Code's provisions or, where it does not, to provide an explanation.

Companies other than those with a Premium Listing of equity shares are likely to find that compliance with the Code, or adequate explanation where a company chooses not to comply, is enforced through the expectations of shareholders and representative bodies such as the Association of British Insurers and the National Association of Pension Funds. If these companies choose not to comply with the Code, they must still comply with DTR 7, which relates to corporate governance statements and the audit committee.

Mandatory disclosures

Accountability to shareholders underpins the UK corporate governance system. The regulatory framework described above places responsibilities on the directors of listed companies to maintain transparency and to provide investors with the information they need to hold the directors to account.

Financial reporting

Under Section 386 of the Companies Act, directors have a responsibility to ensure that proper accounting records are kept that are sufficiently comprehensive to show and explain the company's transactions, to disclose with reasonable accuracy the financial position of the company at any time, and to enable the directors to publish annual accounts that give a true and fair view. Section 388 of the Companies Act provides that accounting records must be kept for six years.

Under DTR 4, LR 9 and Sections 423 and 430 of the Companies Act, directors of a listed company must prepare annual accounts as well as half-yearly financial reports that satisfy certain requirements regarding timing and content. Annual accounts must be sent to members before the annual general meeting and must be made available on the company's website, and both these and the half-yearly financial reports must remain publicly available for at least five years.

The directors must also release interim management statements during both the first and second half of the financial year (although in October 2011 the European Commission published proposed amendments to the Transparency Directive removing this requirement for listed issuers). These statements provide an explanation of material events and transactions that have taken place during the relevant period and their impact on the financial position of the group.

Non-financial reporting

Management and directors' reports

DTR 4.1.5R (2) states that the annual financial report must contain a management report. This must include a fair review of the company's business and a description of the principal risks and uncertainties facing the company. In addition, Section 415(1) of the Companies Act obliges the directors to prepare a directors' report each financial year.

In practice, the company's annual report will set out the information needed to satisfy the requirements of DTR 4 and the Companies Act.

The Financial Reporting Council (FRC) regards the annual report as not only an important means of communicating with shareholders, but also, as stated in its 'Guidance on Board Effectiveness', useful in prompting the board to reflect on the quality of its governance, and how it might improve its structures, processes and systems.

Under Section 417 of the Companies Act, the directors' report must contain a business review that offers a "balanced and comprehensive" analysis of the development and performance of the business throughout the year and its position at the year-end. The purpose of the review is to inform shareholders and help them assess how the directors have performed their duties under Section 172, which provides that directors must promote the success of the company for the benefit of its members as a whole.

The business review of a listed company must:

- contain a fair review of the company's business, and a description of the principal risks and uncertainties facing the company
- include information about environmental matters; the company's employees; social and community issues; any policies in relation to those matters and their effectiveness; and persons with whom the company has contractual or other arrangements essential to its business
- to the extent necessary for an understanding of the development, performance or position of the company's business, include analysis (under Section 415) using financial key performance indicators.

The company's sector and business will be key drivers as to what it reports. There is a wide spectrum of approaches taken by companies in how they report on environmental, employee and social and community issues in their business review. The 2011 review of an international energy giant, for example, sets out brief details of the way in which it selects contractors and notes that suppliers, contractors and partners are expected to comply with the principles of its code of conduct. On the whole, however, detail on employees and on the company's management of its environmental impact is more common than detail on arrangements with contractors and suppliers.

Disclosure under DTR 7.2
DTR 7.2.1R requires directors to make a corporate governance statement in their directors' report. DTR 7.2.5R to 7.2.10R set out specific information that must be included in the governance statement.

DTR 7.2.5R provides that the corporate governance statement must contain a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process. If a company is required to prepare a group directors' report within the meaning of Section 415 of the Companies Act, DTR 7.2.10R provides that the directors must include in that report a description of the main features of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts.

DTR 7.2.6R provides that where the company admitted to trading on the Main Market has securities carrying voting rights, the corporate governance statement must contain specific information on the company's capital and shareholders.

Under DTR 7.2.7R, the governance statement must contain a description of the composition and operation of the issuer's administrative, management and supervisory bodies and their committees.

Obligation to disclose inside information
Directors of listed companies also have

responsibilities to ensure that the company makes certain non-financial information public. This includes information relating to changes to the company's capital structure, any changes to the board of directors, and all resolutions passed by the company other than resolutions relating to ordinary business.

DTR 2 sets out the obligations of listed companies in relation to inside information. This is defined as any information about a company — relating to events, circumstances, changes in circumstances, transactions or trading that exist or occur, or may reasonably be expected to exist or occur — that is not generally available and that a reasonable investor would be likely to use as part of the basis of his investment decisions. The information is therefore likely to have a significant effect on the price of the company's shares or other securities.

The company's primary obligation is to announce publicly all inside information that directly concerns the company, and which is in its possession, as soon as possible through a regulatory information service (RIS). The company should adopt procedures for the identification of inside information and the board should appoint a disclosure committee empowered to consider and approve the making of appropriate public announcements to ensure compliance with DTR 2.

If the company is faced with an unexpected and significant event, a very short delay may be acceptable if it is necessary to clarify the situation. In such situations, if the company believes there is a danger of inside information leaking before the facts and their impact can be confirmed, the company should make a holding announcement. The Financial Services Authority (FSA) is not likely to regard the inability to convene a full board meeting as a legitimate reason for a delay in releasing inside information, as most issuers can delegate the authority to make emergency announcements to a committee of directors, who can hold a telephone meeting to agree a course of action.

All inside information announced via an RIS must be posted on the company's website for one year following publication.

Leadership and the Code in practice

Natural resources company (2011 annual report): "The Board has published a Board Governance Document, which is a statement of the practices and processes the Board has adopted to discharge its responsibilities. It includes the processes the Board has implemented to undertake its own tasks and activities; the matters it has reserved for its own consideration and decision-making; the authority it has delegated to the CEO, including the limits on the way in which the CEO can execute that authority; and provides guidance on the relationship between the Board and the CEO."

Mining group (2011 annual report): "The Chairman routinely holds discussions with the non-executive directors without the executive directors being present."

Directors' responsibilities under the Code

For companies with a Premium Listing of equity shares, and other listed companies that choose to comply with the Code under DTR 7.2.2R, the Code places the following responsibilities on directors.

Section A: Leadership

The Code identifies the board as being collectively responsible for the long-term success of the company. The board's role is to provide entrepreneurial leadership within a framework of prudent and effective controls. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives, and

ensure that its obligations to shareholders and others are understood and met. The board should meet sufficiently regularly to discharge these responsibilities effectively.

There should be a clear division of responsibilities at the head of the company, which will require different people to hold the post of chairman and chief executive officer. The division of responsibilities, roles and functions between the chairman and chief executive should be set out in writing and agreed by the board.

The chairman is responsible for leadership of the board and ensuring its effectiveness. The chairman sets the board's agenda and ensures that adequate time is available for discussion of all agenda items, in particular strategic issues. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information, and for promoting effective communication with shareholders.

The non-executive directors have responsibilities under the Code. Broadly, these include: contributing an independent view to the board's deliberations by constructively challenging and helping to develop proposals on strategy; helping the board provide the company with effective leadership; ensuring the continuing effectiveness of the executive directors and management; and ensuring high standards of financial probity on the part of the company.

Section B: Effectiveness

All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively. The board should not agree to a full-time executive director taking on more than one non-executive directorship at a FTSE 100 company, nor the chairmanship of such a company.

It is the chairman's responsibility to ensure that the directors receive a full, formal and tailored induction on joining the board, and that they regularly update and refresh their skills and knowledge. As part of this, directors should avail themselves of opportunities to meet major shareholders. The chairman should regularly review and agree training and development needs with each director.

The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information in a form and of a quality appropriate to enable them to discharge their duties.

Section C: Accountability

It is the directors' responsibility, in their financial and business reporting, to present a balanced and understandable assessment of the company's position and prospects. This responsibility extends

Effectiveness and the Code in practice

Natural resources company (2011 annual report): "It is made clear in the Terms of Appointment that Directors must be prepared to commit sufficient time and resources to perform the role effectively. The Nomination Committee takes account of the other positions held by each potential Director candidate and assesses whether they will have adequate time to devote to the Board prior to making a recommendation to the Board on whether to appoint them as Director."

On training: "Each Non-executive Director has an individual development plan in order to provide a personalised approach to updating the Director's skills and knowledge."

Mining group (2011 annual report): as part of the process of appointment of non-executive directors, "candidates disclose all other time commitments and, on appointment, undertake to inform the Board of any changes".

to interim and other price-sensitive public reports and reports to regulators.

The directors are responsible for determining the nature and extent of the significant risks that the company is willing to take in achieving its strategic objectives. The directors must understand, and take responsibility for, the risk appetite of the company and the risks that the company takes. The board should maintain sound risk management and internal control systems. The board should also, at least once a year, conduct a review of the effectiveness of the company's risk management and internal control systems, including financial, operational and compliance controls.

The responsibility for overseeing the company's risk management policies and internal controls is delegated to the audit committee of the board. Companies should establish an audit committee of at least three independent non-executive directors — or two in the case of smaller companies, which are defined in the Code as companies that are below the FTSE 350 throughout the year immediately prior to the reporting year.

Section D: Remuneration of directors and senior management
The directors should establish a remuneration committee made up of at least three (two in the case of smaller companies) independent non-executive directors. The chairman may be a member if he or she was considered independent on appointment as chairman.

Section E: Relations with shareholders
The board as a whole is responsible for ensuring that a satisfactory dialogue with shareholders takes place. However, it is the chairman who has primary responsibility for discussing governance and strategy with major shareholders, and for ensuring that the views of shareholders are communicated to the board. In its 'Guidance on Board Effectiveness', the FRC encourages the chairman to report personally about board leadership and effectiveness in the corporate governance statement in the annual report. In the BHP Billiton 2011 annual report, for example, the chairman reports on the company's corporate governance, including efforts to increase the gender diversity of the board.

The Code emphasises the importance of continual communication with major shareholders, and of the annual general meeting, as two aspects of a company's wider communications strategy. The board should use the AGM to communicate with investors and

Accountability and the Code in practice

Natural resources company (2011 annual report): "Each year, the Board reviews and considers the risk profile for the whole business. This risk profile covers both operational and strategic risks. The risk profile is assessed to ensure it supports the achievement of the Group's strategy while maintaining a strong 'AAA' credit rating."

Support services group (2011 annual report): "The Audit Committee comprises all of the Non-Executive Directors… All members of the Committee receive an appropriate induction, which includes an overview of the business, its financial dynamics and risks. Audit Committee members are expected to have an understanding of the principles of, and developments in, financial reporting, including the applicable accounting standards and statements of recommended practice, key aspects of the Company's policies, financing, internal control mechanisms, and matters that require the use of judgment in the presentation of accounts and key figures as well as the role of internal and external Auditors. Members of the Committee undertake ongoing training as required."

Shareholder relations and the Code in practice

Natural resources company (2011 annual report): "The Chairman, with support from the Company Secretariat team, has regular meetings with institutional shareholders and investor representatives to discuss governance matters … The Investor Relations team provides quarterly reports in relation to shareholder feedback generally, which the Board uses to assess how the Group is responding to shareholder views and issues."

Support services group (2011 annual report): "The views of the Company's major shareholders are reported to the Board by the Group Chief Executive and the Group Finance Director as well as by the Chairman (who remains in contact with the 10 largest shareholders)."

Mining group (2011 annual report): "The Chairman periodically offers key shareholders the opportunity of meeting with himself or the Senior Independent Director to discuss governance, strategy or any other matters shareholders wish to raise." At the AGM, "all the Directors are available to answer questions both formally at the meeting and informally afterwards".

encourage their participation. The Institute of Chartered Secretaries and Administrators interprets this to mean that the chairman of a general meeting must be prepared to allow debate and questions; the meeting is an opportunity for shareholders to speak, not just a forum for the board to deliver speeches or prepared answers to previously submitted questions. The chairman should arrange for all directors to attend the AGM, and for the chairman of the audit, remuneration and nomination committees to be available to answer questions.

CLEAR FOCUS

Cobbetts is a leading business law firm with offices in London, Birmingham, Leeds and Manchester, with over 300 lawyers focused on providing innovative and commercial legal solutions to international and UK clients.

The lawyers in our capital markets team are highly rated for the advice which they provide to quoted companies and to companies joining the UK's capital markets, in particular, the AIM market.

Chambers & Partners UK 2012
Cobbetts elicits *"praise from market sources for its national offering in this (the AIM) sphere. It advises an impressive client portfolio comprising national and international companies".*

For more information, please contact:

Daniel O'Gorman: Tel: +44 (0)20 3130 4120
Email: daniel.ogorman@cobbetts.com

Guy Jackson: Tel: +44 (0)113 288 5216
Email: guy.jackson@cobbetts.com

cobbetts

www.cobbetts.com
Birmingham | Leeds | London | Manchester

Cobbetts LLP is a Limited Liability Partnership

14. Corporate governance and AIM

Daniel O'Gorman and Shubhu Patil, Cobbetts LLP

What constitutes an effective and appropriate corporate governance structure for a particular company is not prescribed for AIM company boards in the way it is for boards of companies on the Main Market of the London Stock Exchange.

While regulation for companies with a Premium Listing on the Main Market may be more extensive, the boards of such companies have the certainty of knowing that they must consider the provisions of the UK Corporate Governance Code (the Code) and make the required disclosure in their annual report as to their compliance with the Code.

In contrast, the AIM Rules for Companies do not include provisions that are equivalent to the Code. Instead, corporate governance measures are considered: (1) under the wider requirement for AIM companies to have in place sufficient procedures, resources and controls; and (2) in the context of the responsibility of a company's nominated adviser (Nomad) to assess the ongoing suitability of their AIM company clients. This principles-based approach to corporate governance stems from the Exchange's approach to regulation of AIM in general, which recognises that a 'one size fits all' regime is not always appropriate for smaller and growth companies.

This does not mean, as the Exchange has consistently stated, that corporate governance should be viewed as a less important consideration for AIM companies. Indeed, given the current public and political focus on good corporate practice and behaviour, AIM companies should make sure that they have properly considered and tested the appropriateness and robustness of their systems and practices.

Adopting an effective approach to corporate governance is an important factor in establishing investor confidence in AIM in general and successful investor relations for individual AIM companies. Stronger and more effective governance systems should contribute to improved company performance and, ultimately therefore, help to deliver greater value to a company's shareholders.

While the more detailed guidance available to AIM companies is considered later in this chapter, in practical terms boards should always keep in mind key principles that underpin any system of corporate governance, including:

- **Management effectiveness and independence** — ensuring that the board comprises an appropriate balance of skills, experience and independence and operates in such a way as to actively encourage constructive challenge
- **Transparency** — ensuring that information available to shareholders and stakeholders, including reports, is clear and of a high quality and so enables an assessment of board effectiveness in the context of performance, delivery of strategy and remuneration.

Considerations for AIM companies in putting effective corporate governance systems in place

Without a requirement to adopt a particular corporate governance code, directors of an AIM company have a degree of flexibility and discretion in their approach to corporate governance.

With guidance from its Nomad, the board of an AIM company is able to put in place systems that it believes are best for the company and its particular requirements but that are also consistent with its quoted company status. This allows the board to consider and balance the

needs and resources of what is often a smaller, growing business against the need to have an effective governance system that will deliver transparency and trust between the board and the shareholders. If the directors do not strike the right balance between the proportionality of governance systems and their effectiveness, they risk undermining shareholder confidence.

So, in the absence of mandatory requirements, what should be the starting point for the board of an AIM company in implementing an effective corporate governance structure? The key considerations for directors should be:

- to invest the time as a board to actively consider what is appropriate for their particular company
- in accordance with their obligations under AIM Rule 31, to seek guidance from the company's Nomad
- that the Code is the standard to which AIM companies should aspire
- to seek to follow, as a minimum, the 'Corporate Governance Guidelines for Smaller Quoted Companies', published by the Quoted Companies Alliance (QCA) in September 2010 (the QCA Guidelines), which are widely recognised as the benchmark for SME corporate governance
- to monitor and evaluate the effectiveness of corporate governance systems on a continuing basis so that changes are made to adapt and improve the systems over time.

The expectations of the Exchange and the AIM Rules

Requirements, expectations and the role of the Nomad

As stated above, the Exchange has consistently made it clear that good corporate governance is important and relevant to AIM companies. AIM has the benefit of the Nomad system, under which the advisers are responsible for considering corporate governance issues as part of their wider obligations to assess the suitability of companies for admission to AIM. In particular, the AIM Rules for Nominated Advisers require the Nomad to consider the efficacy of the board as a whole for the company's needs, as well as the adoption by the company of appropriate corporate governance measures. The Exchange therefore expects Nomads to continue to be actively involved in setting and satisfying corporate governance standards.

The Exchange's expectations on good corporate governance for AIM companies are discussed in Issue 2 of its 'Inside AIM' newsletter, July 2010. In summary, this states that:

- Most importantly, the Exchange believes that good corporate governance is just as relevant and important for AIM companies as it is for those on the Main Market
- The Exchange continues to support a flexible and pragmatic approach to corporate governance regulation as being more appropriate for smaller, growing quoted companies
- A 'one size fits all' requirement to comply with a particular code, or provide reasons for any non-compliance, is not considered to be appropriate for AIM; a meaningful and considered approach to processes that are appropriate to a particular company and designed to improve both the running of the company and the interaction with shareholders is the desired outcome (as opposed to a 'box ticking' approach to compliance)
- AIM companies should use and consult their Nomad, who should be in an excellent position to advise on the corporate governance standards with which an AIM company should comply by reference to

factors such as size, stage of development, business sector and jurisdiction

- The Exchange fully supports the use of the QCA Guidelines to achieve a level of corporate governance appropriate for an AIM company
- In assessing the effectiveness of corporate governance systems, the Exchange will look for evidence of discussion and debate (on admission to AIM and on an ongoing basis) of board composition, structure, procedures and controls, using, for example, the Code or the QCA Guidelines as a starting point.

The AIM Rules for Companies

Although the AIM Rules for Companies do not contain express requirements for specific corporate governance procedures, companies admitted to AIM are, of course, subject to various continuing obligations under the AIM Rules for Companies. While a detailed discussion of these obligations is outside the scope of this chapter, it should be remembered that the areas they cover overlap with matters that may be regarded as part of a company's corporate governance. In particular, the rules to which AIM companies are subject on disclosure of information underpin the key governance requirement for an AIM company to keep the market and its stakeholders informed and up to date. Putting in place systems to ensure compliance with these disclosure obligations is, therefore, an important part of an AIM company's corporate governance procedures.

The principal rules in the AIM Rules for Companies dealing with disclosure are:

- **Rule 11**: the general obligation to make notification without delay of new developments that are not public knowledge concerning a change in an AIM company's financial condition, sphere of activity, performance or expectation of performance, which, if made public, would be likely to lead to a substantial movement in the price of the AIM company's shares
- **Rule 17**: listing specific matters that must be notified and disclosed without delay, including changes in interests in shares, board changes and material changes in trading performance or financial condition from any publicly made forecast or estimate
- **Rules 18 and 19**: setting out requirements relating to half-yearly and annual reports
- **Rule 26**: requiring AIM companies to maintain a website on which certain information is available free of charge and is up to date and clearly accessible and identifiable as being the information required to satisfy Rule 26. The information required to be disclosed includes: details of directors and their responsibilities; details of committees of the board and their responsibilities; notifications made by the AIM company in the preceding 12-month period; copies of certain documents such as the company's constitution and latest reports and admission document; and certain information relating to shares in the AIM company, including the percentage of shares that are not in public hands together with the identity and percentage holdings of each shareholder who holds 3 per cent or more of any class of shares in the AIM company. The availability of the Rule 26 information in relation to each AIM company is a key starting point to assist shareholders and stakeholders in making informed assessments about the governance, control and performance of AIM companies. In particular, by requiring clear disclosure relating to the ownership of shares in AIM companies, investors and potential investors are able to make an assessment about the independence of corporate governance systems, not only from the directors who have executive responsibility in a company, but also from the persons who have significant shareholdings in an AIM company.

The QCA's 12 essential guidelines for good practice

Guideline	Summary of recommendation of application of the guideline
Flexible, efficient and effective management	
1. Structure and process	Put in place the most appropriate governance methods based on the company's culture, size and business complexity. The company should be clear on how it intends to fulfil its objectives and, as the company evolves, so should its governance
2. Responsibility and accountability	Make clear where responsibility lies for management and achievement of key tasks. The board has collective responsibility for long-term success. The roles of chairman and chief executive should not be exercised by the same individual
3. Board balance and size	The board must not be so large as to prevent efficient operation. It should contain at least two independent non-executive directors (one of whom may be the chairman if deemed independent at the time of appointment) and should not be dominated by any one person or group
4. Board skills and capabilities	The board must have an appropriate balance of functional and sector skills and experience. It should be supported by committees (audit, remuneration and nomination) that have the necessary character, skills and knowledge
5. Performance and development	The board should periodically review its performance and the performance of its committees and individual board members. There is a need to identify ineffective directors and either help them to become effective or replace them. Membership of the board should be refreshed periodically
6. Information and support	The board and its committees should be provided with the best possible information so that they can constructively challenge recommendations before making decisions. Non-executive directors should have access to external advice when necessary
7. Cost-effective and value-added	There will be a cost in achieving efficient and effective governance, but this should be offset by increases in value. There should be a clear understanding between board and shareholders of how this value has been added (for example, through the publication of key performance indicators and through meetings with shareholders)

Corporate governance guidance for AIM companies

The QCA Guidelines and other QCA guidance

As explained elsewhere in this guide, the QCA is a trade members' organisation whose work focuses on issues affecting small and mid-cap quoted companies outside the FTSE 350.

The QCA published its guidelines for smaller

The QCA's 12 essential guidelines for good practice

Guideline	Summary of recommendation of application of the guideline
Entrepreneurial management	
8. Vision and strategy	There should be a shared vision of what the company is trying to achieve and over what period, and what is required to achieve this. Vision and direction must be well communicated, internally and externally
9. Risk management and internal control	The board is responsible for maintaining a sound system of risk management and internal control. It should define and communicate the company's risk appetite, and appropriately balance risk management with entrepreneurship. Remuneration policy should help the company to meet its objectives while encouraging behaviour that is consistent with its risk profile
Delivering growth in shareholder value over the long term	
10. Shareholders' needs and objectives	There should be a dialogue between shareholders and the board so that the board understands the shareholders' needs and objectives and their views on the company's performance. Vested interests should not be able to act in a manner contrary to the common good of all shareholders
11. Investor relations and communications	There should be a communication and reporting framework between the board and all shareholders, such that shareholders' views are communicated to the board and shareholders in turn understand the unique circumstances of the company
12. Stakeholder and social responsibilities	Good governance includes a response to the demands of corporate social responsibility and a proactive CSR policy. This requires the management of social and environmental opportunities and risks

quoted companies with the stated aim of addressing the gap in corporate governance guidance for quoted companies that do not have a Premium Listing of equity shares and for which the requirement to 'comply or explain' against the Code is not mandatory. The main features of the QCA Guidelines are as follows:

- The guidelines apply key elements from the Code, and other relevant guidance, to the needs of smaller quoted companies for which the Code may not be entirely relevant due to their size or relative lack of complexity
- The guidelines' central premise is that "transparency and trust between boards and shareholders are of the utmost importance, and that these factors will both promote the success of the company and reduce the demand for greater regulation"
- The guidelines are designed to be 'outcome oriented' and to encourage directors and shareholders to think about how they can actively build trust — rather than treat the guidelines as a checklist.

Corporate governance statement: demonstrating good practice

The 12 guidelines set out in the panels on pages 98 and 99 represent the QCA's view on the matters that smaller quoted companies should address in their corporate governance systems. However, as the QCA Guidelines state: "It is not enough for a company to be well managed. Trust between boards and shareholders depends on the demonstration of the quality of management."

So, rather like the 'comply or explain' approach applying to companies with a Premium Listing of equity shares in relation to the Code, the QCA Guidelines underpin the principles of best practice with the recommendation that each smaller quoted company should publish a corporate governance statement annually that describes how it achieves good practice. The QCA Guidelines recommend that:

- The statement should be published in the annual report and accounts (analogous to companies with a Premium Listing) or, failing that, on the company's website
- It is not sufficient for the statement to assert that the company achieves good governance; the company must demonstrate in the statement how it does so
- As a minimum, the statement should describe how each of the 12 guidelines for good practice is put into effect and describe any additional corporate governance structures that the company applies beyond this basic level
- Where the company is not able to achieve implementation of the 12 guidelines for good practice, it should describe how the features of good governance are being achieved and explain why its arrangements are best for the company and its shareholders at the company's current stage of development
- Given that the QCA Guidelines are considered minimum best practice for smaller quoted companies, the directors should consider carefully, and provide a reasoned explanation for, any deviations from the QCA Guidelines
- There should be certain 'minimum disclosures', included both in the annual report (relating, for example, to the performance evaluation of directors and the reports of the remuneration and audit committees) and on the company's website (for example, making available the terms of reference of committees and the terms of appointment of non-executives).

The requirement of the QCA Guidelines that companies publish an annual corporate governance statement, coupled with the Exchange's stated position that it "fully supports the use of the QCA Guidelines to achieve a level of corporate governance measures appropriate for an AIM company", may therefore be regarded as establishing a de facto 'comply or explain' regime for AIM companies.

Other QCA guidance: audit and remuneration committees

The QCA's other guidance and publications include:

- a 'Remuneration Committee Guide for Smaller Quoted Companies' (February 2012)
- an 'Audit Committee Guide for Smaller Quoted Companies' (February 2009).

Clearly, both remuneration policy and audit and internal/risk management controls are key aspects of corporate governance for any quoted company. The QCA's guidance on remuneration and audit committees is, like the QCA Guidelines themselves, designed to assist AIM companies in the effective constitution and operation of those committees in a way that is appropriate for smaller quoted companies. The tables opposite and over page include, among other things, a summary of the QCA's recommendations concerning the

Summary of guidance and best practice in key areas

Best practice recommendations for some key areas of corporate governance with which AIM companies should seek to comply

Area of governance	Applying best practice
1. The board	
Role of chairman	The role of chairman and chief executive should be separate and not be exercised by the same individual (QCA Guidelines). If the roles are combined, there should be an explanation as to how governance is protected (for example, through the appointment of a senior independent director), the exceptional circumstances that cause the roles to be combined and the intentions for the separation of the roles (QCA Guidelines and NAPF AIM Policy). The chief executive should not go on to be chairman of the same company. If, exceptionally, this does happen, appropriate explanation needs to be provided (UK Corporate Governance Code and NAPF AIM Policy)
Independent non-executive directors	The company should have at least two independent non-executive directors (one of whom may be the chairman if deemed independent at the time of appointment) and the board should not be dominated by one person or a group of people (QCA Guidelines). The NAPF AIM Policy requires (for larger boards) two independent directors excluding the chairman and (for smaller boards comprising no more than four directors) two independent non-executive directors, one of whom may be the chairman
Appointment of a senior non-executive director	The UK Corporate Governance Code requires one of the independent non-executive directors (other than the chairman) to be appointed as a senior independent director. For AIM companies, the appointment of a senior independent director is required where a company has a combined chairman and chief executive officer (NAPF AIM Policy).

composition of both audit and remuneration committees.

The National Association of Pension Funds: policy and voting guidelines for AIM companies

The NAPF provides representation and services for the pensions industry in the UK. To protect the interests of its members as institutional investors in quoted companies, the NAPF publishes guidance on matters including corporate governance and voting guidelines.

The NAPF's 'AIM Policy' was published in March 2007 and, unlike the NAPF's policies relating to companies with a Premium Listing of equity securities, it has not been updated since the introduction of the Code in 2010 and still refers to the guidance contained in the Code's predecessor — the Combined Code. The principles set out in the NAPF's AIM Policy are, however, still applicable.

In their admission documents and/or annual reports, AIM companies will usually refer to how they

Summary of guidance and best practice in key areas

Area of governance	Applying best practice
2. Independence of non-executive directors	The criteria for assessing the independence of non-executive directors set out in the UK Corporate Governance Code are useful for adoption by AIM companies, and independence should be demonstrated if the criteria are not met; the test of independence should not be solely checklist-driven (QCA Guidelines). Payment of fees satisfied in shares of the company does not, of itself, impair independence provided that there are restrictions on how quickly those shares can be disposed of (QCA Guidelines). Independence of a director may be compromised if a director has a beneficial or non-beneficial shareholding of more than 3 per cent of the company's issued share capital (NAPF AIM Policy). Participation in the company's share option scheme or performance-related pay scheme may compromise independence. The QCA Guidelines state that "on the rare occasions post-IPO that non-executive directors participate in such schemes, they should have different performance conditions from the executive directors and should be required to hold their shares for at least 12 months after leaving office"
3. Remuneration committee	The UK Corporate Governance Code recommends that the remuneration committee comprises three or (for smaller companies) two independent non-executive directors. The remuneration committee should be composed of non-executive directors, all of whom should be independent. The chairman (if considered independent) may be a member of the committee but it is best practice that he does not chair the committee (QCA 'Remuneration Committee Guide for Smaller Quoted Companies')
4. Audit committee	The UK Corporate Governance Code recommends that the audit committee comprises three or (for smaller companies) two independent non-executive directors and, for smaller companies, the chairman (if considered independent) may be a member of (but not chair) the audit committee in addition to two other independent non-executive directors. QCA recommendations are that at least two independent non-executive directors should comprise the audit committee and that, if the board considers the chairman to be independent and non-executive, then the chairman may be one of the two independent non-executive directors on the audit committee (QCA Guidelines and QCA 'Audit Committee Guide for Smaller Quoted Companies'). At least one member of the audit committee should have "recent and relevant financial experience" (UK Corporate Governance Code and QCA 'Audit Committee Guide for Smaller Quoted Companies')

approach compliance with the Code and/or the QCA Guidelines. But it does not seem to be common practice for AIM companies to state how they approach compliance with the NAPF AIM Policy.

Applying the corporate governance guidance

AIM companies' stated policies

In the admission document prepared at the time of joining AIM, companies are required to include a statement as to whether or not they comply with the corporate governance regime of their country of incorporation (and, if not, to provide an explanation for their non-compliance). AIM companies seem largely to make a statement along the lines of one of the following formulations, namely that they intend to comply with:

- the Code, so far as is practicable given their size and nature; or
- the QCA Guidelines; or
- both the Code, so far as is practicable for a company of their size and nature, and the QCA Guidelines.

While statements like these have the feel of 'standard wording' (and an assessment of how effectively a company is implementing corporate governance procedures can only ultimately be made following admission and through annual corporate governance statements and other disclosures), they do indicate a broad acceptance by AIM companies of the principle that compliance with the QCA Guidelines should be their starting point for implementing corporate governance processes.

There is less consistency between AIM companies in the approach to ongoing reporting of corporate governance implementation and the annual corporate governance statement. This is perhaps to be expected in light of the flexibility given to boards and the varied ways in which AIM companies of different sizes and operating in different sectors may approach corporate governance processes.

The extent of ongoing disclosure and reporting of corporate governance practices and effectiveness is, however, sometimes identified as a potential weakness of AIM companies, so boards should maintain a focus on this area and endeavour to improve ongoing disclosure and meet the requirements of the QCA Guidelines.

Conclusion

So, given flexibility, how should directors of AIM companies approach the implementation of an effective and appropriate corporate governance structure? The key points are that directors should:

- use the QCA Guidelines as the benchmark for an AIM company's corporate governance systems
- aspire to compliance with the Code
- actively consider what is appropriate for their company (taking account of factors such as sector, size, jurisdictions in which the company operates etc) in producing an effective outcomes-based governance system appropriate for a company trading on a public market, rather than 'box ticking' compliance
- continually challenge the appropriateness and effectiveness of the company's systems as the company evolves
- consult with the company's Nomad on an ongoing basis
- report to shareholders on the corporate governance procedures and the evaluation of their effectiveness to demonstrate good practice, adopting, as a minimum, the QCA Guidelines' recommended requirement to publish an annual corporate governance statement alongside other recommended disclosures
- regard effective corporate governance as positively contributing to long-term growth and delivery of value to shareholders.

www.pwc.co.uk/riskresilience

Creating value in a turbulent world.

pwc

We help our clients to align their risk and business strategies so they're more successful. Because putting risk at the centre of your business is now more important than ever before. To find out more visit www.pwc.co.uk/riskresilience

© 2012 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

15. The role of the board in effective risk management and oversight

Alpesh Shah, PricewaterhouseCoopers LLP

Business risks are those things that affect the ability of a company to achieve its strategic objectives. Given the uncertainties around risk, boards need to understand the principles of good risk management to ensure all risks are effectively identified, assessed, and managed — from the strategic planning of a company through to its day-to-day running.

This chapter considers how boards and companies can meet the challenge of becoming risk-resilient by complying with external guidance and through implementing best practice. Companies that are successful at this will be better able to respond to risks that could challenge their business's strategy and survival — and to take advantage of new opportunities.

Risk in the context of external codes and guidance

Good corporate governance must be an important focus for all organisations, and risk management and internal control are integral to achieving this. In order to help companies realise this, there are a number of external governance codes overseen by independent regulators, committees and institutions that provide guidance to companies looking to improve their approach to corporate governance and risk management.

The Financial Reporting Council (FRC), through its work on the Corporate Governance and Stewardship Codes, has been key to the establishment of a highly regarded system of corporate governance, setting effective risk management at the heart of achieving this. In particular, the 'Turnbull Guidance', published by the FRC in 2005, sets out best practice for internal control and risk management for UK listed companies.

The FRC is not the only independent body looking at risk management. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides guidance on the components that can help companies assess and enhance their enterprise-wide approach to risk management.

Both the FRC and COSO's systems, along with other governance codes and frameworks, tend to be based on principles as opposed to rules. This approach recognises that an effective system of risk management will vary from company to company and should reflect the individual circumstances within which each organisation operates. Implementation of these principles in an appropriate manner is at the heart of the board's risk management responsibilities. A principles-based approach is only effective where there is active challenge within the boardroom, transparency on the strategic direction of a company and visibility over the risks a company may face.

In addition, governance codes cover good practice but often at a minimum level. Merely meeting the requirements of the codes will not be enough. As well as understanding the principles of good practice, boards need to ensure they are utilising additional knowledge and techniques to provide a comprehensive approach to managing risk that aligns with the strategy of the company.

Before we address how companies can use governance codes and additional best practice, it is important to understand risk in the context of the business environment.

Understanding the landscape of risk

It is clear that the risk landscape facing companies is changing. Boards can see that, but it is often difficult for them to define what is

behind the changes, or how they should respond to them.

In *The Black Swan: The Impact of the Highly Improbable*, published in 2007, the author Nassim Nicholas Taleb put forward his concept of unforeseen 'black swan' risk events that have a major impact, such as the September 11 attacks or the Indian Ocean tsunami of December 2004, and for which previous experience cannot prepare us. This idea has rapidly taken hold, and has been applied to recent events ranging from the credit crunch to the Arab Spring. Today, 'black swan' events like these are regarded as one of three types of risk facing companies as well as countries.

The first is 'known risks' — those that can be identified and planned for, in an effort to avoid or mitigate them. The second is 'emerging risks' that have come on to the radar but whose full extent and implications are not yet completely clear. The third is the 'black swans' identified by Taleb, which hit businesses and even societies as a whole without warning, meaning they cannot be predicted or avoided. By their nature, black swan events should only occur at unpredictable intervals, yet recent evidence suggests that events fitting the definition of black swans are happening more frequently.

The four categories of risk

The existing approach to managing risk has involved dividing these three types of risk into four main categories: financial, operational, hazard and strategic.

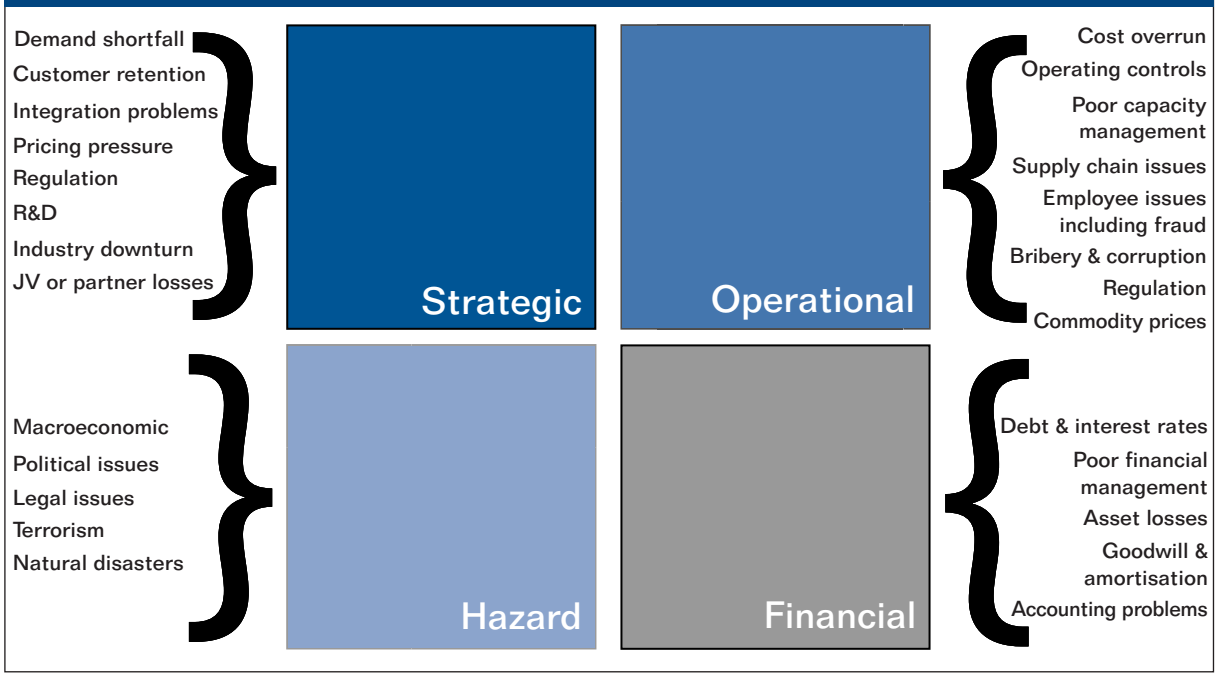
- **Financial risks**. These are typically well controlled and are often the focus of many board risk discussions driven by the audit process and heightened regulations. In addition, as financial information is a key element in stakeholder communications and in measuring performance and strategic delivery, board discussions will devote considerable time to these risks
- **Operational risks**. These will typically be managed from within the business and will often have a focus on health and safety issues where industry regulations and standards require. These internally driven risks may have an impact on a company's ability to deliver on its strategic objectives
- **Hazard risks**. These tend to be external factors that affect the environment in which a company operates. Insurance and appropriate contingency planning would help address some of these risks, but because by definition they cannot be controlled, there is a danger that boards and senior management will not reflect on them in their strategic thinking. The mindset that strategy should be focused on controllable factors is in itself a high-risk one
- **Strategic risks**. These include risks that are again often external and, as such, can fall off a company's risk radar. It is incumbent upon boards to ensure that all types of risk are included in their strategic discussions.

(Figure 1 provides examples of the different risk types within each category.)

Companies generally do a good job of focusing on two of these risks — financial and operational. But they have often been less successful at linking all these categories together, or understanding the interdependencies between them. In addition, many businesses have focused much less attention on strategic risk, largely because they regard risk and strategy as separate from each other, rather than seeing risk-taking as a key part of value creation.

Companies today face an environment where known or identified risks are surrounded by areas of uncertainty; where a company's sustainability and licence to operate are under constant and

Figure 1: The four categories of risk



close scrutiny; and where global risks emerge rapidly, can spread quickly across traditional risk categories, and are often difficult to control or even identify clearly. It is increasingly clear that an approach that puts risks in separate compartments and fails to cover all of them together is not fit for purpose. Given the changes to the risk landscape, companies need to be agile and innovative in the way they approach risk. Risk management is still primarily focused on familiar and more readily quantifiable risks. This approach may miss the risks that, while less visible, are still critical, and often have a dramatic impact on value and market perception.

The importance of striking the right balance between financial and non-financial risks underlines the need to align risk management with overall business objectives. Direction from the board can help companies with a more developed approach to risk management by broadening awareness of the spectrum of risks that they face, how they affect the business and how they can be better controlled.

The potential benefits of a broader approach to risk are not just loss avoidance, but improvements in a company's capacity to take risks and capitalise on opportunities. The board must seek to step back from simple causal risk analysis and understand (with the business) how complex or intangible risks — such as those associated with change or organisational behaviour — are best managed.

There is no one single answer to identifying and mitigating against the risks that may have an impact on a company. External corporate governance guidelines such as those provided by the FRC provide a good starting point.

Aligning risk and strategy

Good risk management not only requires identification, assessment and reporting of risks to the board to determine a company's risk profile;

also essential is an understanding of how much risk is acceptable, how much a company can bear, and which are the key risks that will affect the company's ability to achieve its strategic or performance objectives. The danger is that discussions of risk and discussions of strategy often take place as separate processes within a company and thus do not get an appropriate level of attention from the board and management.

Boardroom discussions will often focus on setting and achieving key strategic objectives that are intended to support or enhance the business value chain and so protect or improve a company's value to its stakeholders. This will be measured as performance and reflected in management incentives and board remuneration. However, inherent in any company's value chain is exposure to a variety of risks. Any changes in that chain — through the implementation of strategy, for example — will affect the risk profile. Thus, a discussion of the value-adding benefits of strategic options should also consider the implications for the company's risk exposures.

The key for the company is to determine its risk appetite — the right balance between risk and value.

The importance of risk appetite
A company's risk appetite is driven by a range of external influences — including shareholders, analysts, regulators, rating agencies, competitor actions and customers — as well as the management's own expectations.

Gauging the risk appetite should be a priority for all companies, but currently it is a task that most boards are struggling to accomplish. Due to the uncertainty of today's environment, solely analysing historical data is no longer a reliable way of predicting future events and impacts. So the board needs to be more explicit about the organisation's risk appetite in pursuing its strategy, and to build awareness at all levels of what risks it is willing to bear.

Key questions to consider

- How much does risk feature in your strategic discussions?
- Do you discuss risk and strategy in the same language?
- How much risk is your company willing to take to achieve its strategic objectives?
- How aligned are your risk processes with your strategic and performance management processes?

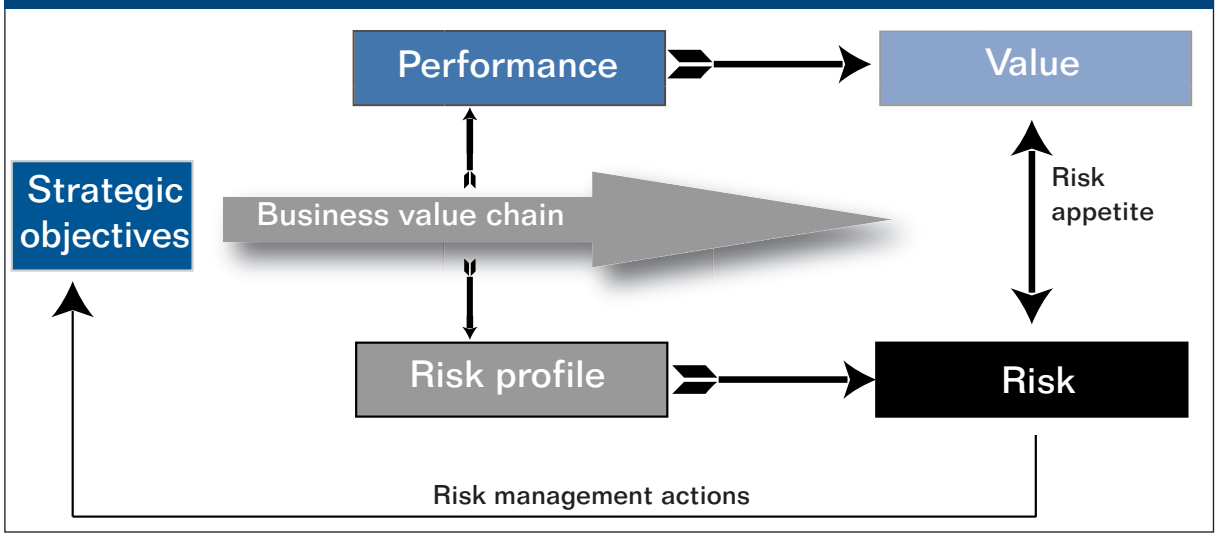
A major benefit of risk appetite is that it ensures risk is appropriately and consistently considered at major decision points in the organisation. To change people's behaviour in relation to risk, additional training or a change in personnel may be required, but in most organisations the tone set by the board and senior management tends to have by far the greatest impact.

Including risk consideration in board decisions
Boards may well focus on risks as they relate to the key assumptions made in setting the expected outcome of a particular strategy. What often may not be appreciated, though, is the impact on the strategy of factors outside the company's control, such as global trends.

The external viewpoint of non-executive directors will play an essential part in remedying this by bringing a breadth of risk perspective to the development of strategy. The challenge for boards is to ensure that the processes followed in reviewing and approving strategy are flexible enough to incorporate this broader awareness.

As highlighted by an Institute of Directors publication, 'Business Risk: A practical guide for

Figure 2: Aligning risk and strategy



board members' (2012), boards should ask themselves the following questions:

How well is my strategy actually defined?
A robust articulation of the key elements of strategy (intent, drivers, the context in which it will be delivered) will allow boards to isolate and identify how the strategy will interact with the risks faced by the business. A lack of clarity will mean risk and strategy continue as two separate processes within a company.

How broad are the risks that we are considering?
Strategy needs to be defined in the context of a company's overall risk environment. The broader the consideration of the risks, the better the strategy can be developed to respond to them. Bringing together internal information and the external risk exposures highlighted in particular by senior management and non-executive directors should be a key focus of the board.

What risk scenarios have we considered to test our plans?
It is often not easy to identify all potential risk exposures and their causes. Those that are going to be of most interest to the board will often be defined by the extent of their potential impact. Scenario analysis, where management are encouraged to consider a range of possible situations that could result in significant adverse consequences for the business, can help to ensure a breadth of perspective. Workshops, with input from non-executive directors, that set out a range of plausible scenarios around key strategic outcomes are often a good way to bring this type of approach to the boardroom.

Stress tests for business plan assumptions, to determine when the business may 'break', will also assist boards in determining how much risk is acceptable.

Have we mapped our risks to key measures of performance and value?
Where possible, consideration of risks in the context of how shareholders or stakeholders measure value in the business is vital. This will help management to communicate how the risks they are taking, or the business is exposed to, may affect the desired outcome. Creating a 'common

Key questions to consider

- Can your company articulate its risk appetite and do you draw distinctions between different risk appetites across different parts of a business?
- Do you communicate your risk appetite internally and externally — are key decisions made consistent with your risk appetite?
- How much are you able to challenge the business on the balance between its risk profile and risk appetite?
- What risk information is presented to allow the board to determine the current risk profile?

currency' for risk and performance also allows management to prioritise risk management activities and focus on the more relevant risks to stakeholders and the board.

In the next section we'll examine how risk management frameworks can help business leaders think through informed value-creating decisions and help a company achieve its goals.

Approaches to managing risk

Enterprise risk management and internal controls

In the context of risk management and internal control, each company will require its own specific approach to managing risk. As an example, companies in different sectors will require their own tailored approaches due to the size, scale and complexity of their products, services and the industry in which they operate. In addition, the country where a company has operations will also affect any considerations with regard to risk.

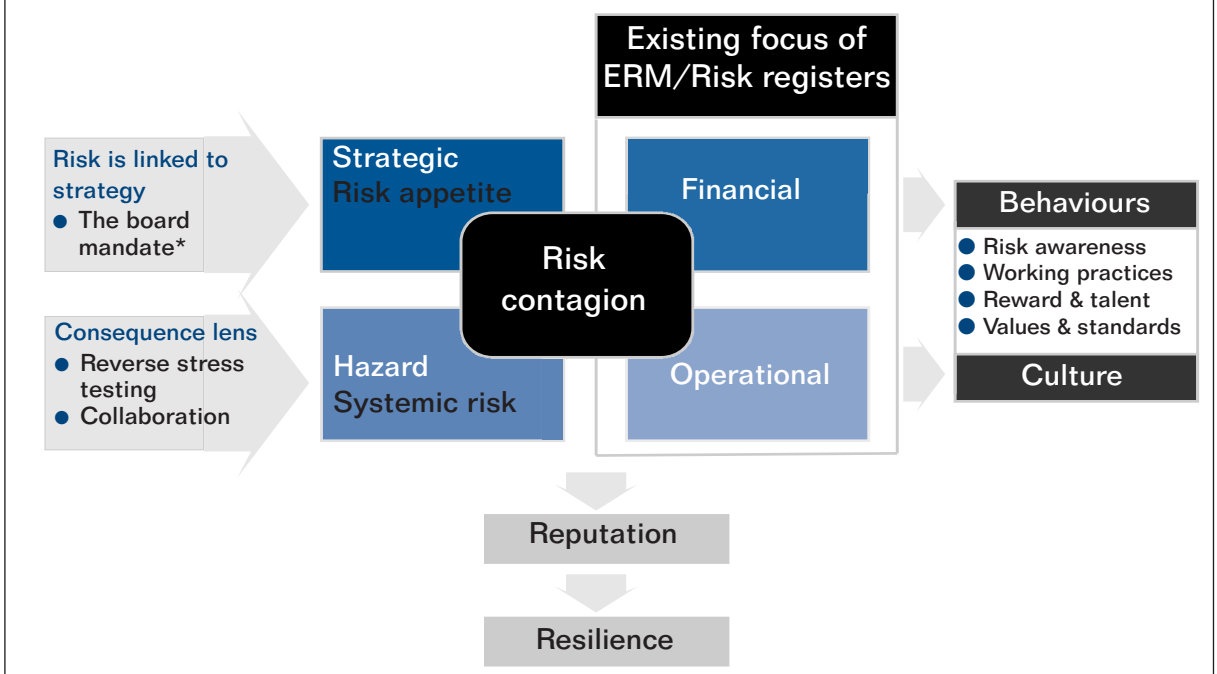
These challenges have brought enterprise risk management (ERM) and internal controls into the spotlight. Currently used by most major companies, ERM was developed in response to the emergence of more complex risks, with a focus on providing stronger control over operational and financial risks. Companies applying ERM have tended to focus less heavily on aligning risk and strategy or applying the same standards of risk management to the broader spectrum of risks to which they are exposed. However, when properly implemented, ERM is fully equipped to manage today's greater diversity of risks and the closer interdependency between them, and it provides a sound base on which to build.

Risk-based internal controls are designed to help a company achieve its objectives and also look at the financial and operational areas of a company. The Internal Control-Integrated Framework — devised in 1992 by the COSO — has proved effective for many different companies and for many different purposes.

The COSO framework defines internal control as a process that is designed to provide reasonable assurance about the achievement of objectives in the following categories:

- **Effectiveness and efficiency of operations**. This encompasses clarification of the roles and responsibilities of management and employees; greater controls over the management of business growth; reductions in costs resulting from greater operating efficiency; and enhanced operating performance
- **Reliability of reporting**. The goal here is to ensure that more accurate and timely information is available to better manage the business, reduce the risk of errors or irregularities, and heighten management's credibility with stakeholders
- **Compliance with applicable laws and regulations**. Internal controls should reduce the risk of employee or customer litigation or

Figure 3: The board mandate



'* Tomorrow's Company - The Case For the "Board Mandate"'

business disruption, and create more credibility in contractual relationships with vendors, customers and regulators.

Assessing effectiveness is most relevant when management, or other users, are expected to vouch for their system of internal control — for example, with respect to internal control over external financial reporting in compliance with the US Sarbanes-Oxley Act 2002.

The Turnbull Guidance sets out best practice on internal control and risk management for UK listed companies, with the sole purpose of assisting them in applying section C.2 of the UK Corporate Governance Code. The Turnbull Guidance is intended to:

- embed internal control in the business processes by which a company pursues its objectives
- remain relevant over time in a continually evolving business environment
- enable each company to apply it in a manner that takes account of its particular circumstances.

COSO and Turnbull are two examples of guidance for reducing financial and operational risks and, to a degree, reputational impacts. But management and employees also need to take responsibility as well; this often starts with setting the tone from the top with a properly communicated risk appetite that guides senior management in setting goals and making decisions.

The board mandate

Figure 3 illustrates how a board can address this challenge. The first step is to create a clearly articulated 'board mandate', as proposed in a 2011 report from Tomorrow's Company, 'The case for the Board Mandate'. This captures the essence or

'character' of what makes a company distinctive, and provides a clear view of the board's attitude to integrity, risk and safety, and to its environment, culture and value proposition. That in turn provides the setting for a company to bring together the existing strengths of ERM in managing operational and financial risks, with the additional agile and adaptable techniques demanded by the newer and less predictable dynamics of strategic and systemic risks.

Figure 3 captures this within one overall framework. Financial and operational risks are the prime focus of ERM, while risk and strategy are linked through the use of risk appetite, and systemic risks can be better understood through analysis of consequences. If properly embedded, this should help protect the reputation of the company and make it more resilient, provided that the right behaviours and culture are in place across the rest of the business.

When fused together, these components can enable a board to make the right responses to today's risk landscape, so helping to build a trusted reputation and organisational resilience.

Another technique for managing risk is reverse stress-testing — an approach that effectively accepts that it is no longer possible to forecast events themselves, and instead focuses on managing their knock-on effects or consequences. To pick recent examples, an airline might test out the impact of most of Europe's airspace being closed down (as occurred during the volcanic eruption in Iceland), or a bank might model the effect of a major counterparty collapsing or a eurozone member country defaulting. Reverse stress-testing is proving a very effective way of focusing on extreme events and protecting companies against 'unknown' risks.

Ultimately, the responsibility for driving and embedding the risk management change required lies not with the risk function, but with the board. That responsibility involves building on ERM to fuse strategy more closely with risk, as well as debating and articulating a more explicit and holistic risk appetite, and investigating collaboration to foster wider resilience across systems.

Key questions to consider

- How broad is your company's approach to risk management?
- How often do you hear about new and different risks that your company is actively managing?
- How confident are you that your company has the right structures in place to identify and escalate risks appropriately?
- Have you identified what risks can really hurt you and are you sure you have identified them all?

The role of the board and company committees

The economic crisis that started in 2008 increased the focus on the role of boards and committees and the information that companies disclose. As an example, the audit committee's role in ensuring accurate and transparent disclosure is more important than it has ever been. The job is more difficult and challenging too, given the increased expectations of shareholders, regulators and other stakeholders — heightened scrutiny when things go wrong; more responsibility for risk management; and more focus on the need for fraud prevention.

As part of its 'Boards and risk' report, the FRC shared contributions from a number of companies and investors in the belief that the findings would be helpful to companies and boards in their thinking and approaches to risk. Released in September 2011, it found that while techniques used by boards had been developing rapidly and that one size does not always fit all, there are some common themes and techniques.

While the day-to-day oversight of how risk is managed can be delegated to an appropriate committee of the board (such as the audit or risk committee), it is imperative that the board takes overall ownership for risk. Executives and senior management will often be driven to improve performance to achieve strategic objectives, reinforced by remuneration and incentive mechanisms, but the board also needs to ensure that the risks senior management are taking to achieve these goals are understood and appropriately mitigated.

The need for risk oversight

Whatever risk framework is adopted by a company, clear risk oversight from the board, as distinct from management, is essential. The role of non-executive directors is important here as they can bring valuable insights from other companies, industries and geographies, and these will include perspectives on both risks and risk management.

As discussed above, one of the more significant challenges to good risk management is narrowness of perspective. There is a danger of focusing too much on health and safety and financial or operational issues that are at the forefront of day-to-day business activity. The broader perspective on a variety of risks that comes from a diverse board membership, taking in external hazards and strategic threats, helps support a richer and more comprehensive risk management process. Demonstrating the potential relevance of these external, independent views to a company and getting senior management and executive buy-in presents an additional challenge for the board.

Additionally, there is often a desire for unity of thinking and opinion around the board table. This may engender confidence in external stakeholders and internal management that the strategic direction of a company is sound and supported by all. However, the role of non-executive directors in challenging executives and senior management is essential to good governance. The challenge with risk is no exception. There is a need for appropriate risk information to be available to the whole board; for risk management competency around the board table to effectively challenge this information; and for an open and constructive dialogue between executives and non-executive directors on risk issues.

Audit and risk committees

As the senior committee of a company, the audit committee has often assumed shared responsibility for managing risk as well as audit. Various corporate governance guides outline the expectations placed on audit committees and they generally focus on financial statements and financial risks. Quite often, however, they have played a much broader risk management role.

Some companies, particularly those within financial services, use a dedicated risk committee to consider and manage the day-to-day aspects of risk. In large companies — depending on the nature, scale and complexity of the business's operations — there may well be good reasons for this. However, a separate risk committee is not the only solution, nor will it be appropriate for every company. Re-engineering the existing audit and risk committee by co-opting new members with a different skillset and background can also be an effective way of allowing a committee to deal more comprehensively with risk management.

In addition, consideration should be given to the following factors when looking to improve the structure and effectiveness of both the audit and risk committees:

- **Committee composition**. A committee needs the right combination of skills and experience to carry out its responsibilities effectively. It also needs a chair with the knowledge and commitment to drive the committee's work

Enhancing the effectiveness of the board and its committees

The board

Culture and tone from the top. Getting the right culture within a company is critical in creating an environment that encourages compliance with law and regulations as well as the right behaviours — within all roles and across the entire business.

Risk appetite and risk oversight. The board must take the overall ownership of the risk agenda and articulate the company's risk appetite. The board needs to ensure that the risks the company is taking to achieve these goals are understood and mitigated. By determining the risk appetite, the board will be articulating the amount of risk the company is seeking in order to achieve its strategic objectives.

Strategy and implementation. Strategy sets the direction for a company and the right strategy is the starting point for success. The board has a vital role to play in overseeing management's development of the strategy and its implementation. If given the right information, its involvement will help the company drive the plan most likely to enhance shareholder value.

Audit committee

Financial reporting and disclosures

Regulators and financial statement users continue to press companies for more information and to get that information sooner. The committee must be aware of the financial reporting risks to focus its attention appropriately.

Internal audit

Similarly, the committee relies heavily on internal audit to provide an objective view on how the company is handling a number of key risks, including those relating to financial reporting and compliance.

Relationship with external auditors

The audit committee has to select the right external auditors to conduct a quality audit. External auditors are in a unique position to provide unbiased feedback to the committee. As part of executing their audit plan, the external auditors provide the audit committee with assurance regarding the company's financial reporting.

Risk committee

Governance of risk

It is a challenge for a board and audit committee to feel reassured that the company is addressing risk appropriately. The risk committee must be responsible for ensuring that the day-to-day management of risk across all parts of a business is effective.

Risk competency

It is imperative that appropriate risk management skills exist across the company from the board downwards. The risk committee should ensure that relevant individuals have the right level of skills and expertise to manage risks effectively and challenge the business.

Crisis management

At times, breakdowns within a company can lead to potential crises. The risk committee must prepare for, assess and take steps to resolve situations — be they operational, financial, strategic or hazard.

Management Information

Risk metrics and key performance indicators provided to the board will enable them to make better-informed strategic decisions based on their risk appetite. The risk committee can perform a powerful role in overseeing the collation and preparation of this information to the board.

- **Supporting committee effectiveness**. A charter is useful to document the audit and risk committee's purpose, roles and responsibilities. It helps distinguish the committee's responsibilities from those of the full board of directors. A committee that periodically evaluates its performance will be able to identify ways to improve its effectiveness. Orientation training for new members and ongoing development for all members are essential, particularly given the pace of change in financial reporting and governance standards
- **Meetings**. To ensure committee meetings run well, the committee must have the right agenda and receive the right materials beforehand. The attendees, and how they interact with committee members, also influence the success of meetings. Given the scale of its responsibilities, the committee needs to ensure it is meeting often enough and at the right points during the year.

A source of practical help is the FRC's 'Guidance on Audit Committees', which was first published in 2003 and updated in December 2010. It is intended to "assist company Boards when implementing the sections of the UK Corporate Governance Code dealing with Audit Committees and to assist directors serving on Audit Committees in carrying out their role".

From risk management to resilience

In summary, companies should look to build on their current risk management frameworks by making three changes:

Develop a risk aware culture. There is a need to move away from merely identifying, measuring and prioritising the various risks to a company, and towards a broader agenda that takes in a company's industry and the political and financial environments. In other words, companies must progress from explicit risk controls to a culture in which risk is managed in a co-ordinated way across different interests, departments and business units, and external relationships

Explicit focus on risk appetite. Some employees may regard risk management as someone else's problem and a distraction from their day job. In fact, it must become part of everybody's job, every day. Also, many non-executives voice frustration that the executives on their boards are too cautious in terms of risk. So awareness building by the board and greater clarity on risk appetite would aid board effectiveness

Align risk and strategy. There should be a parallel drive to integrate risk and strategy, and to embed a risk-aware culture, behaviours and beliefs at all levels. Ideally, both of these strands will be led and championed by the chief strategy and/or chief risk officer or equivalent, who should report directly to the chief executive and even in some cases have a seat on the main board — a structure that is all too rare outside the financial services sector.

The benefits of being risk resilient

In combination, it is these actions that will help a company realise some important benefits that will enable it to progress from managing specific

Key questions to consider

- Are the chief executive and board setting the right behavioural example and risk-aware culture, in line with the corporation's strategy?
- Does the board have people with enough industry and risk expertise to ask tough questions about executives' decisions?
- Do rewards encourage risk-based thinking and behaviour?
- Do you have the right governance structure for your committees?

risks to achieving wider resilience to risk events. These are:

- a flexible perspective on risk and uncertainty, and an approach for managing them that is more closely integrated with the business strategy — and which recognises that a company's risks are constantly changing
- clearer ownership of risks at leadership levels — with risk awareness and accountability being shared across a company through a common risk culture
- a greater ability to influence and shape personal behaviour. Enhanced risk ownership, awareness and culture can help companies better manage the actions of individual employees anywhere in the world.

Finally, there is growing evidence that businesses that are seen to truly embed a risk-aware culture and behaviours are valued more highly by the public equity markets.

Herbert Smith

"Clients come to Herbert Smith for solutions to their risk and corporate governance needs."

Our technical expertise, sound commercial advice and market-leading sector knowledge provide an excellent resource to companies and their directors to assist them in complying with all aspects of company law and corporate governance good practice.

We work in partnership with our clients to ensure they can deal with risk effectively and are in compliance with all relevant regulation including the Companies Act 2006, the Listing, Prospectus, Disclosure and Transparency Rules, the UK Bribery Act and the Takeover Code.

Companies call on our legal experts to assist them with director's duties, the operation of boards and board committees, AGM's, company reporting, group reorganisations, share registers, and inside information and market abuse issues. We also have extensive experience assisting on a wide range of shareholder activism matters, both for activist investors and the companies being targeted.

Contact:
Carol Shutkever, Partner
carol.shutkever@herbertsmith.com
Tel: +44 20 7466 2013

Herbert Smith LLP
Exchange House, Primrose Street, London. EC2A 2HS
www.herbertsmith.com

16. Inside information

Carol Shutkever, Herbert Smith LLP

The disclosure and control of inside information is a key element in the functioning of the UK securities markets. Companies must ensure that they promptly disclose any new inside information, and control its use before disclosure.

The regulatory framework for inside information in the UK markets has been set by the EU Market Abuse Directive (MAD), which requires member states to impose rules about the disclosure and control of inside information by companies whose securities are traded on a regulated market, and to impose a prohibition on market abuse, including the misuse of inside information. In the UK, these two elements of MAD are implemented through the Financial Services and Markets Act 2000 (FSMA) and the Financial Services Authority's Disclosure and Transparency Rules (the DTR). Both of these regimes apply to companies listed on the London Stock Exchange's Main Market.

The market abuse regime has been extended in the UK to apply to AIM companies as well as those on the Main Market; under the FSMA, AIM is subject to the UK market abuse regime. In relation to AIM companies, the DTR requirements do not apply, but the AIM Rules for Companies (the AIM Rules) contain requirements for the control of price-sensitive information that have similarities with the rules for companies listed on the Main Market.

This chapter discusses the main features of the UK regimes, along with the practical steps and procedures that listed companies can take in order to comply with their obligations.

Requirements for listed companies

The obligations of listed companies in relation to the disclosure and control of inside information are set out in DTR 2. The primary disclosure obligation is that a listed company must make an announcement via a regulated information service (RIS) as soon as possible of any inside information that directly concerns the company (DTR 2.2.1R). This is subject to some limited exceptions, discussed below, relating to delayed disclosure and selective disclosure.

The definition of inside information

The definition of inside information for DTR 2 purposes is the same as the definition used for the UK market abuse offence and is set out in Section 118C of the FSMA.

'Inside information' is defined as information that:

- is not generally available
- relates, directly or indirectly, to the company or its listed securities
- would, if generally available, be likely to have a significant effect on the price of the securities or on the price of related securities; information would be likely to have a significant effect on price if, and only if, it is of a kind that a reasonable investor would be likely to use as part of the basis of his investment decisions
- is precise, because it indicates circumstances that exist or may reasonably be expected to come into existence, or an event that has occurred or may reasonably be expected to occur, and is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances, or that event, on the price of the securities or related securities.

The Financial Services Authority (FSA) considers that the 'significant effect on price test' is always satisfied if the information is of a type that a reasonable investor would be likely to use as part of his investment decision. Potential or actual price movement is not the test to be applied.

Although information is required to be 'precise' in order to become inside information, all that is required is a reasonable expectation about the circumstance or event happening, not certainty or a high level of probability. Also, where a particular event occurs in stages, then each stage of the process can be information of a precise nature that therefore constitutes inside information. For example, the fact that there has been an approach to a target company on a takeover bid can itself be inside information, even if the takeover itself is not yet certain (although, as described below, the company is likely to be able to delay disclosure as it is a matter in the course of negotiation).

Identifying inside information

The directors of a listed company must carefully and continuously monitor whether changes in the circumstances of the company, or events affecting the company, are such that an announcement obligation has arisen under DTR 2. Listing Principle 2 in Listing Rule (LR) 7 requires a listed company to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations. A company must therefore have systems in place to ensure that information is escalated in a timely way to the board to enable it to decide whether the information constitutes inside information that should be announced.

Ability to delay disclosure in certain cases

The disclosure rules (DTR 2.5) provide an exception to the announcement obligation in certain circumstances. DTR 2.5.1R states that a company may delay the public disclosure of inside information, so as not to prejudice its legitimate interests, provided that:

- the delay would not be likely to mislead the public
- any person receiving the information before it is announced owes the issuer a duty of confidentiality
- the issuer is able to ensure the confidentiality of the information.

If the company delays disclosure, it will need to ensure that it has prepared a holding announcement to release immediately in case of any leak.

Guidance is given in DTR 2.5.3 about the circumstances in which a delay in disclosure is permitted. A company may delay disclosure, for example, in the event of ongoing negotiations, where the outcome or progress of those negotiations would be likely to be affected by public disclosure, and impending developments that could be jeopardised by premature disclosure. A company is not, however, permitted to delay disclosure of financial difficulties, or of a worsening financial condition, in the hope that negotiations about a refinancing will improve the situation. Only the fact that negotiations are taking place (not the financial difficulties themselves) may be withheld from the market for a period if public disclosure would jeopardise them.

Selective disclosure

When a company is entitled to delay disclosure of inside information, the company, or a person acting on its behalf, may disclose that information to third parties under confidentiality restrictions provided that the disclosure is made in the normal course of the exercise of the person's employment, profession or duties (DTR 2.5.6 and 2.5.7G). This means that the listed company must have a legitimate reason for the disclosure. There is a non-exhaustive list of people to whom selective disclosure can be made, including major shareholders of the listed company, its lenders and credit-rating agencies.

Market rumours

If the company has delayed disclosing inside information but it is the subject of largely accurate market rumours, it is likely that disclosure could

Decision process: disclosure of inside information by listed companies

Is there inside information directly concerning the company that:
- is not generally available?
- is precise?
- a reasonable investor would be likely to use for investment decisions?

→ NO → No announcement required. The company must continue to monitor whether any change in circumstances gives rise to inside information

↓ YES

Is the company permitted to delay the disclosure of the information on the grounds that …
- legitimate interests (matters in course of negotiation) need to be protected?
- the delay is not likely to mislead the public?
- the company can maintain confidentiality?

→ NO → The company must immediately announce inside information via an RIS

YES → Access to inside information must be controlled prior to disclosure. The company must:
- establish control arrangements
- create an insider list
- have a holding announcement ready

Announcement of inside information must be made via an RIS as soon as conditions for delay are no longer met

↓

Is the company permitted to disclose inside information …
- in the normal exercise of employment or duties?
- to people on the non-exhaustive list of recipients?
- to people owing the company a duty of confidentiality?

→ NO → The company cannot disclose the inside information selectively

↓ YES

Selective disclosure permitted. Announcement of inside information must be made via an RIS as soon as conditions for delay are no longer met

not be held back for any longer as the company would be unable to ensure the confidentiality of that information. If so, the information would have to be announced by the company as soon as possible — though a holding announcement could be used if a delay were needed before a detailed disclosure. However, if the market rumour is false, then there is no requirement for a company to respond to it or to state that it is false.

Method of publishing inside information
Inside information must be published via an announcement through an RIS as soon as possible after the obligation to announce arises. A listed company must also immediately post all inside information disclosed via an RIS on its internet site (DTR 2.3) and keep it there for one year.

A listed company must take reasonable care to ensure that any announcement made via an RIS is accurate and not misleading (DTR 1.3). There are currently six authorised RIS providers listed by the FSA: Business Wire; ONE from Thomson Reuters; News Release Express from Marketwire; RNS from the London Stock Exchange; marCo — Market Communication Office from Tensid; and DGAP IR.COCKPIT from EquityStory AG.

Control of inside information and insider lists
Listed companies must establish effective arrangements to deny access to inside information to anyone other than persons who require it for the exercise of their functions within the company (DTR 2.6.1R).

Part of this process is the requirement to set up and maintain an insider list — that is, a list of the employees and other persons working for the company who have access to inside information on the company, whether on a regular or occasional basis. The company must also ensure that its advisers and agents draw up insider lists themselves if they have inside information about the company, and it must include the names of the principal contacts at those advisers and agents on its own insider list.

The insider list must state why and when each person is put on the list and it must be updated promptly whenever a new person has access to inside information, whenever there is a change in the reason why a person is on the list, and whenever a person on the list no longer has access to inside information. An insider list must be kept for five years from the date on which it was drawn up or updated.

A listed company must ensure that its employees and advisers with access to inside information acknowledge the legal and regulatory duties that they have as a result and are aware of the sanctions for the misuse or improper circulation of inside information.

Model Code on securities dealings
A listed company must ensure that 'persons discharging managerial responsibilities' (PDMRs) comply with the Model Code in the annex to LR 9. PDMRs are defined in Section 96B of the FSMA as being:

- all of the directors of the company
- any senior executives who have regular access to inside information on the company as well as the power to make managerial decisions affecting the future development and business prospects of the company.

Individuals subject to the Model Code must seek clearance before dealing in the company's securities. 'Dealing' is defined widely in the Code and includes, for example, using shares as security, entering into a contract for difference and the exercise of an option over securities.

Clearance to deal under the Model Code cannot be given during a 'close period' or at any time when any inside information on the company is in

existence, unless one of the limited exceptions applies (for example, certain grants of share options or awards under an employee share scheme). The 'close periods' are, broadly, the period of 60 days immediately before the preliminary announcement of annual results, the period from the end of the half-year financial period to the publication of interim results and, if the company issues quarterly reports, the period of 30 days prior to publication. PDMRs are also required to advise persons connected with them not to deal during a close period.

A company must not carry out any dealings in its own securities at a time when a PDMR would be prohibited from dealing under the terms of the Model Code (subject to certain exceptions for pre-agreed buyback programmes).

Even if one of the exemptions in the Model Code applies, a dealing could still constitute market abuse or insider dealing, and those restrictions must always be considered separately.

Requirements for AIM companies

Obligation to announce price-sensitive information

The obligation for AIM companies to disclose inside information is set out in Rule 11 of the AIM Rules. An AIM company must make an announcement without delay of any new developments that are not public knowledge concerning a change in:

- its financial condition
- its sphere of activity
- the performance of its business
- expectation of its performance.

The obligation applies to information that, if made public, would be likely to lead to a substantial movement in the price of the company's securities.

The definition is broadly in line with the definition used in DTR 2 for listed companies, although it is potentially narrower in scope. However, AIM companies should also bear in mind the wider definition of inside information because that definition applies for market abuse purposes.

Ability to delay disclosure

Under the guidance notes to Rule 11, an AIM company may delay the disclosure of information that relates to impending developments or matters in the course of negotiation. If it does take advantage of the right to delay, then it is allowed to make selective disclosure to certain categories of people, including its advisers, employee representatives and regulatory bodies, provided that they are informed that they are not permitted to deal until the information is announced. Any breach of confidence would lead to an obligation to make an immediate holding announcement.

Control of inside information

There are no requirements for an AIM company to maintain an insider list, nor any specific requirements in the AIM Rules in relation to control of inside information. However, the general guidance set out below on identifying and controlling inside information should also be of practical use to AIM companies.

Market abuse

The UK market abuse regime applies both to the Exchange's Main Market and AIM and is set out in Sections 118 to 137 of the FSMA. It is designed to prevent behaviour that undermines market integrity and investor confidence. The market abuse offence is not a criminal one, but a civil one.

Scope of the market abuse regime

Market abuse is behaviour — relating to, or having an impact on, investments traded on the Main Market or AIM — that involves:

- the misuse of inside information

- the creation of a false or misleading impression as to the supply of, demand for, price or value of investments
- the distortion of the market in investments.

The definition of inside information used for the market abuse offence is the same as that used for the disclosure obligation of listed companies (as described on the previous page).

The FSA can impose a penalty of an unlimited amount on any person who has engaged in market abuse or who has required or encouraged others to do so, or may publish a censure. The regime applies to companies and other legal entities as well as to individuals, and it also encompasses all market participants, including listed companies themselves, not just FSA-authorised firms.

The Code of Market Conduct (in the 'FSA Handbook') provides guidance on the types of behaviour that will amount to market abuse and gives details of safe harbours from the market abuse regime for certain actions and conduct.

Application to listed and AIM companies

A failure by a listed or AIM company to comply with its obligations to release inside information could constitute the offence of market abuse (by the company or its directors) through the creation of a false or misleading impression, as well as resulting in a breach of DTR 2 (or the AIM Rules). Improper disclosure of inside information by a listed or AIM company (for example, to the press or analysts) could also be treated as market abuse.

Criminal offence of insider dealing

There is a separate criminal offence of insider dealing contained in Part V of the Criminal Justice Act 1993. In particular, a director or other employee of a listed or AIM company may be guilty of insider dealing if he discloses inside information other than in the proper performance of his employment, office or profession, or if he deals in the company's securities or encourages another person to deal at a time when he is in possession of inside information. A person guilty of insider dealing is liable to a fine and up to seven years' imprisonment.

Practical procedures for dealing with inside information

Listed companies need to make sure that they have procedures in place to identify inside information, to control its disclosure and to comply with their announcement obligations. Set out below are some suggested practical steps and procedures (which will also be of relevance for AIM companies).

Determining what is inside information

There is no definitive list of what types of information will and will not be inside information because the analysis will vary between companies and the context of the information. However, listed companies should take the following points into consideration:

- Whether or not a particular piece of information is judged to be inside information will be affected by the size of the company and its group, developments in the company's recent past, previous announcements to the market, and activity and market sentiment in relation to the company and its business sector
- Information that is likely to be considered relevant to the decision of a 'reasonable investor' is information that affects: the assets and liabilities of the company; the performance, or the expectation of the performance, of the business; the financial condition of the company; major new developments in the business of the company; and information previously disclosed to the market
- Will an event, or new information, have a

significant effect on future reported earnings per share, pre-tax profits, borrowings, market expectations of performance, or any other factors that commonly influence the company's share price?

- Does the information relate to developments — such as changes in the source, composition and timing of profits — that may affect the way in which the company's financial performance will be achieved? Such information may still constitute inside information even where financial performance will remain in line with the market's expectations
- The previous information and announcements released by the company — both financial information (including the last annual report) and ad hoc announcements (particularly those about the company's prospects, financial condition and trading) — will be very important in determining whether or not the market needs to be updated with the new information
- Market expectations will in part be based on public profit or earnings forecasts, but may also include past trading performance and public statements on strategy. Analyst forecasts should be taken into account when considering current market expectations
- The more specific the information, the greater the risk that it is inside information. The threshold of whether information is sufficiently 'precise' is low. Even if it relates to just one stage of a process or event, delaying disclosure will only be possible if it falls within the exception for ongoing negotiations
- If a company is negotiating a new financing arrangement, there can only be a delay in an announcement of the negotiations themselves. The company cannot delay announcing any worsening in its financial condition that may have led to the negotiations
- Each piece of information must be assessed individually as to whether it constitutes inside information, rather than looking at the overall effect. For example, if the company has made an unexpected loss in one area of its business but has realised gains in another, the requirement to announce the losses and the gains must be assessed separately, even where the figures net off against each other. Bad news cannot be offset against good news when deciding if an announcement is necessary.

Examples of circumstances in which listed companies have been fined or censured by the FSA for failing to release inside information in time include the potential loss of a major contract, the loss of a major customer, a change in the source and composition of forecast profits, and a deterioration in the working capital position.

Procedures for identifying and announcing inside information

It is important to note that ultimate responsibility for compliance with disclosure requirements lies with the board of the company. So the board needs to ensure that the proper procedures are in place.

The need for a swift decision-making process means that responsibility for identifying whether an announcement is needed can be delegated to a committee of directors, sometimes known as a disclosure committee. The procedures for review of information must allow the company to make an announcement within hours, rather than days.

The reporting lines must be clear and should start at the operating level in the organisation and then go up to board (or board committee) level. Clear written procedures, systems and controls need to be established, implemented and maintained, with the responsibility being clear for the different elements. All relevant staff (not just insiders) need to be aware of the procedures, the reasons for

Inside information procedures — listed company checklist

- Ensure procedures are in place for monitoring inside information and identifying events or circumstances that may require an announcement
- Ensure a regular, reliable flow of information, such as key performance indicators and forecasts, to the board
- Monitor share price, market rumours and market expectations (for example, through analysts' reports)
- Be clear on reporting lines and responsibility for decisions on the need for announcements
- Have a whistleblowing procedure that includes reporting on breaches of internal controls and reporting obligations
- Consult with brokers and legal advisers if in any doubt
- Ensure that decisions about the need for an announcement are recorded
- Put procedures in place for maintaining and updating insider lists
- Ensure that inside information procedures are linked to Model Code/share-dealing clearance procedures, and that these procedures are properly followed and recorded
- Include the inside information procedures in the staff handbook and provide training for new employees and refresher training and alerts for existing employees
- Announcements must be made without delay; procedures must enable timely decisions and release of information
- Check that all information in any announcement is complete, accurate and not misleading
- Check that the announcement contains all necessary information and rubrics
- When satisfied with the fairness and accuracy of the announcement, release it through an RIS and add to the company's website.

them, the importance of reporting information in their business areas and to whom they should report. Training should be provided both for new recruits and as 'refreshers' for existing staff — in particular for those staff who will play a key role in ensuring and implementing compliance.

The procedures must ensure the regular, reliable flow of management information on key performance indicators and forecasts to allow the board (or the disclosure committee) to assess whether an announcement is required.

The company should also have procedures for monitoring movements in the company's share price, market rumours and market expectations (for example, through assessing analyst reports).

If there is any uncertainty about whether an announcement is required, the company's brokers and, if appropriate, lawyers should be consulted immediately, given all relevant information and asked to advise.

Record keeping

Companies should keep a written record of any conclusions on the timing, form and circumstances of announcements, including any decision that an announcement is not required. In the event of an FSA investigation (which may occur some time after the event), written records of the timeline, the views of directors and advice received from third parties will assist in responding to queries from the regulator and defending the company's actions.

Control of inside information

Procedures should be put in place to ensure that if there is a legitimate delay in the disclosure of inside information (for example, because a transaction is being negotiated), inside information is protected and only disclosed on a 'need to know' basis. These procedures could include password-controlled access to electronic documents, control over the number of copies of documents, Chinese walls within the IT system to restrict access to documentation, use of codewords and 'clear desk' policies.

When briefing analysts and major shareholders, companies must take care that inside information is not inadvertently disclosed. It can be helpful in this respect to take minutes of the meeting, and it is now common practice for presentations to analysts to be made available on the company's website (which does not itself meet the requirements on the disclosure of inside information, but is a way of demonstrating that inside information was not disclosed). A company must also take care when dealing with queries from the press and other media, and should ensure that only nominated staff talk to the media and that they do so using an agreed script or Q&A.

17. The UK Bribery Act 2010 and its implications for businesses

John Rupp, Robert Amaee and Ian Redfearn, Covington & Burling LLP

There was a time in the not so distant past when the US Foreign Corrupt Practices Act was the only game in town for prosecuting those who bribed foreign government officials. Although many other countries had criminalised such conduct, many others had not — and most of the anti-bribery laws on the books of countries other than the US were not enforced.

One of the most striking developments of the past few years has been the extent to which countries other than the US have increased their investigation and prosecution of domestic and foreign bribery in both the public and private sectors. Although there was a debate in the UK more than a decade ago about the extent to which UK law prohibited bribery outside the UK, that debate was settled by the entry into force of the Anti-Terrorism, Crime and Security Act 2001 in that year. The patchwork of applicable laws and a number of other factors nevertheless discouraged prosecutions — in particular, prosecutions for bribery outside the UK.

The UK Bribery Act 2010, which came into force on July 1, 2011, is a powerful new tool for prosecuting bribery within and outside the UK in the public and private sectors. The Bribery Act reformed the criminal law of bribery in the UK, simplified the process for prosecuting bribery offences, and provided for increased penalties for those who are convicted of such offences. Although only one prosecution under the Bribery Act has been completed so far, it should be on the radar of all UK commercial organisations, as well as all commercial organisations that do business in the UK.

Jurisdictional reach

The Bribery Act has broad extra-territorial effect. The offences of bribing another person, being bribed and bribing a foreign public official can be committed by any individual or commercial organisation if an act or omission forming part of the offence takes place in the UK.

If that jurisdictional test is not satisfied, the Bribery Act nonetheless may be triggered if any of those involved in the bribery are found to have a 'close connection' to the UK. British citizens, British nationals, individuals 'ordinarily resident' in the UK, UK-incorporated companies and UK partnerships are all deemed to have that 'close connection' to the UK.

The offence of failing to prevent bribery, which applies only to commercial organisations, has an even broader jurisdictional reach. While that offence can obviously be committed by commercial organisations incorporated or formed in the UK, it also can be committed by commercial organisations incorporated or formed outside the UK if the commercial organisation is carrying on a business, or part of a business, in the UK.

The Adequate Procedures Guidance published by the Ministry of Justice recommends that non-UK companies and partnerships take a common-sense approach to deciding whether they are 'carrying on a business, or part of a business', in the UK. The guidance suggests that a non-UK organisation would need to have a demonstrable business presence in the UK to be covered by the Bribery Act.

There has been some debate about whether a listing on the London Stock Exchange would in itself mean that a company has a 'demonstrable business presence' in the UK. The Adequate Procedures Guidance states that the UK government does not expect a securities listing

alone to constitute carrying on a business or part of a business in the UK. But it notes that the "final arbiter, in any particular case, will be the [UK] courts", and Richard Alderman, the former director of the Serious Fraud Office (SFO), the UK's lead anti-bribery enforcement authority, declared that the SFO would not be impressed with "overly technical interpretations" of the Bribery Act.

The Adequate Procedures Guidance is not binding on either the SFO or the UK courts, and the SFO has discretion to decide which cases it wishes to prosecute. As the Adequate Procedures Guidance points out, the courts will be responsible for deciding whether a commercial organisation falls within the scope of the Bribery Act. For the time being, therefore, a prudent company with a listing on the London Stock Exchange would be well advised to assume that it is subject to the Bribery Act, at least until such time as the courts rule to the contrary.

Offences

General offences

Bribing another person
A person commits an offence under Section 1 of the Bribery Act if he or she offers, promises or gives a financial or other advantage to another person and he or she:

- intends the advantage to induce a person to perform a relevant function or activity improperly;
- intends the advantage to reward a person for the improper performance of a relevant function or activity; or
- knows or believes that acceptance of the advantage would constitute improper performance of a relevant function or activity.

References in this chapter to 'persons' include both natural and legal persons.

In the first two circumstances, it does not matter whether the person to whom the advantage is offered, promised or given is the same as the person who is being induced to perform or rewarded for performing a relevant function or activity improperly. In each case, the advantage may also be offered, promised or given through a third party.

The term 'relevant function or activity' is defined broadly in Section 3 of the Bribery Act to include any function of a public nature, any activity connected with a business, any activity performed in the course of a person's employment, and any activity performed by or on behalf of a body of persons (whether corporate or incorporate).

The person performing the relevant function or activity must be expected to do so in good faith or impartially or be in a position of trust by virtue of performing it. A relevant function or activity may be performed outside the UK, however, and it is not necessary for it to have a connection to the UK.

A person will be deemed to have performed a relevant function or activity 'improperly' if he or she performed it in breach of a 'relevant expectation' — that is, an expectation that it would be performed in good faith or impartially — or if the person failed to perform the relevant function or activity, which in itself would constitute a breach of a relevant expectation.

The relevant expectation will be assessed by reference to what a reasonable person in the UK would expect in relation to the performance of the relevant function or activity. If performance of the function or activity is not subject to English, Scottish or Northern Irish law, local customs or practices must be disregarded unless they are expressly permitted or required by the written law of the country concerned.

Being bribed
A person commits an offence under Section 2 of the Bribery Act if he requests, agrees to receive or accepts a financial or other advantage:

- intending as a consequence for a relevant function or activity to be performed improperly (whether or not by the same person who requested, agreed to receive or accepted the advantage);
- when the request, agreement or acceptance would constitute improper performance of a relevant function or activity; or
- as a reward for improper performance of a relevant function or activity.

It does not matter whether the person requests, agrees to receive or accepts the advantage directly or through a third party. Neither does it matter whether the advantage benefits the recipient (or intended recipient) or another person.

The terms 'relevant function or activity' and 'improper performance' have the same meaning with respect to Section 2 of the Bribery Act as they have with respect to Section 1. It does not matter whether the person who requests, agrees to receive or accepts an advantage knows or believes that the performance of a particular function or activity is improper.

Bribery of foreign public officials
A person commits an offence under Section 6 of the Bribery Act if he bribes a foreign public official with the intention of:

- influencing the foreign public official in his or her capacity as a foreign public official; and
- obtaining or retaining business or an advantage in the conduct of business.

For purposes of this offence, a person bribes a foreign public official if:

- he or she, directly or through a third party, offers, promises or gives a financial or other advantage to a foreign public official or to another person at the request of, or with the assent or acquiescence of, the foreign public official; and
- the foreign public official is neither permitted nor required by the written law applicable to him or her to be influenced in his or her capacity as a foreign public official by the offer, promise or gift.

The term 'foreign public official' is defined broadly in the Bribery Act to include any individual who:

- holds a legislative, administrative or judicial position of any kind in a country or territory outside the UK;
- exercises a public function for or on behalf of a country or territory outside the UK, or for any public agency or public enterprise of that country or territory; or
- is an official or agent of a public international organisation —— that is, an organisation whose members are countries or territories, governments or other public international organisations.

Failure of commercial organisations to prevent bribery
A commercial organisation commits an offence under Section 7 of the Bribery Act if an associated person bribes another person with the intention of obtaining or retaining business or an advantage in the conduct of business for that commercial organisation. Although positioned in the Bribery Act as a separate offence, the SFO would not look at what a commercial organisation had done or not done to combat bribery unless it concluded that a bribe had been offered, promised or paid by or on behalf of the commercial organisation or for the organisation's benefit.

An 'associated person' is one who performs services for or on behalf of a commercial organisation that is subject to the Bribery Act. When assessing whether a person is performing services for or on behalf of a commercial organisation that is subject to the Bribery Act, prosecutors and the courts must take into account the circumstances informing the relationship between the person and the commercial organisation. They would consider, among other factors, the degree of control that the UK commercial organisation exercised over the non-UK person who actually offered, promised or paid the bribe.

It is a defence to Section 7 for a commercial organisation to prove that it had adequate procedures to prevent associated persons from bribing another person for or on behalf of the commercial organisation. The key aspects of the adequate procedures defence are summarised later in this chapter.

Penalties

The maximum penalties for Bribery Act offences are severe. An individual convicted of bribing another person, being bribed or bribing a foreign public official is liable to imprisonment for a term not exceeding 10 years, an unlimited fine or both. Commercial organisations convicted of bribing another person, being bribed, bribing a foreign public official and failing to prevent bribery are liable to an unlimited fine.

Implications for senior officers

If a commercial organisation commits an offence under Sections 1, 2 or 6 of the Bribery Act with the consent or connivance of a senior officer of the commercial organisation or a person purporting to act in such a capacity, that senior officer or person could face personal criminal liability. The term 'senior officer' is defined broadly to include a director, manager, secretary or similar officer.

Increasingly, the UK courts are taking a hard line against senior officers who are complicit in corruption. In sentencing three former executives of a company that had engaged in bribery, one judge said in 2011: "When a director of a major company plays even a small part [in a bribery scheme], he can expect to receive a custodial sentence."

Implications for public procurement

The Public Contracts Regulations 2006 (the Regulations) prevent public authorities from selecting as a contractor any commercial organisation that has been convicted of bribing another person in violation of Section 1 or bribing a foreign public official in violation of Section 6 of the Bribery Act. This mandatory debarment rule applies in all other EU states under Article 45 of the EU Public Procurement Directive (2004/18/EC).

The Regulations also give contracting authorities discretion to exclude from selection any commercial organisation that has been convicted of having violated Section 7 of the Bribery Act, which — unlike Sections 1 and 6 — does not require actual knowledge by the commercial organisation that a bribe has been paid on its behalf or for its benefit. The UK government confirmed in March 2011 that a conviction under Section 7 will attract discretionary rather than mandatory exclusion from public procurement under the Regulations.

Implications for insurance coverage

In the absence of specific agreements with underwriters, directors' and officers' (D&O) liability insurance does not typically cover liability for bribery-related offences. Those within a commercial organisation having responsibility for its insurance arrangements should therefore speak with the organisation's underwriters to ensure that those arrangements address the risk that senior officers may be found personally liable under the

Bribery Act. Similarly, they should consider whether the organisation's insurance arrangements need to provide protection against the risk of civil claims being brought by shareholders and others against senior officers in the event that the commercial organisation is convicted of having failed to prevent bribery by 'associated persons'.

Underwriters are unlikely to extend D&O insurance coverage to Bribery Act liabilities unless commercial organisations have already implemented adequate anti-bribery procedures. In the absence of such procedures, underwriters may decide to restrict the scope of the coverage or, at the very least, increase the premiums for that coverage. We therefore consider in the next section the steps that commercial organisations should consider taking to prevent the commission of bribery offences by 'associated persons'.

Adequate Procedures Guidance

The guidance focuses on six principles that, in the UK government's view, should be reflected in a commercial organisation's anti-bribery procedures. The practical implementation of these principles will vary depending on the risk profile of a particular commercial organisation. Non-governmental organisations such as Transparency International, as well as trade bodies and industry groups, have provided further helpful guidance.

Proportionate procedures

"A commercial organisation's procedures to prevent bribery by persons associated with it are proportionate to the bribery risks it faces and to the nature, scale and complexity of the commercial organisation's activities. They are also clear, practical, accessibly, effectively implemented and enforced."

A multinational commercial organisation with operations in countries presenting a high risk of bribery is likely to require more extensive anti-bribery procedures than a commercial organisation whose operations are limited to countries presenting a low bribery risk. Similarly, the nature of a commercial organisation's operations can affect its bribery risk profile. Other things being equal, a commercial organisation that depends on government authorisations of one sort or another, or that sells extensively to government entities, would generally require more extensive anti-bribery procedures than a commercial organisation selling only within the private sector.

The Adequate Procedures Guidance provides a non-prescriptive and non-exhaustive list of subjects that commercial organisations should consider addressing in their anti-bribery procedures, including: due diligence for existing and prospective 'associated persons'; the imposition of limits on gifts, hospitality and other related promotional expenditures, as well as charitable and political donations; the development and implementation of financial and commercial controls; the implementation of appropriate employee disciplinary processes; the utilisation of contractual anti-bribery provisions; and the provision of anti-bribery training.

The manner in which a commercial organisation addresses the foregoing issues should be dictated by the specific risks that the organisation faces. For example, an organisation that routinely invites customers or others to major sporting events should consider adopting detailed hospitality procedures that: explain when current and potential customers or others can be invited to such events; restrict the cost of the hospitality that is provided; specify who within the organisation must approve any hospitality that has been proposed; and establish a register that records, among other things, the cost of the hospitality provided and the identity of the recipients. In contrast, an organisation that does not routinely offer corporate hospitality may be able to control any risks with less burdensome procedures.

Top-level commitment

"The top-level management (be it a board of directors, the owners or any other equivalent body or person) are committed to preventing bribery by persons associated with it. They foster a culture within the organisation in which bribery is never acceptable."

According to the Adequate Procedures Guidance, top-level management commitment is likely to involve selecting and training senior managers to lead the organisation's anti-bribery efforts; leading key initiatives such as the preparation of an appropriate code of conduct; giving instructions for undertaking bribery-related risk assessments; reviewing the results of such assessments; monitoring breaches of the organisation's anti-bribery policy and procedures; and playing an active role in making key decisions relating to the bribery risks affecting the organisation. The Adequate Procedures Guidance also encourages the periodic issuance by top-level management of statements confirming the organisation's zero-tolerance policy on bribery.

Risk assessment

"The commercial organisation assesses the nature and extent of its exposure to potential external and internal risks of bribery on its behalf by persons associated with it. The assessment is periodic, informed and documented."

An effective risk assessment should consider both internal and external risks. Internal risks include deficiencies in employee training; a lack of clarity regarding an organisation's anti-bribery procedures; an approach to remuneration that encourages excessive risk-taking; and deficiencies in an organisation's financial controls. External risks can stem from a range of factors, including the countries in which an organisation operates, the people with which it does business and the types of transaction in which it engages.

A helpful starting point for any assessment of external risk is the corruption perceptions index published by Transparency International, which ranks countries from least corrupt to most corrupt, based on the perceptions of a reasonably broad-based sample of those having knowledge of the particular country. The index is updated annually, so it can be used by a commercial organisation to assess how the risks that the organisation encounters in a particular country have changed over time.

With regard to the assessment of internal risks, an organisation ought to consider the possible anti-bribery implications of any significant changes in the nature of its business. For example, if an organisation decides to start selling products or services to public sector organisations or to implement a commission-based remuneration programme for its employees, those changes are likely to affect the organisation's bribery-related risk profile.

Due diligence

"The commercial organisation applies due diligence procedures, taking a proportionate and risk based approach, in respect of persons who perform or will perform services for or on behalf of the organisation, in order to mitigate identified bribery risks."

The greater the bribery risk posed by a person who is performing or will perform services on behalf of or for the benefit of a commercial organisation, the more extensive the due diligence that will be required. In low-risk situations, it may be sufficient to rely on public sources such as company registrar filings or media articles. In higher-risk situations, however, a more resource-intensive process will generally be required, perhaps including interviews with prospective intermediaries. It is advisable to conduct due diligence at the outset of a relationship and intermittently during the course of the relationship.

Communication and training

"The commercial organisation seeks to ensure that its bribery prevention policies and procedures are embedded and understood throughout the organisation through internal and external communication, including training, that is proportionate to the risks it faces."

Commercial organisations should seek to provide anti-bribery training to all new and existing employees who are or will be engaged in activities that may present bribery risks. Effective training should be continuous, regularly monitored and evaluated. Commercial organisations should also consider providing anti-bribery training to 'associated persons', particularly if the 'associated persons' are operating in high-risk countries or engaging in high-risk activities such as interacting with public officials.

For instance, if an organisation engages an agent to obtain government licences or permits in a country that presents a high risk of corruption, the organisation should consider providing face-to-face training to the agent to ensure that he or she fully understands the organisation's legal and ethical requirements.

Monitoring and review

"The commercial organisation monitors and reviews procedures designed to prevent bribery by persons associated with it and makes improvements where necessary."

As noted in the Adequate Procedures Guidance: "The bribery risks that a commercial organisation faces may change over time, as may the nature and scale of its activities, so the procedures required to mitigate those risks are also likely to change." That means, among other things, that periodic risk assessments should be built into a commercial organisation's anti-bribery procedures.

Additional rules for regulated commercial organisations in the financial services industry

Additional rules apply to organisations that are regulated by the Financial Services Authority (FSA). Although the FSA does not enforce or provide guidance on the Bribery Act, organisations regulated by the FSA have separate obligations to establish and maintain effective systems and controls to mitigate the risks of financial crime, including bribery and other forms of corruption such as money laundering.

A March 2012 FSA thematic review into the investment banking sector suggested that many regulated organisations have inadequate anti-bribery systems and controls. Of the 15 regulated firms that the FSA visited for its review, including eight major global investment banks, 'most', according to the FSA, "had not properly taken account of [the FSA] rules covering bribery and corruption". As the then FSA acting director of enforcement and financial crime said: "The investment banking sector has been too slow and too reactive in managing bribery and corruption risks."

The FSA has broad powers over organisations in the financial services sector. That includes power to impose significant, multi-million-pound financial penalties on firms that are found to have deficient systems and controls, even if such deficiencies have not led to actual corrupt conduct. Several recent cases illustrate that risk.

In 2009 and 2011, the FSA fined two insurance brokers that it deemed to have defective systems and controls. The first was fined £5.25 million and the other was fined £6.89 million. The FSA did not prove that the firms had actually engaged in corrupt conduct. Neither did it prove recklessness on the part of the firms. Similarly, in August 2012, the FSA fined Turkish Bank £294,000 for breaching the Money Laundering Regulations 2007, which impose anti-money laundering due diligence

obligations on regulated financial institutions. As with the earlier cases against the insurance brokers, the FSA did not find evidence of deliberate or reckless wrongdoing.

To assist regulated commercial organisations in developing robust systems and controls, the FSA has published 'Financial crime: a guide for firms', which includes a section on bribery-related risks. The guide addresses many of the same compliance programme features as the Adequate Procedures Guidance, including top-level engagement in managing financial crime risks, continuous risk assessment and monitoring, and proportionate due diligence focusing on agents and other intermediaries.

The Proceeds of Crime Act 2002 and the prosecution of bribery offences

The full implications for UK commercial organisations, and organisations carrying on a business, or part of a business, in the UK, cannot be understood without taking into account the requirements of the UK Proceeds of Crime Act 2002 (POCA). Although the Bribery Act does not require commercial organisations to report to law-enforcement authorities bribes that have been or may have been paid by or on behalf of the organisation, the organisation may have a mandatory reporting obligation under POCA.

Most bribery that occurs is intended to generate, and does generate, revenue for the organisation on whose behalf the bribe has been paid. If such revenue is transferred to the UK and some additional conditions are satisfied, the organisation possessing the revenue may be deemed to be in possession of 'criminal property' under POCA. The receipt, possession or disposition of criminal property in or from the UK may be prosecuted in the UK if the organisation has not filed a suspicious activity report (SAR) with the Serious Organised Crime Agency (SOCA) and SOCA's consent to the receipt, possession or disposition of the criminal property is not obtained.

Even if SOCA does grant consent, that does not prevent the SFO or the Crown Prosecution Service from prosecuting the underlying bribery. The SFO encourages commercial organisations to self-report bribery or suspected bribery to the SFO simultaneously with the submission of a SAR to SOCA. The SFO has also encouraged organisations to disclose bribery or suspected bribery voluntarily in appropriate cases, even if the filing of a SAR is not required.

An SFO guidance document, 'The Serious Fraud Office's Approach to Dealing with Overseas Corruption', states that: "The benefit to the corporate [of voluntarily disclosing bribery or suspected bribery to the SFO] will be the prospect (in appropriate cases) of a civil rather than a criminal outcome as well as the opportunity to manage, with us, the issues and any publicity proactively." Whether a commercial organisation will avoid prosecution under the Bribery Act by self-reporting will depend, of course, on a range of factors, including the seriousness of the alleged conduct, the extent of the organisation's co-operation with the SFO, and the organisation's commitment to effective remediation.

POCA contains broad powers allowing enforcement authorities, including the SFO, to confiscate or recover criminal property. Part 5 of POCA, for example, allows enforcement authorities to recover in civil proceedings property that is or represents property obtained through 'unlawful conduct'. That includes conduct that (a) occurred in the UK and is unlawful under UK criminal law, or (b) occurred in a country outside the UK and is unlawful under that country's criminal law and would be unlawful in the UK if it occurred in the UK. The SFO has used its civil recovery powers periodically in cases involving bribery and other forms of corruption — in the

most prominent cases, recovering several million pounds from the defendant companies. In July 2012, for example, the SFO recovered more than £1.8 million from Oxford Publishing Limited by means of a civil recovery order.

Conclusion

Commercial organisations that have not already done so should review their existing policies and procedures to take into account their potential exposure under the Bribery Act and other relevant legislation such as POCA. The consequences of non-compliance — both financial and reputational — can be devastating.

SHEPHERD+ WEDDERBURN

Shepherd and Wedderburn is one of the UK's leading law firms. We have an uncompromising commitment to our clients, with quality at the heart of everything we do.

Our clients agree.

"Technically and commercially excellent, their experience shines through and makes the client experience superb. They have an understanding of our business objectives and they are seen as an integral part of the business team."

CHAMBERS 2012

For more information contact Walter Blake at walter.blake@shepwedd.co.uk

London
Edinburgh
Glasgow
Aberdeen

www.shepwedd.co.uk

18. Managing directors' conflicts

Walter Blake, Shepherd and Wedderburn LLP

Historically, with their roots in the common law regime, the rules on conflicts of interest have been difficult for directors to navigate. This task should have been made easier by the introduction of a statutory framework for conflicts under the Companies Act 2006 (the Act), which became effective on October 1, 2008. While the Act has not really simplified or clarified the rules on conflicts, or significantly affected what is expected from directors in terms of behaviour, it has restated those rules in a statutory context.

Overview

The Act sets out seven 'general duties' owed to a company by a director, three of which relate directly to directors' conflicts of interests. These are:

- to avoid a situation in which a director has, or can have, an interest that does or may conflict with the interests of the company of which he is a director
- not to accept benefits from third parties
- to declare any interest in a *proposed* transaction or arrangement with the company.

The duties are owed to the company, not to any individual shareholder(s) who may, in limited circumstances, take action to enforce the duties in the name of the company.

In addition, there is a separate obligation (not, strictly speaking, a general duty) to declare any interest in an *existing* transaction or arrangement with the company. Failure to comply with this obligation (unlike the general duties) is a criminal offence.

There was considerable debate around the time that the new statutory provisions came into force over the extent to which they changed the existing common law rules. It is now generally accepted that they modified the common law rules on directors' conflicts in two key respects. First, directors now have the power to authorise certain conflicts of interest that previously could only be authorised by shareholders. Second, certain transactions or arrangements between directors and the company are now permitted (without the need for separate authorisation) provided they have been appropriately disclosed to the other directors.

Duty to avoid conflicts of interest

Under Section 175 of the Act, a director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This has come to be known as a 'situational conflict'.

The duty only applies to situations arising after October 1, 2008. It applies in particular to the exploitation of any property, information or opportunity, whether or not the company could take advantage of it for its own purposes.

The duty does not apply to transactions or arrangements with the company (although it appears to catch transactions or arrangements with subsidiaries of the company), which are generally subject to separate disclosure (as opposed to authorisation) requirements under Sections 177 and 182 for proposed and existing transactions respectively. As discussed below, however, certain transactions between a director and the company require specific shareholder approval.

The scope of the Section 175 duty is very broad. It applies to both actual and potential conflicts and, although principally aimed at preventing directors from exploiting situations for their own benefit at the company's expense, it also catches conflict

situations where the director does not benefit personally (for example, where he is a director of two or more group companies whose interests conflict).

The definition of 'conflict of interest' includes a conflict of interest and duty, and a conflict of duties.

Authorisation of conflicts by directors
Section 175 gave directors a new power to authorise situational conflicts of interest. The duty to avoid situational conflicts is not breached if the relevant matter has been authorised in advance by the directors, provided that:

- in the case of a public company, the company's constitution allows the directors to give the authorisation
- in the case of a private company, the company's constitution does not contain anything that invalidates the authorisation.

Many public companies have amended their articles of association to take advantage of the authorisation regime. Private companies incorporated before October 1, 2008 must pass a shareholder resolution giving directors the power to authorise.

Authorisation of a situational conflict under the new statutory power must be given at a quorate meeting of the board of directors. The authorisation is only effective if quorum requirements are met without the relevant director voting or would have been met without his votes being counted. Generally, conflicted directors should not attend a board meeting (or the relevant part of the meeting) at which the matter is being considered.

Each board member, in considering whether to authorise a conflict of interest, will of course need to consider his other duties — including, in particular, the overriding statutory duty to act in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole.

Authorisation by the company
The directors' power to authorise situational conflicts does not replace or restrict the power of the company — whether through shareholder resolutions or provisions in the articles — to authorise matters that would otherwise be a breach of the directors' general duties (see 'safe harbours', below).

GC100 guidance on conflicts of interest
In January 2008, the GC100, a grouping of the senior legal officers of more than 85 FTSE 100 companies, published a detailed note on conflicts of interest. This provides helpful guidance on the exercise of the Section 175 power to authorise conflicts and related issues. The GC100 also published a suggested checklist for company secretaries, a draft briefing paper for directors and a questionnaire designed to help directors identify conflicts of interest. The Association of British Insurers has advised that listed companies should undertake to follow emerging best practice in line with GC100 guidance.

Duty not to accept benefits from third parties
Under Section 176 of the Act, a director must not accept a benefit from a third party conferred by reason of his being a director or doing (or not doing) anything as a director. The duty is intended to prevent a director from exploiting his position for his own benefit.

The duty does not prevent a director from receiving benefits from either the company, an associated body corporate or a person acting on behalf of the company or an associated body corporate; or from a person by whom his services (as a director or otherwise) are provided to the company.

The duty is wide enough to catch gifts and corporate hospitality. However, it is not breached if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. As such, low-level gifts or corporate hospitality in the normal course of business are unlikely to result in a breach.

The duty sits alongside the UK Bribery Act 2010 and other legislation intended to combat bribery and corruption. Companies should ensure that their policies and procedures for dealing with bribery and corruption are kept up to date and that directors are aware of their responsibilities.

Declaring interests in transactions or arrangements with the company

Proposed transactions with the company (Section 177)

A director has a statutory duty to declare to the other directors the nature and extent of any interest, direct or indirect, in a *proposed* transaction or arrangement with the company. Authorisation by the directors under Section 175 of the Act is not possible; that authorisation procedure only applies to situational conflicts (and not to conflicts of interest arising in relation to a transaction or arrangement with the company). Consequently, for a proposed transaction or arrangement with the company, the directors have to decide whether to proceed and, if so, whether any special conditions should apply to deal with the conflict.

The declaration must be made before the company enters into the transaction or arrangement, and a director should also update any previous declaration of interest if it proves to be, or becomes, inaccurate or incomplete. The requirement to update previous declarations is not subject to a materiality threshold, so a relatively trivial change could trigger that obligation.

Existing transactions with the company (Section 182)

There is a separate requirement for a director to declare to the other directors the nature and extent of any interest, direct or indirect, in an *existing* transaction or arrangement with the company. This may happen, for example, when a new director is appointed and has some interest in a pre-existing transaction.

There is no need to declare an interest in an existing transaction or arrangement if that interest has already been declared as a proposed transaction, although directors will have to provide an update for previous declarations if they prove to be, or become, inaccurate or incomplete.

The declaration must be made as soon as possible and it is a criminal offence (rather than a breach of duty) to fail to declare an interest in an existing transaction (or to update a previous declaration) in accordance with Section 182.

Declaring interests under Sections 177 and 182

A declaration under Section 182 must (and a declaration under Section 177 may) be made at a meeting of the directors, by notice in writing to the other directors (email can be used if the directors agree) or by general notice to the other directors.

A general notice, for these purposes, should state that the director has an interest in a particular entity or is connected to a specified person and he/she is therefore to be regarded as interested in any future transaction or arrangement with that entity or person.

The general notice should state the nature and extent of the director's interest in the other entity or the nature of the connection to the other person. The notice should be given at a meeting of the directors, failing which the director should take reasonable steps to have it brought up and read at the next meeting after the general notice has been given.

As a concession to common sense, directors are not required to declare interests (or update previous declarations) if they are not aware of the interest or the relevant transaction or arrangement. Directors are, however, presumed to be aware of matters of which they ought reasonably to be aware. There is no need to declare an interest if the other directors are already aware (or ought reasonably to be aware) of it, or if it concerns the terms of a director's service contract that has been or is being considered by the other directors.

Safe harbours

No reasonable likelihood of a conflict

There is no breach of the various statutory provisions if the relevant matter cannot reasonably be regarded as likely to give rise to a conflict of interest. It will not always be easy for directors to determine whether particular circumstances fall within this safe harbour and, where there is any doubt, they should declare the matter and seek director and/or shareholder authorisation as appropriate.

Authorisation of conflict by the company or under its articles of association

There is no breach of the general duties (including Sections 175, 176 and 177 of the Act) if:

- the company has specifically or generally authorised (whether by shareholder resolution or through the articles of association) an act or omission by any or all of the directors that would otherwise constitute a breach; or
- there are provisions in the company's articles dealing with conflicts of interest, and those provisions have been followed.

As a practical matter, shareholder approval under this safe harbour — where it can be readily obtained — may well be the best solution for resolving a conflict if there is any doubt as to the availability of another exemption or safe harbour.

Specific transactions requiring shareholder approval

There is no breach of the general duties on conflicts of interest under Sections 175 and 176 of the Act where shareholder approval for specific transactions is required and that approval has been obtained. Transactions where such approval may be required include directors' long-term service contracts, substantial property transactions, loans, quasi-loans and credit transactions, and payments for loss of office.

Ratification

Shareholders can ratify any breach of the general duties on conflicts of interest by ordinary resolution or unanimous approval. The vote of the conflicted director, and any shareholder connected to him, cannot be counted for the purpose of any ratifying resolution.

Consequences of breach

An action for breach of duty will generally be brought against a director by the company. Remedies for breaches of the duties set out above may include an injunction, setting aside of the transaction, restitution and account of profits, restoration of company property held by the director, damages, or termination of the director's service contract. As stated above, failure to comply with Section 182 is a criminal offence.

Duties continue after cessation of directorship

Certain statutory duties continue even after a person has ceased to be a director. A former director has a continuing obligation to avoid a conflict of interest under Section 175 in relation to the exploitation of any property, information or opportunity of which he became aware while he was a director.

There is also a continuing duty not to accept benefits from third parties under Section 176 in relation to things done or not done while a director.

Managing directors' conflicts

Benchmarking and briefing directors

Companies will wish to monitor best practice in this area and consult their legal and other advisers where appropriate. Companies should also ensure that directors are aware of their statutory duties as well as the relevant internal policies and procedures. These should be covered in the induction process for new directors.

Continuing duty

Directors need to monitor their personal positions on an ongoing basis in order to identify any actual or potential conflicts of interest that should be avoided or authorised under Section 175, or declared or updated under Sections 177 or 182. Directors should also be reminded that reputational damage can easily result from a situation that may not technically constitute a breach of duty or other obligation relating to conflicts of interest.

Consider the provisions of articles

Many companies will have updated their articles of association to reflect the statutory provisions on conflicts of interest around the time those provisions came into force — in October 2008. Any requirements in the articles relating to notification, quorums and voting should be carefully followed.

Directors' other duties

In considering whether to authorise a conflict of interest under Section 175, each non-conflicted director must have regard to his other duties, including the overriding duty to act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole.

Anticipate issues

Directors should seek to anticipate the types of issues that could arise from a conflict situation. For example, where the director is also a director of a competitor or 'represents' a major shareholder, there is plenty of scope for difficulties. Directors should seek to identify and consider such issues as soon as possible.

Authorisations

It may be appropriate to make any authorisation subject to conditions or restrictions, such as placing a time limit on the authorisation or stating that it can be revoked at any time, and restricting the disclosure of confidential information.

Review of authorisations

Companies should keep a record of authorisations that have been granted and put in place procedures to review authorisations from time to time, perhaps annually.

Annual report

The Association of British Insurers has indicated that it would expect boards of listed companies to report annually that there are procedures in place to deal with conflicts of interest and that they operate effectively.

Situational conflicts

Examples of situations where a director could face an actual or potential conflict may include:

Where the director is, or has been, appointed by a private equity investor

In considering whether to grant authorisation, the directors will need to have regard to their general and other duties to the company, including the duty to act in a way they consider, in good faith, would be most likely to promote the success of the company for the benefit of the shareholders as a whole. In practice, the directors will often wish to authorise this type of conflict, especially where the private equity investor has a contractual right to appoint a director. They may, however, wish to attach conditions to any authorisation in order, for example, to safeguard confidential company information and to set out what should happen if circumstances change.

Where a director is, or in some way represents, a customer, supplier or competitor of the company

This situation could arise, for example, where the wife of a director is employed by a competitor of the company, or where a director also serves on the board of a company that is a customer or competitor. The other directors will need to consider whether they wish to authorise such conflicts given their general and other duties. The matter may be relatively straightforward if they believe that the arrangement brings clear benefits to the company (such as access to the director's particular expertise or industry knowledge) and that the conflict can be appropriately managed (through, for example, safeguards to protect confidential information).

Where a director is, or in some way represents, an adviser of the company

If the directors are prepared to authorise this type of conflict situation in the particular circumstances, it is likely that the company will also agree that the director has no obligation to disclose confidential information that he obtains through his role with the adviser. By way of reciprocation, it is also likely that the adviser will agree that the director has no obligation to disclose confidential company information.

Where a director is also a director of the corporate trustee of the company pension scheme

Companies may consider authorising this type of conflict through the articles of association in order to avoid the need to go through the Section 175 procedure each time there is a change of relevant personnel. The directors should of course consider the surrounding circumstances carefully before authorising the conflict. A director who is also a director of the company pension scheme trustee will need to monitor his position continuously to identify any actual or potential conflicts. The Institute of Chartered Accountants in England and Wales and the Pensions Regulator have each published helpful guidance on conflicts of interest for trustees of company pension schemes.

Other areas for consideration

Listing Rules — related-party transactions
The rules on 'related party' transactions contained in the Listing Rules (LR) may be relevant for certain conflicts involving directors of listed companies, as the definition of 'related party' includes a company's current, and certain previous, directors. The rules — set out in LR11 and applying only to companies with a Premium Listing — are intended to prevent related parties from taking advantage of their position and to prevent any perception that they may have done so. Related-party transactions require (among other things) shareholder approval in accordance with LR 11.1.7R, although there are some exceptions and also modified requirements for certain smaller transactions.

Takeover Code — management buyouts
Under the Takeover Code, where an offer is a management buyout or similar transaction, a director of the target company will normally be regarded as having a conflict of interest if it is intended that he/she should have any continuing role (whether in an executive or non-executive capacity) in either the acquiring or target company in the event of the offer being successful. Where a director has a conflict, he/she should not normally be joined with the remainder of the board in the expression of its views on the offer, and the nature of the conflict should be clearly explained in the target board's circular.

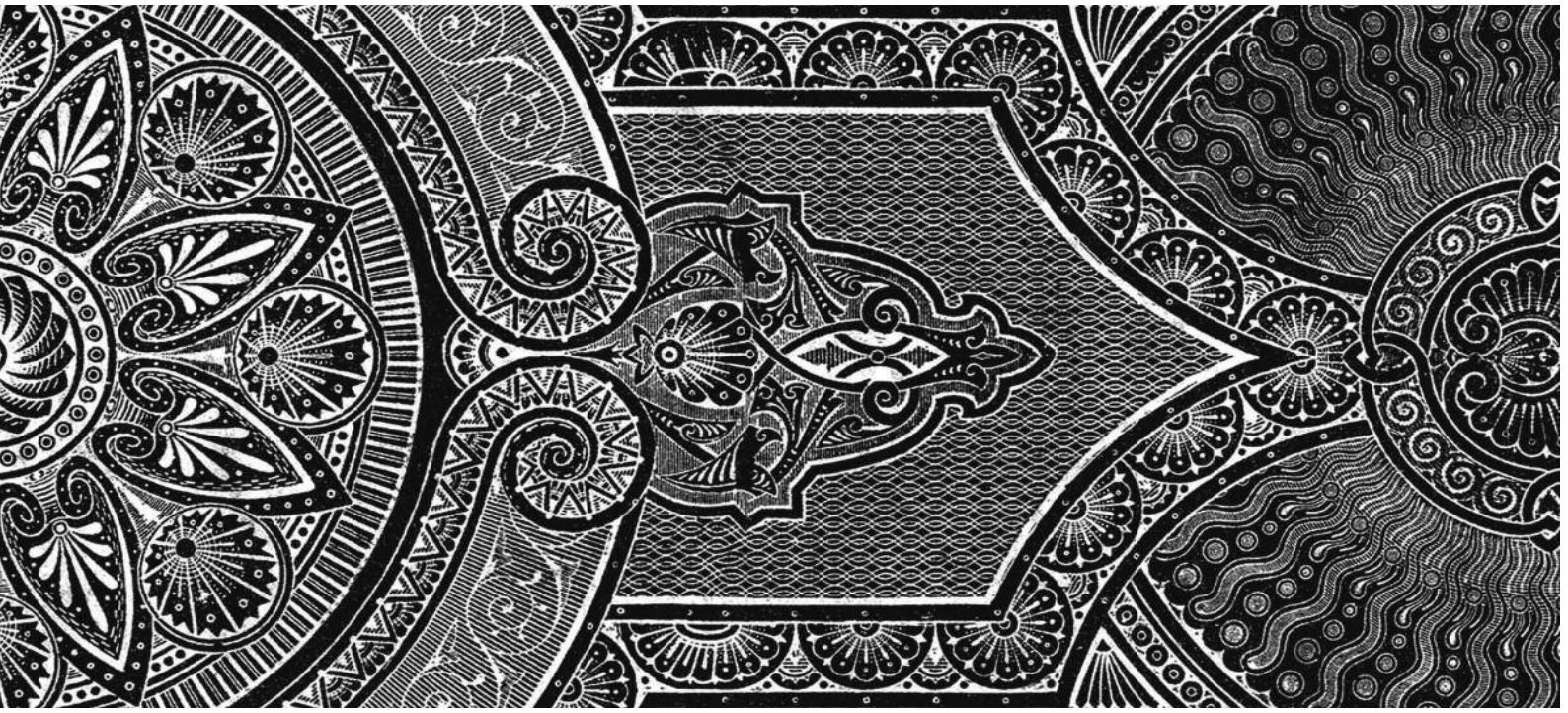
Any conflicted director should disclose the conflict to the other directors as soon as possible. The target company will wish to put certain safeguards in place, including setting up an independent committee of the board to deal with the proposed transaction, so that conflicted directors are excluded from the discussions. The board committee will also need to give specific consideration at an early stage to the disclosure of confidential information by a conflicted director to third parties.

Conclusion

Although the Companies Act 2006 has codified the rules on directors' conflicts of interest in a statutory context, this remains a complex area for companies and directors. The new UK regime on directors' conflicts has, however, probably resulted in:

- more attention being paid to conflicts (actual and potential) by companies and directors
- the adoption by many companies of more formal procedures for dealing with conflicts
- directors being less likely than before to fall foul of the rules on conflicts, particularly if they follow developing best practice.

Leading in financial advice, worldwide



Rothschild is one of the world's largest independent financial advisory groups

Our Global Financial Advisory business provides impartial, expert advice to corporations, governments, institutions and individuals. With approximately 1,000 advisers in 40 countries around the world, our scale, reach, intellectual capital and local knowledge enable us to develop relationships and deliver effective solutions to our clients, wherever their business takes them. This is why we are leaders in financial advice, worldwide.

LCH.CLEARNET

LCH.Clearnet (2012)

- Fairness opinion on the recommended cash offer from the London Stock Exchange
- Builds a global provider in clearing and risk management services

GBL

Groupe Bruxelles Lambert (2012)

- Sell down of 2.3% stake in Pernod Ricard for €499m and 10.0% stake in Arkema for €432m
- Follows global strategic review of the company

Nestlé Good Food, Good Life

Pfizer

Nestlé (2012)

- US$11.85bn acquisition of Pfizer's Nutrition business
- Largest M&A deal in food and beverage sector for two years. Largest acquisition by Nestlé in 10 years

amadeus Your technology partner

BC Partners, Cinven and Air France (2012, 2011)

- Independent adviser to shareholders on four consecutive sell-downs in Amadeus IT Holding raising a total of €2.2bn
- Further €473m partial sell down by Air France-KLM
- Extension of advice on €1.45bn IPO in 2010. The only financial adviser to be involved in all six transactions

周大福 CHOW TAI FOOK

Chow Tai Fook (2011)

- Adviser on US$2bn IPO on Hong Kong Stock Exchange
- One of the largest new consumer listings of 2011. Company became the world's largest listed jewellery retailer

magazineluiza.com

Magazine Luiza (2011)

- Adviser on US$584m IPO
- One of the largest Latin American IPOs of 2011, completed in a challenging market environment

ROTHSCHILD

Global Financial Advisory

Leading in financial advice, worldwide

Image: detail from £500 bond for the Brazilian 5% funding loan of 1901, issued by Rothschild (The Rothschild Archive)

19. The role of the independent adviser

Adam Young and Sarah Blomfield, Rothschild

The proper identification and management of conflicts of interest has always been one of the underlying tenets of the orderly functioning of financial markets. In recent years, however, there have been mounting concerns about conflicts resulting from the increased range of activities undertaken by many investment firms and banks. This was brought into sharp focus in the fallout from the 2008 financial crisis, which placed the integrated 'one-stop shop' investment banking model under particular scrutiny.

Post financial crisis, many companies have chosen to appoint specialist independent corporate finance advisory firms to work alongside the investment bank in the IPO process and once on the market. Independent advisers offer advice on mergers and acquisitions, debt and equity offerings. For example, on an IPO transaction they are focused on advising the management team and managing the logistics of the process, while the bank is responsible for distribution and ensuring that investors buy the company's shares. The main responsibility of an independent adviser includes the identification and management of conflicts of interest between the constituencies involved — for example, issuer, bankers, analysts and investors. They can therefore help a client company procure value from all parties, acting as an independent sounding board on key decisions.

Failings in governance and the road back

The recent financial crisis has revealed some shortcomings in corporate governance and the role of non-executive directors, whose job it is to oversee the execution of company strategy by the executive team. Some non-executive directors have been criticised for failing to fulfil their role of strong independent oversight. Caught in the harsh glare of the spotlight, many have appointed specialist independent corporate finance advisory firms to assist them.

The corporate governance framework in the UK specifically requires a company to be led by an effective board, at least half of which should comprise non-executives deemed to be independent. Directors have a fiduciary duty to act in the best interests of shareholders as a whole and not on behalf of a significant shareholder or stakeholder interest, or indeed just themselves. Furthermore, since the Companies Act 2006, directors of UK companies now have a statutory duty to avoid conflicts of interest.

Against this backdrop, a board cannot afford to be seen to be compromised, and a company's choice of financial adviser(s) is critical. This chapter considers some of the common situations where a board may consider it prudent to take independent financial advice.

The role of advisers in IPOs

Owners of companies seeking an IPO want to maximise the valuation of their business while institutional investors want to buy those shares at the lowest reasonable price possible. An integrated bank appointed as a bookrunner to help sell the shares in an IPO is tasked with achieving the issuer's objectives and that is its primary focus. As those institutional investors are also clients of the same banks, paying them fees for their brokerage and sales and trading services, conflicts may occur despite 'Chinese walls' being in place in the firm.

Independent financial advisers can appear more objective as they don't try to cross-sell other services and usually do not lend money. Therefore, an independent adviser can be perceived as being entirely on the side of the issuer and management on every topic. This allows the adviser to work very closely with the company, almost becoming a member of the internal team. In the past few years, 70 per cent

of all the larger IPOs in western Europe have utilised an independent financial adviser.

Valuation

An adviser's role includes helping to optimise the valuation — not just at IPO, but also in after-market trading given that in most cases the pre-IPO shareholders will retain major stakes going forward. Advisers manage the valuation dialogue so that the issuer has a realistic view of the likely IPO price from the beginning of the process, and this view is then refined and updated as the process moves on. They will also help the issuer negotiate the valuation with the bookrunners and ensure that the valuation feedback received from investors is presented in a clear, frank and accurate manner.

Letting the managers manage

Executing an IPO and being on the market consumes a significant amount of management time, especially since most executives will have had little or no public company experience. By engaging a dedicated equity capital markets advisory team, a company can outsource the project management of an IPO process, enabling the management team to continue running the business with the minimum of distraction.

The bookrunner 'beauty parade'

The independent advisers help the management team select the bookrunner syndicate by compiling a list of possible candidates based on their first-hand knowledge of the market and the research, sales, trading and investment banking capabilities of the major candidate banks. They send out detailed requests for proposals (RFPs) to selected banks and compile matrices to compare responses to key selection criteria, as well as drawing up lists of follow-up questions. They advise on putting together an experienced syndicate, drawing up heads of terms and negotiating the fee structure. They analyse the RFP responses and run 'beauty parades' where investment banks pitch to become part of the syndicate.

The logic behind this is that independent advisers are able to provide an objective view. The RFP process is usually viewed by the bookrunning candidates as a fair, transparent and level playing field on which to compete. It therefore maximises competitive tension and puts the issuer firmly in control of the negotiation of fees and contractual terms in the mandate letter. Independent advisers will also provide a view to the client as to which lawyers, accountants and third-party experts to appoint. Substantial fee savings can be achieved, with no loss of quality.

Dealing with the documentation

An IPO process is heavily regulated and document-intensive, with the prospectus in particular often being lengthy and complex. Independent advisers help the issuer to navigate the process and may be asked to assist with management of the prospectus timetable and to liaise with regulators to alleviate time pressures. Potential due diligence 'red flags' and disclosure issues will be raised in advance with the issuer.

Tensions may arise between the bookrunners, which want to maximise disclosure in the prospectus to limit their own risk, and the issuer, which may wish to balance the degree of disclosure in the prospectus with regard to commercially sensitive matters. A good independent adviser will draw upon its experience and judgement to provide a sensible compromise.

The legal documentation, particularly the underwriting agreement, which is the principal agreement governing the relationship between the issuer and the bookrunners, can be a minefield to negotiate. Given the various competing objectives, there is a risk that the respective parties' positions become entrenched.

Naturally, bookrunners will want to negotiate the most favourable terms and will cite market standards and precedent agreements from previous mandates in support of their case. The issuer will also want to negotiate the most favourable terms but may not have the detailed knowledge of market precedent. Key issues in the underwriting agreement are often not purely legal and require detailed knowledge of the issuer's business and commercial judgement. An independent adviser can provide an objective view on current market practice and cite concrete examples from previous deals where, for example, bookrunners may have agreed to compromise in favour of the issuer.

Keeping the show on the road

Once the independent adviser has recommended a group of banks to run the process and the syndicate is in place, it will manage 'behind the scenes' to ensure that the bookrunners remain cohesive and are all working together towards the same goal. Some issuers prefer their independent adviser to act as the key point of contact with the syndicate to free up the issuer to concentrate on the flotation. The focus here is on keeping the syndicate aligned to solve problems before they reach the client. Other issuers prefer to be fully involved with the adviser at their side.

With the syndicate in place, an independent adviser will continue to help the issuer by monitoring how banks are marketing the offering, soliciting and evaluating investor feedback and advising on tactics during the book-building and allocation process.

During the book-building process, an independent adviser will provide assistance with understanding the full range of pricing options available to the issuer and the implications of each scenario — in particular, the potential impact on after-market trading. One of the key objectives of a successful IPO will be the formation of a high-quality institutional shareholder base that will react rationally to developments in terms of their trading behaviour.

An independent adviser will scrutinise the composition of the allocation proposal and analyse the profiles of the investors — requesting changes, if appropriate, and providing colour on the likely composition of the shareholder base.

Secondary offerings

Post IPO, there are a number of instances where a listed company will wish to continue to receive independent financial advice. Where further 'sell downs' of stock are envisaged, vendors/issuers will turn to independent advisers to project-manage the process, provide guidance on optimal timing and manage the syndicate, pricing and allocation. For these types of transaction, independent advisers can run confidential competitive auctions among bookrunner candidates in order to achieve firm, fixed-price underwriting at an optimal price — and eliminate the risk of leaks.

Issuers wishing to raise further capital by way of a secondary equity raising will often turn to independent equity advisers to advise on the timing and pricing of a rights issue or placing. The advisers will also be consulted on the selection of underwriters, the underwriting fees and the targeting of specific investors.

The level of underwriting fees for rights issues in the UK has been an area for scrutiny in the recent past from investors and for investigation by regulators. Independent advisers can play an important role in helping ensure that the fees appropriately reflect the risks that are being run by the underwriters.

Rights issues require bookrunners/brokers to take firm underwriting risk for a period of at least two weeks. Usually, banks do not welcome this risk unless they are confident that the rights issue will

be strongly supported by shareholders. An independent adviser will work up strategies to reduce the probability of this occurring, including techniques such as broadening the underwriting syndicate to include a more diverse range of banks and spreading the risk into smaller parcels, when conditions suggest this is the best strategy.

In the last few years, approximately 50 per cent of all the larger UK rights issues, placings and open offers have utilised an independent financial adviser.

Mergers and acquisitions

One of the main reasons why clients hire an independent financial adviser in an M&A deal is to seek a fairness opinion. Broadly, a fairness opinion addresses, from a financial point of view, whether a transaction is in the best interests of shareholders. Independent advisers are engaged as they are not aligned to a particular interest (be that a board member, shareholder or other stakeholder) or predisposed to any particular outcome.

Fairness opinions have no set formula and will be determined by the parameters of the commercial transaction. In the UK, they are sometimes required by regulation (pursuant to the UK Takeover Code and Listing Rules issued by the Financial Services Authority), and occasionally a client may wish to have an opinion from an independent bank to support a board decision on the merits of a particular transaction and create an appropriate audit trail.

In part because of the regulatory backdrop, fairness opinions are less usual in the UK market but are a more common feature of M&A globally, particularly in the US where directors face heightened judicial scrutiny of their business judgement and where the burden of proof is based in part on the structural protections employed by the board. Internationally, there is heightened sensitivity to conflict issues, which can span jurisdictions regardless of legal regime. Companies and their boards are focused on avoiding litigation and reputational damage by anticipating how facts could potentially be misrepresented with hindsight.

Regulatory environment (UK)

There are certain circumstances where a fairness opinion provided by an independent adviser is a mandatory requirement in the UK.

The UK Takeover Code

The Takeover Code, which governs acquisitions of companies, inter alia, listed in the UK, requires the board of an acquirer or target to receive independent advice from a financial adviser.

- Rule 3.1 of the Takeover Code stipulates that the board of a target company must obtain competent independent advice on any offer, and that the substance of such advice must be made known to its shareholders. Typically, an offer document will contain a statement to the effect that: “The directors of [X], who have been so advised by [Y] bank, consider the terms of the offer to be fair and reasonable”
- Rule 3.2 states that a board must also obtain competent independent advice when the offer is a reverse takeover or where the directors are faced with a conflict of interest
- Rule 15 holds that when an offer is made for a company with outstanding convertible securities, the acquirer must make an appropriate offer or proposal to the holders of such convertibles, to ensure that their interests are safeguarded. The board of the offeror must obtain competent independent advice on the offer or proposal
- Rule 16 states where there is a ‘special deal’ for certain shareholders (management, for example), the Takeover Panel will require, as a condition to its consent to such a deal, that the independent adviser to the offeree publicly states that in its opinion the arrangements are fair and reasonable

- Under Appendix 1 on a 'whitewash' transaction where the procedure for making a mandatory offer under the Code is waived by target shareholders, the relevant circular must contain a statement from a competent independent adviser regarding the transaction, the controlling position that it will create and the effect it will have on shareholders generally.

In all the above scenarios, the independence of the financial adviser will be rigorously assessed by the Takeover Panel. The onus will be on the adviser to establish that it meets the Panel's criteria.

Listing Rules

Where a listed company enters into a transaction with a 'related party', as defined in Chapter 11 of the UK Listing Rules, a statement must be made in the shareholder circular that the transaction is fair and reasonable so far as the shareholders of the company are concerned, and that the directors have been so advised by an independent adviser acceptable to the Financial Services Authority.

In the case of a related-party transaction that involves the acquisition or disposal of an asset where any percentage ratio is 25 per cent or more, and for which appropriate financial information is not available, an independent valuation must be prepared. Typically, an independent adviser will undertake the required work, present its conclusions to the board and put its name to the relevant disclosure in the shareholder circular.

Voluntary circumstances

A client may request an independent bank to give a fairness opinion on a voluntary basis. In these circumstances, the bank will undertake detailed valuation work and analysis and provide the client with its conclusions — usually in the form of a relatively short-form letter that sets out the principal decisions made regarding the data, methodologies and analyses, including any qualifications or assumptions made.

Examples of where a voluntary fairness opinion from an independent bank may be sought include the following scenarios involving actual or potential conflicts of interest:

- the chief executive wants to bid for the company
- the controlling shareholder wants to take a company private (delist)
- a private equity firm wants to take a company private and offer roles to management
- a significant shareholder wishes the company to buy a private company that the shareholder owns
- a parent company wishes to demerge a public company subsidiary, after paying a special dividend to the parent
- an acquirer wants to offer different consideration to different constituencies (not permitted under the Takeover Code in the UK but may apply to private companies or in different jurisdictions)
- situation-specific conflicts — for example, where the government is a long-term owner or a reference/majority shareholder and is selling its stake or preparing to float.

Conclusion

As we have seen, conflicts of interest have been a major driver in the global trend towards using independent advisers. Senior executives and boards are demanding higher standards around conflict management, and at the same time the regulators and the market as a whole are turning the spotlight on the record of non-executives for impartiality and strong oversight.

Some companies feel they can make their own judgements, but more and more are choosing to appoint an independent adviser to help steer a course through the twists and turns of a transaction.

Real leadership

demands the leading expertise.

Call on the leading minds in remuneration.

In today's extremely complex environment, exercising leadership in the planning and oversight of executive remuneration requires following an expert guide. One with in-depth, comprehensive, up-to-the-minute knowledge. A reputation for straight talk. And a view of the world that lets you see several steps ahead.

As the leading independent executive compensation consultancy, Pearl Meyer & Partners and its London practice Patterson Associates are uniquely equipped to provide the senior-level attention and in-depth technical expertise boards need to navigate these challenging times. To see what the leading minds say about today's leading issues, call +44 (0) 203 384 6711.
www.pattersonassociates.co.uk

Pearl Meyer & Partners
Comprehensive Compensation®

www.pearlmeyer.com

PATTERSON ASSOCIATES

A PEARL MEYER & PARTNERS PRACTICE

©2012

20. Executive remuneration

Simon Patterson and Fiona Bravery, Patterson Associates LLP (a Pearl Meyer & Partners practice)

These are challenging times for remuneration committees, which have become a lightning rod for shareholder discontent over performance and governance. Directors are grappling with a range of public and privately funded reports, official reviews and regulatory initiatives on executive pay, amid the growing influence of proxy voting firms. Rather than just voting with their feet, shareholders now can potentially drive their investments with a voice in the design of compensation programmes via the 'say on pay' rules. At the same time, companies are under continual pressure to provide competitive executive pay packages to attract and retain the talent they need. All this in the face of an economic downturn.

As directors rethink how to reward their top executives, they must combat the generalisations and misconceptions that have grown up around this issue. The remuneration environment is likely to be in a state of flux for some time, evolving as the government and regulators reconsider the need for increased structure and regulation.

Current UK requirements for remuneration

Disclosure: Companies Act 2006, The Directors' Remuneration Report Regulations 2002

Quoted companies must disclose the remuneration of all executive directors in the board remuneration report contained within the annual report. This must be approved by the board of directors, and signed by a director or the company secretary, and the pay programmes put to a non-binding shareholder vote. (Note that this is subject to change following the announcement from Vince Cable, the Secretary of State for Business, Innovation and Skills, on pay reforms in June 2012.)

The remuneration report currently comprises two main sections:

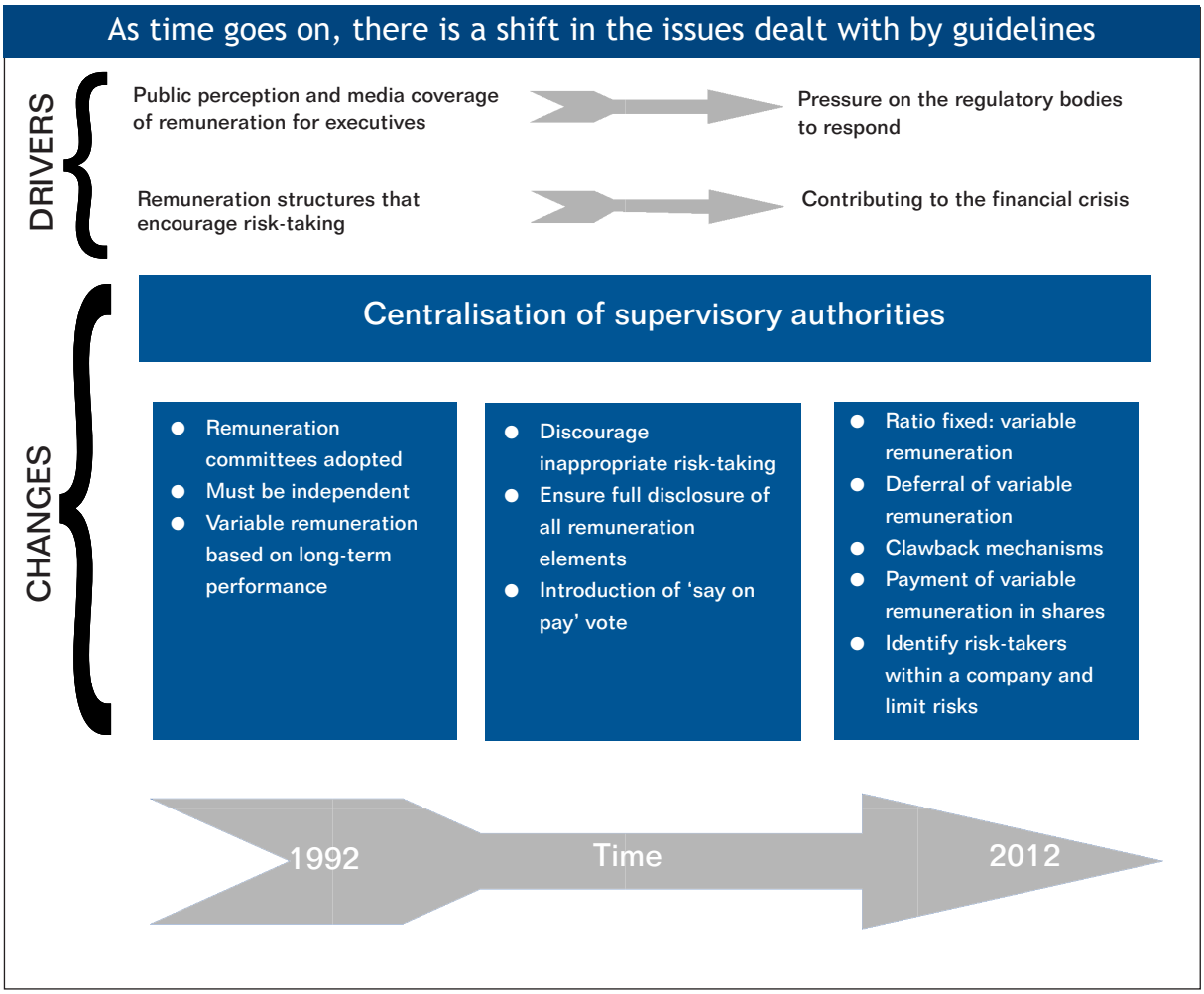
- The audited part, which states the salary, fees, benefits in kind, pension, long-term incentive schemes and any other share options and share awards paid out during the reporting year to each director
- The unaudited part, which includes the company's remuneration policy, performance conditions, a performance graph (comparing the company's total shareholder return over the past five years to a group of peers) and details of directors' contracts and termination periods/payments. It should include a clear explanation of the performance conditions chosen for long-term incentive (LTI) arrangements, and how the company will assess whether these performance conditions have been met.

The Companies Act 2006 also requires approval by shareholders of payments made to directors for loss of office.

Further codes of conduct

The regulation of executive remuneration and the disclosure requirements have continued to grow in the years since the Companies Act was passed. However, some observers believe that the bigger window now available into the details of high-level remuneration programmes has only served to drive up pay levels further, as executives whose pay is publicly benchmarked against their peers strive to be rewarded 'above median'.

Most recently, the financial crisis highlighted a serious global failure in risk management practices that prompted many countries to re-examine their regulatory structures. In the UK, the Turner review and Walker review, both in 2009, recommended action to ensure that performance-based



incentives do not encourage undue risk-taking. In January 2011 the Financial Services Authority (FSA) published a new version of its Remuneration Code to take into account changes required by the European Capital Requirements Directive.

The UK Corporate Governance Code

Published by the Financial Reporting Council (FRC), the UK Corporate Governance Code (the Code) replaced the Combined Code in 2010 and applies to all Premium Listings, whether UK incorporated or not. It requires that companies disclose how they apply, and whether they are in accordance with, the Code's principles — on a 'comply or explain' basis. A key focus of the Code is board accountability, including a shareholder vote to re-elect directors of FTSE 350 companies.

The Code also set out new standards for board leadership and effectiveness, remuneration, accountability, and shareholder relations. Developed in accordance with the European Commission and previous reviews, it requires a "formal and transparent procedure for developing policy on executive remuneration", led by a remuneration committee of two or three non-executive independent directors.

The remuneration committee has responsibility for setting the pay of all executive directors and the chairman, as well as the level and structure of rewards for senior management. To avoid any conflict of interest, a director cannot be involved in determining his or her own remuneration, although it is expected that the chair or chief executive will be consulted about the board's pay. Shareholders must be formally invited to approve all new LTI schemes, as defined in the Listing Rules, and any significant changes to existing schemes. Ideally, new LTIs should replace existing schemes to maintain the simplicity of the overall programme. The remuneration committee must also disclose its use of any internal or external consultants.

The Code recommends that remuneration be "sufficient to attract, retain and motivate directors of the quality required to run the company successfully" but that "a company should avoid paying more than is necessary for this purpose". A significant proportion of executive remuneration should be tied to corporate and individual performance designed to promote the company's long-term success. The Code also recommends that the remuneration committee:

- use caution when applying peer group comparisons to avoid an upward ratchet of pay with no corresponding improvement in performance
- be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases
- avoid the use of share options or other performance-related elements in non-executive remuneration programmes
- limit director notice or contract periods to one year or less
- subject incentive payouts to challenging performance criteria, including non-financial measures, that reflect the company's strategy and are adjusted to reflect current or future risks
- institute clawback provisions to permit the company to reclaim incentive payouts in exceptional circumstances of mis-statement or misconduct.

Following the government's announcements for significant pay reforms in June 2012, the FRC has announced that it will consult on potential changes to the Code.

Additional rules for banks and financial services companies

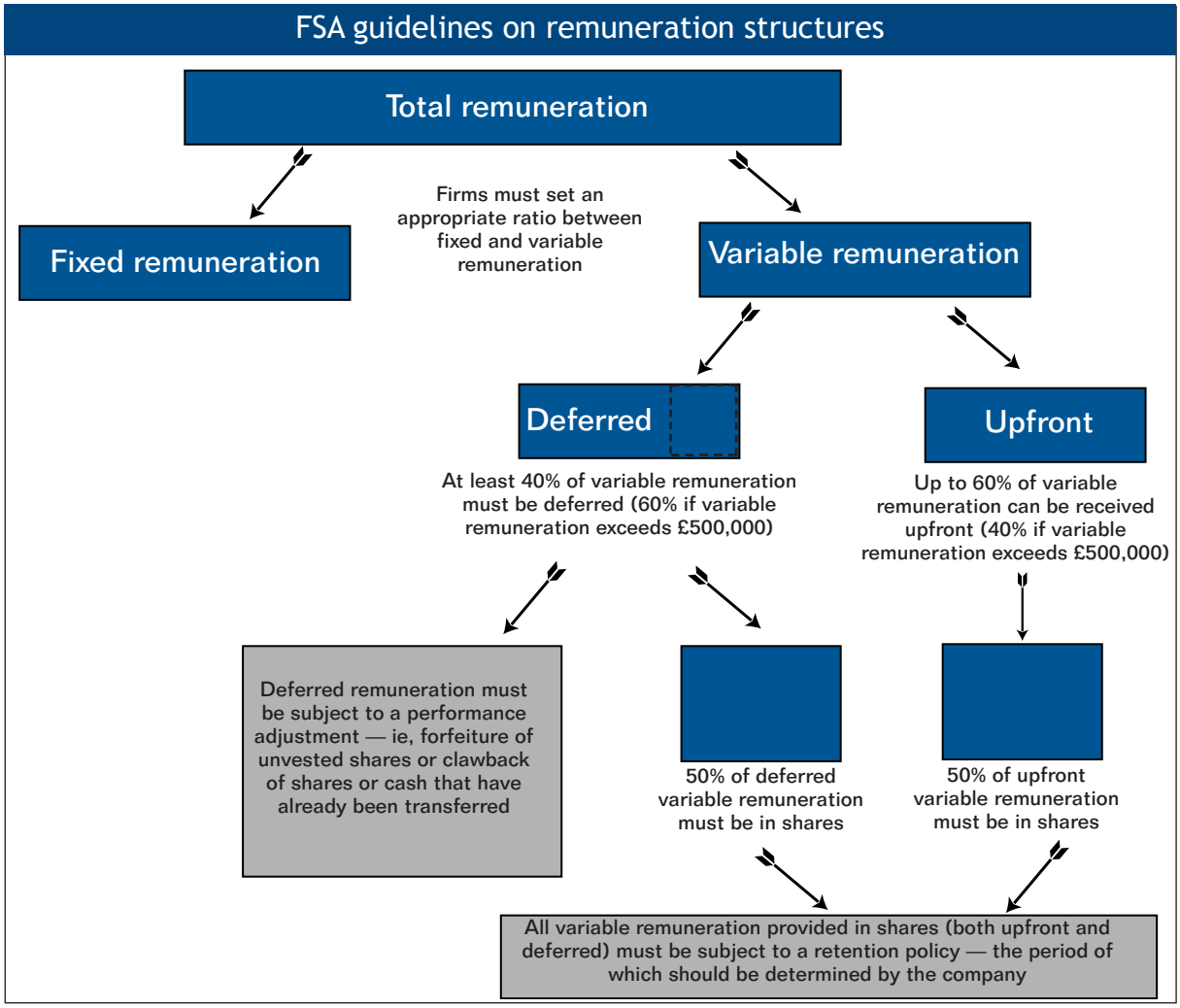
The Walker review recommended substantial changes to board governance at banks and large financial institutions, including expanded disclosure of remuneration, deferral of bonuses to high-paid executives and a requirement that the chairman of the remuneration committee stand for re-election if a committee report receives less than 75 per cent approval by shareholders.

The updated FSA Remuneration Code (see the diagram on the next page) calls for setting an appropriate ratio between fixed and variable remuneration; deferring a significant (40 to 60 per cent) portion of the bonus; and providing 50 per cent of variable remuneration in shares. The Remuneration Code also introduced a tiered system of compliance that enables firms to better align remuneration policies with their size, nature and risk.

Most recently, Project Merlin — the agreement between the British government and the country's biggest banks to boost lending and make pay more transparent — required that from 2012, in addition to the standard remuneration report, banks must disclose the remuneration of their eight highest-paid senior executive officers.

Shareholder accountability: 'say on pay'

Under the Code, the board chair is responsible for ensuring that the company's principal shareholders are kept fully informed about any current and



anticipated remuneration issues. More specifically, Section 439 of the Companies Act 2006 provides that UK-listed companies must give shareholders a non-binding 'say on pay' advisory vote on executive remuneration. While intended to provide boards with a sense of shareholder support for remuneration practices, a negative vote does not prevent the board from accepting the remuneration report.

Over time, the nature of the issues voted against has progressively changed. Early on, complete disclosure used to be an issue, but improving compliance and best practice standards in the UK have meant that this is now the norm. Generally, negative shareholder votes have tended to reflect objections to one-off executive awards and severance payments.

Shareholders have typically approved programmes when pay is clearly shown to be tied to performance. Recently, however, there has been an increase in negative votes, including some of greater than 30 per cent, where shareholders are not satisfied with remuneration levels in light of the level of performance. For example, in 2012

there were protests over pay awarded despite poor performance at the global advertising agency WPP, where 60 per cent of investors voted against the remuneration report, and at insurer Aviva, where 54 per cent voted against. Shortly after the vote, Aviva's chief executive resigned. Similarly, the chief executives at Trinity Mirror and AstraZeneca resigned shortly before their annual general meetings because shareholder revolts were anticipated, though they did not materialise.

The future for executive remuneration

In November 2011, a report from the High Pay Commission (HPC) recommended that companies go 'back to basics' on executive pay programmes. The report focused on the rise in executive rewards since the mid 1970s in comparison with the general workforce. It recommended a 12-point plan focused on "accountability, transparency and fairness", with a pay structure consisting simply of a base salary and — only if performance standards tied to long-term targets and company strategy are met — one discretionary performance-related award. While the aim for simplicity is commendable, we believe that there is a place for properly structured long-term incentive plans.

Government proposals on executive remuneration

The conclusions of these various reports, combined with growing unrest among stakeholders, led the Department for Business, Innovation and Skills (BIS) to consult on executive pay and shareholder voting rights. The results of the consultations were published in January and March 2012 and addressed the issues of pay on four fronts: greater transparency in directors' remuneration reports, increased shareholder power, diversity of boards and remuneration committees, and best practice on pay-setting.

Further to this, the Business Secretary announced on January 23, 2012 that secondary legislation would be introduced on these issues, applicable to financial years from October 2013. It is unclear to what extent such legislation would apply to smaller quoted companies on markets like AIM.

On May 23, 2012, the BIS published the Enterprise and Regulatory Reform Bill 2012-2013, with Section 57 of the Bill proposing the deletion of Section 439(5) of the Companies Act 2006. This would remove the statutory provision that prevents a person's entitlement to remuneration being conditional on the shareholders' approval of a quoted company's remuneration report, paving the way for introduction of a binding shareholder vote on executive remuneration.

The government reforms are intended to realign pay and performance, encourage better communication between companies and shareholders, and empower shareholders to hold companies to account. The proposed legislation separates directors' pay into two distinct sections, one looking at proposed pay policy and the other at how pay policy has been implemented.

Shareholder power — a binding vote on future pay policy

A company's proposed pay policy would, under the legislation, be subject to a binding vote that would take place annually unless companies choose to leave their pay policy unchanged — in which case the vote would be held at least every three years and require a simple majority. The reforms have defined how the proposed pay policy should be presented. The current policy requirements include:

- a table setting out the key elements of pay and supporting information, including how each supports the achievement of the company's strategy, the maximum potential value and performance metrics
- information on employment contracts
- scenarios for what directors will get paid for performance that is above, on or below target

- information on the percentage change in profit, dividends and the overall spend on executive director pay
- the principles on which exit payments will be made, including how they will be calculated; whether the company will distinguish between types of leaver or the circumstances of exit; and how performance will be taken into account
- material factors that have been taken into account when setting the pay policy, specifically employee pay and shareholder views.

Payments may only be made within the scope of the policy. If the policy is not approved by shareholders, companies will need to revert to their existing policy.

Transparency — clearer reporting and an advisory vote on implementation of pay policy
In addition to the binding vote on pay policy, companies will continue to have an annual advisory (ie, non-binding) vote on how pay policy was implemented in the previous year, including actual sums paid to executive directors. This vote will require the support of a majority of shareholders to pass. Reporting for this advisory vote will require the following information:

- a single total figure of compensation for each executive director; this number is intended to be comprehensive and cover all types of rewards received by executive directors in the previous year, including fixed and variable compensation, and pension; it is also intended to reflect actual pay earned rather than potential pay awarded, including full bonuses awarded for the reporting period and long-term incentives where the reporting year is the last financial year of the performance cycle
- details of performance against metrics for long-term incentives
- total pension entitlements (for defined benefit plans)
- exit payments actually made in the year
- details on variable pay awarded in the year
- total shareholdings of executive directors
- a chart comparing company performance and chief executive pay
- information about who has advised the remuneration committee
- shareholder reaction in terms of the prior year's advisory vote.

If a company's advisory vote does not pass, the company will be required to hold a binding shareholder vote on its overall pay policy the following year. Companies will be required to make a public statement if a significant minority of shareholders vote against a pay resolution.

While some companies already include some of this information in their remuneration reports, the regulations require more succinct explanations and demand consistency across reports.

Diversity
Drawing from a more diverse talent pool for directors, including the recruitment of professionals, public servants, academics and lawyers, is intended to change entrenched attitudes to executive remuneration. Boards would be advised to have at least two members who have not previously served as directors.

Best practice
To mitigate 'payment for failure', the requirement for clawback provisions set out in the FSA's Remuneration Code for financial institutions would be extended to all UK-quoted companies under the Code. The legislation will address potential conflicts of interest in the use of remuneration consultants, including how they are hired and paid. Additionally, a new 'High Pay Centre' is to be established to publish research on executive pay levels in the UK and to engage

with policymakers and companies about reforming current practices.

Paying for performance

"Pay for performance has added to the staggering complexity of executive packages and yet there is no clear evidence that it works. Boards need to think again about how to structure their pay awards."

Has anything changed since this statement by the High Pay Commission in September 2011?

Despite the High Pay Commission's proposal to strip executive pay down to a basic salary and discretionary bonus, pay that is tied to performance remains a key business tool as well as a driving force in 'say on pay' votes. Caution should be exercised in the use of discretionary bonuses, which are sometimes provided to executives when the LTI scheme is underwater and not going to pay out. Moreover, well-designed long-term incentive programmes are more likely to correlate with better shareholder value.

While there are many perspectives on how to achieve meaningful pay-performance alignment, some general principles apply:

Base performance incentives on strategic goals
Some performance-based executive remuneration schemes have justifiably been criticised for providing large rewards for less than stellar company performance. The solution is for companies to establish clear strategic priorities on which to build more robust and transparent pay programmes. These should contain genuinely challenging performance targets that directly support those business needs and, if met, deliver an appropriate level of rewards.

Ensure that different incentive plans work together
Too often, the components of annual and long-term incentive plans are independently designed and evaluated, without consideration of their effect on each other. Instead, companies should aim to balance their use of short- and long-term incentive schemes so that they act together to drive executives to deliver the company's business strategy.

Use the right performance measures
Similarly, short- and long-term incentives should be selected and developed in tandem, ideally incorporating targets for both profitable growth and investment returns. Measurements of changes in shareholder value should consider internal metrics that truly reflect the key success factors for the company.

Model different performance scenarios
Although many companies calculate how incentives will pay out if goals are achieved in terms of targets and budgets, pay is so highly leveraged in some programmes that even a small change in performance can produce drastically different outcomes. Remuneration committees should be aware in advance exactly how each incentive scheme would pay out under the full range of performance scenarios, from positive to negative.

This is set to be an increasingly important issue because disclosure of such scenarios would be required in the remuneration report under the government's pending proposals.

Understand your pay positioning in the market
Shareholders are particularly well attuned to the 'going rate for the job', and the selection of peer companies against which to benchmark executive pay can dramatically affect remuneration levels. Typically, company size and industry are the main factors governing pay opportunities, but including a more diverse range of peers — such as companies with a similar business cycle or product maturity — could add valuable perspective.

As investors evaluate pay for performance more closely, companies should be wary of rewarding executives with 'above median' packages for average performance.

Keep it simple

Trust is needed to engage executives and make incentives meaningful. While it might seem wise to develop a pay scheme that covers every contingency and permutation, at a certain point complexity becomes counter-productive. Ultimately, a remuneration programme's success requires that its workings be transparent and clearly understood by both executives and shareholders. When executives are given a clear 'line of sight' between their performance and their pay outcomes, companies can avoid the all-too-common pitfall in which an incentive programme is discounted by participants as 'never going to pay out'.

Conclusion

At its most elemental level, an effective incentive compensation programme should be designed to motivate executives to achieve the goals deemed most important to the organisation's success. It is one of the remuneration committee's most important responsibilities to identify precisely what kind of performance executives should be paid for and what level of execution to target.

If the committee is doing its job well, it will have assessed the mood of investors and guided the development of an incentive compensation programme that is aligned with their expectations. Done well, remuneration is a very powerful force for building corporate value.

Bringing clarity at the intersection of science, business and policy

- Climate Change & Energy Management
- Contaminated Land Assessment & Remediation
- Ecological Services
- Energy & Carbon Management
- Environmental Compliance
- Environmental Due Diligence
- Environmental Planning & EIA
- Health & Safety Services
- Product Safety & Regulatory Compliance
- Sustainability Services
- Waste Management
- Water & Wastewater Management

ENVIRON
environcorp.com

21. Sustainability governance: taking corporate social responsibility on board

Lisa Nelowet Grice, ENVIRON International Corporation

Concerns over the connections between economic development and social, community and environmental issues have been voiced by various entities for centuries. The concept of concretely linking these elements as 'sustainability' was placed on the global agenda in 1987 when the United Nations' World Commission on Environment and Development, headed by Gro Harlem Brundtland, famously declared: "Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs."

The Commission went on to catalogue how social issues were intertwined with natural resource limits and economic growth. Attention began to focus on the role played by corporations in taking account of the needs of all their stakeholders and promoting responsible development. This was no longer an optional extra; the environmental, social and economic effects of growth had to take their place in the mainstream of strategy.

Companies are driven to take sustainability on board by a wide array of business imperatives.

Once a company has clearly articulated its drivers for incorporating sustainability governance into its overarching business strategy, the challenge lies in plotting the course towards achieving those sustainability-driven objectives.

Identifying drivers

Drivers for companies to adopt sustainability as a key governance practice range broadly. For one company, the driver may be customer demand, for another it may be securing goodwill in the communities in which it operates. For another, regulatory positioning may be the paramount objective. Fundamentally, companies that successfully leverage the governance advantage of sustainability are those that, as in any business undertaking, have accurately identified their specific drivers and subsequent responses. Drivers can be aggregated into the following categories:

- cost competitiveness
- regulatory positioning
- market acceptance
- stewardship.

Drivers for sustainability as a component of corporate governance

Cost competitiveness	**Regulatory positioning**	**Market acceptance**	**Stewardship**
Managing resource availability	Informing policy developments	Customer demands	Environmental stewardship
Reducing operating costs	Planning for changing regulations	Strengthening the brand	Community stewardship
New sources of revenue	Benefiting from incentives	Consumer expectations	Supply chain EH&S responsibility
Employee relations	Responding to disclosure requirements	Supply chain EH&S risk	Product stewardship
Maintaining business continuity	Building community acceptance	Investor expectations	Worker health and wellness

Cost competitiveness

Most companies with nascent sustainability programmes recognise the near-term opportunity of reducing operating costs through improved energy efficiency and waste reduction (bringing down disposal costs and avoiding wasted raw material costs), but the opportunity also exists for long-term cost containment. By driving a company to consider the environmental and social impacts of the resources it consumes (either directly or through its supply chain), sustainability thinking enables it to identify risks to resource availability far in advance of less prescient competitors.

For example, a company whose product relies on substantial water use in the supply chain may complete a water risk assessment as a prudent exercise in sustainability governance. Should that company discover that an important supplier is located in a region where water is scarce, it may choose to head off the availability risk by changing suppliers or at least ensuring it could turn to alternative sources. Thus sourcing strategies and sustainability go hand in hand.

In 2008, Walmart reflected on the resource availability aspects of sustainability in its decision to expand its offerings of seafood certified by the Marine Stewardship Council. Trevyr Lester, a planner in the supermarket's seafood department, stated: "If we don't manage our fisheries to a responsible level, we won't have fisheries to buy from."

Integrating sustainability into supply chain planning not only serves to maintain resources but also business continuity on a grander scale. Take the potential impact of severe weather events, induced by climate change, on suppliers in increasingly vulnerable locations or on logistics. Cost competitiveness drives other sustainability practices as well, in some cases generating new sources of income such as recycling revenues as part of a waste management initiative, or carbon credits from greenhouse gas (GHG) management.

Staff recruitment and retention present significant cost-containment opportunities: reducing turnover and increasing the ability of the company to attract quality employees inevitably reduces costs. Increasingly, studies show that employees, particularly the next generation, are looking for companies with a commitment to sustainability.

Regulatory positioning

Regulatory positioning serves up a suite of issues that drive sustainability performance in companies. As policymakers at the local, regional, national and global levels ponder and proceed with governmental action on wide range of sustainability issues affecting products, operations and the supply chain, companies can proactively demonstrate solutions to these challenges and perhaps even influence policy decisions.

In 2011, for example, Home Depot, the global home improvement retailer, hosted over 20 in-store meetings with members of the US Congress to show them first-hand consumers' choices and preferences on energy-saving products and guide them to supporting energy-efficiency policies.

Garnering actual experience in advance of regulation also enables companies to respond more effectively once rules are in place. In the US, for example, companies that joined the Environmental Protection Agency's voluntary Climate Leaders programme learned how to identify, quantify and reduce GHG emissions in advance of the EPA's Mandatory Reporting of Greenhouse Gases Rule. Regulatory incentives, such as rebates to encourage adoption of renewable energy or of energy-efficient technologies, serve as additional drivers.

Further drivers of regulatory positioning focus on external communications and community engagement. Mandatory disclosure requirements are accelerating, with government guidance seeking transparent communications to

shareholders on sustainability issues as far-ranging as GHG management and 'conflict minerals' in the supply chain. External communications affect a company's image, not only with investors but with other stakeholders. Communities affected by the operations of corporates are increasingly concerned that those companies demonstrate strong corporate sustainability governance. Meanwhile, companies have long recognised the value of strong community relationships so that, for example, they can build a committed workforce and minimise local opposition to the granting of operating permits.

Market acceptance

In 2009, Walmart asked suppliers to provide information on their sustainability performance. The multinational retailer is not alone. Companies as varied as Sun Chemical, a world leader in printing inks, and Johnson & Johnson are asking their suppliers for information on sustainability performance ranging as widely as carbon-reduction goals to sustainable procurement practices. These customer demands for information are implicitly or explicitly tied to potential buying decisions, driving both brand-prominent and own-label (private-label) companies to consider the content of their responses. That need is particularly strong among branded companies, which have the added incentive of protecting and enhancing their label in the market, with the result that sustainability actions and communications may be ratcheted up to keep up with, or ahead of, competitors.

Of course, at the end of the day the consumer is king, and market research indicates a variety of consumers who prefer to purchase more sustainable products. The Natural Marketing Institute, a US consultancy specialising in health and sustainability, divides the consumer population into five segments based on sustainability purchasing preferences, with only one of these segments being the 'unconcerned'. Certainly there is a segment that will make purchases based loosely on the idea that it's the right thing to do. But there are other segments that will buy more sustainable products for varied reasons such as perceived personal health benefits (organic food, for example), perceived personal economic benefits (compact fluorescent light bulbs, say), or following a popular trend (for example, buying 'locally sourced' produce one year and 'fair trade' the next).

Market acceptance and avoidance materialise in other drivers too. Poor performance in the supply chain on the environment and health and safety (EH&S), for example, risks a consumer backlash. Consider Apple's recent challenges in China where its key supplier Foxconn, which assembles devices such as the iPad and iPhone, has been accused of mistreating workers in its factories — allegations that led to calls in the US in January 2012 for a boycott of Apple products. The technology giant has historically conducted 'code of conduct' audits of its suppliers, completing 229 such audits in 2011 alone. But responding to these increased concerns from the market, it opened its supply chain to an auditing team from the Fair Labor Association (FLA) in February 2012. The FLA, a collaborative effort between socially responsible organisations around the world, carried out what it called a 'full-body scan' at Foxconn and delivered a scathing report on health and safety breaches. Three months later, Apple agreed a deal with the Chinese supplier to share the costs of upgrading working conditions in its factories.

And as the Carbon Disclosure Project (CDP) has demonstrated in spades, investors are clearly a force behind sustainability governance. The CDP is a not-for-profit organisation that works with investors and businesses to disclose and manage environmental information. In 2003, the CDP launched its first questionnaire on carbon performance, requesting information on emissions and energy use and pointing out the relevance of such data to share prices in order to establish its

credibility. Now in its 10th year, the CDP works with 655 investment institutions with US$78 trillion in assets under management, and secures detailed responses from over 3,000 companies in 60 countries around the world.

Meanwhile, shareholders are increasingly demanding sustainability performance information through the filing of resolutions. In 2011 alone, the Investor Network on Climate Risk, a grouping of more than 100, mainly US, investors managing nearly US$10 trillion in assets, recorded 102 sustainability-related shareholder resolutions. These demanded actions as wide-ranging as avoiding the use of palm oil from endangered forests, to detailing the environmental impact of supply chains, to providing comprehensive sustainability reporting. More than half of those resolutions that were subject to shareholder votes received approval levels of 25 per cent or more.

Stewardship

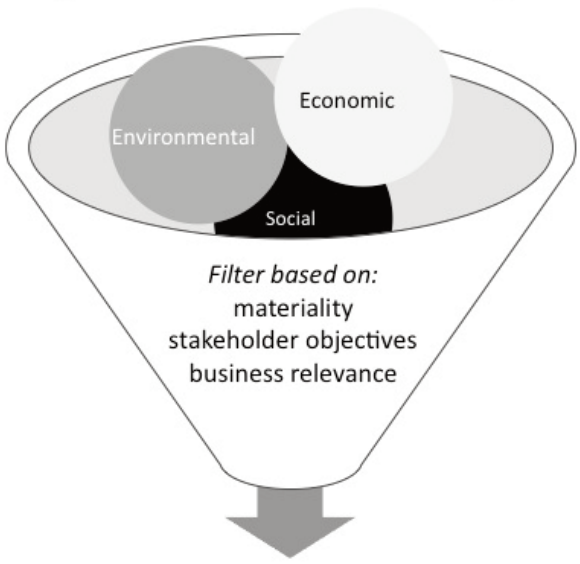
For many companies, and individuals within companies, taking full responsibility for one's actions is a fundamental driver for sustainability practice. Stewardship represents integrity, a focus on 'doing the right thing', and it goes beyond mere compliance. It is applied to protection of employees, the environment, and the communities affected by company operations, products and supply chains.

As market trends and government policies evolve, a focus on committed stewardship can provide companies with the long-term vision to stay ahead of risks and efficiently identify and leverage opportunities.

Incorporating sustainability governance as a commercial practice

Once a company has identified its key drivers for taking sustainability on board, the next step is to define those core economic, environmental and social issues that are most meaningful to itself and its stakeholders. The diagram above illustrates how companies can take a long list of potential issues in each of the three areas and then filter them to arrive at a set of focal points that are most relevant. For instance, a shortlist of environmental issues may include water stewardship, air emissions, biodiversity or carbon management. Social factors may include labour rights, respect for cultural heritage, worker safety, wellness, or diversity. Economic factors may be value created, local sourcing or staffing, or public benefits. Once issues are identified, they are further refined to focus on strategies pertinent to the company's operations, its supply chain and its products.

Focusing the sustainability imperative



Key Sustainability Focus Areas for Company:
Operations, Products, Supply Chain

Engaging stakeholders

As discussed above, an effective sustainability programme requires optimal stakeholder engagement, with 'optimal' in this case meaning the identification of stakeholders who are fundamental to business health and success. Such

stakeholders probably include employees, investors, customers, consumers, regulators, environmental or social advocacy groups, suppliers, insurers, lenders, and the communities in which a company operates and the communities affected by the company's supply chain or products.

Once the stakeholder groups are identified, companies gauge the influence of each one, map out the issues pertinent to them, and then establish sustainability performance and communication objectives for each group.

Collaboratively engaging stakeholders in decision-making processes improves implementation in those areas the stakeholder influences and creates more sustainable solutions for both the company and stakeholders. For example, when the National Geographic Society (NGS) designed 'Real Pirates', its US exhibition charting the history of Atlantic piracy and its origins in the slave trade, the society recognised the importance of talking to stakeholders to fully address the socio-cultural aspect of the programme. The original project proponents had been criticised for potentially trivialising the slavery aspect of piracy's past. However, by proactively engaging academic experts and social advocacy stakeholders in the exhibit design process, the NGS not only created a successful show from a commercial perspective, it maintained the trust of these key stakeholder communities and protected its brand reputation as a source of credible and holistic content.

Plotting the course

Plotting the course towards achieving sustainability-driven objectives involves following tried and tested management practices: establish overarching and specific objectives, assign responsibilities and processes for achieving them, then monitor progress and implement corrective actions as required.

For example, the global chemicals company Sigma-Aldrich identified green chemistry as a key aspect of its sustainability programme, having considered stakeholder concerns, materiality and business relevance. It then set out the concrete goal of increasing sales of greener chemicals from a 2010 baseline of US$54 million to a 2015 target of US$67.5 million. To support that target, it has been providing customers with clear insight into why a product is considered green and detailed information backing its reasoning, informed by the American Chemical Society's '12 Principles of Green Chemistry'.

Notably, the Sigma-Aldrich target incorporates business value. Establishing targets that collaterally achieve business value ensures that the commercial imperative for sustainability is satisfied. A target for carbon reduction, for example, may not inspire all parties within an organisation to contribute. But a target of energy cost savings may do.

Plotting the course also involves establishing a communications plan to ensure that tactical achievements are consistent with the overall goal and are clearly communicated to stakeholder groups. If the objective of a water-reduction target, say, is to ensure both the continued availability of the resource and the local community's support for a company's use of it, then a communication plan that inspires the community with the company's stewardship accomplishments is vital.

Gauging success and continual improvement

A well-designed and implemented sustainability programme delivers clear business value. That value may be demonstrated by supportive stakeholders, improved employee recruitment and retention, revenue growth, bottom-line improvements, brand enhancement, or accommodating regulatory positions.

For example, Sun Chemical tracked the progress of its energy efficiency programme and calculated that it had reduced electrical and thermal energy (and associated costs) by 53 per cent, thereby reducing the carbon footprint by 30 per cent from 2005 to 2012, while delivering equal sales revenues over the same period. Those savings met the overarching objectives of making Sun Chemical's processes leaner and greener, using less and getting more as per the company's sustainability motto.

Gauging success requires a clear identification of measurable objectives, and the crafting of a mechanism for tracking progress, evaluating deviations and redirecting performance where required. Measurable objectives include concern with the inherent business value of performance, as discussed above, and may be as simple as tracking cost reductions or sales increases. Alternatively, more involved investigations may be required, such as employee or consumer surveys, tracking reductions in water resource vulnerability, or cataloguing changes in supply chain audit results.

Taking corporate responsibility on board

Sustainability governance, like any corporate governance approach, creates a system of accountability for how a company is managed, focusing on the economic, environmental and social performance related to the company's operations, products and supply chain. Fundamental to a company's ability to achieve its sustainability objectives is imbuing every level of the corporate hierarchy with a sense of ownership so that all individuals in all departments — from marketing to manufacturing, from procurement to sales — recognise their ability to contribute and make the programme successful.

Expanded ownership becomes culture. And just as with any governance initiative, when objectives are embedded in the corporate culture, the best value can be realised.

“For more than 80 years, our business has been the success of your business. Our leadership is inspired, our insight is powerful, and our delivery is bold. Around the clock and around the world, we execute strategies that deliver concrete business results. **It’s wisdom at work**.”

Jack L. Martin
Global Chairman and CEO

We understand the power of people. We know how, when and where to strategically engage the public in conversations that achieve results for our clients. That’s what our people do best. Scan the QR code and hear why Hill+Knowlton Strategies is making such a buzz.

HILL+KNOWLTON
STRATEGIES

hkstrategies.com

22. The relationship between directors and shareholders: financial communications and investor relations

Claire Koeneman and Robert Ludke, Hill+Knowlton Strategies

In today's world of dynamic capital markets and fast-paced media, effective financial communications and investor relations play key roles in forging an understanding between a public company's directors and its shareholders. In order to succeed over the long term, forward-looking companies should put in place a strategic plan that addresses the following:

- establishing sound corporate governance programmes
- working with trusted communications partners
- communicating to manage corporate reputations
- integrating business, financial and non-financial reporting
- keeping stakeholders informed and engaged.

Establishing sound corporate governance programmes

The quality of corporate governance is an important driver of shareholder value, and public companies that score highly in this area generally outperform their peers. A thorough governance framework should provide strategic direction for the company, and ensure the effective monitoring of management by the board of directors and the accountability of management and directors to shareholders.

Best practices for boards generally include establishing major policies and goals for the organisation, which should involve oversight and guidance of the company's strategic plan, annual business plan and budget. Leadership planning — including selection, evaluation and compensation of the top executives — should be taken into account, as should chief executive succession planning. A solid corporate governance programme will also monitor the effectiveness of management decisions, evaluate the company's quarterly, annual and long-term performance, and include long-range planning.

Public companies should also consider additional steps to ensure that their boards function at a high level. One of these steps may be to recruit directors with expertise in a variety of areas, with a majority being independent but still committed to the company's strategy and culture. In addition, it is important to establish proper board leadership — for example, by designating a lead director — as well as to maintain the board at a manageable size. Good corporate governance requires frequent board meetings of half-day or all-day duration, with an agenda and background materials supplied well in advance. Independent directors should be encouraged to meet privately — in other words, without the chief executive or senior management being present — during appropriate portions of board meetings.

Working with trusted communications partners

In order to achieve long-term success, public companies must give their communications advisers a seat at the table, integrating them into the team along with advisers from the legal, accounting, management consulting and investment banking fields. Experienced communications professionals provide value to a company by ensuring that messages and strategies for financial communications, investor relations and media relations are aligned, giving the company one voice.

Financial communications and investor relations

A high-performing financial communications team helps a company enhance shareholder value by effectively managing its relationships with the investment community and the financial media. This includes providing consistent, accurate information and appropriate access to company management in order to build relationships with the media that influence opinion in the City of London, on Wall Street and in other financial communities.

These efforts can bring bottom-line as well as reputational benefits: "Fundamentally, the remit of investor relations is not only to create an awareness and understanding of your company amongst the investment community … Entering into a dialogue and developing relationships with the investment community over time so that its participants become cognisant with the company and its investment proposition is generally seen as a worthwhile exercise when trying to achieve efficient, cost-effective access to capital." ('Investor Relations: A Practical Guide', London Stock Exchange, March 2010)

A financial communications team will provide support for all of the key elements of an investor relations programme — including message development, issues management and materials development (for example, annual reports and earnings announcements) — and can also lead studies of investor perceptions to establish a benchmark and identify key issues and influence attitudes. Additional tactics include outreach to sell-side and industry analysts, institutional targeting of 'buy and hold' investors, and co-ordination of key investor conferences.

External financial communications professionals should also work closely with senior management and the company's in-house investor relations (IR) team when organising and preparing for IR events such as earnings announcements, investor days and shareholder meetings. In addition, these external professionals should help ensure that the messages delivered to investors are clear, concise and compelling, while providing seasoned execution support in the following ways:

- contacting investors, analysts and the media on behalf of a company
- co-ordinating conference calls, webcasts and investor meetings
- developing the press release, presentation, conference call script, Q&A document and other materials for financial announcements
- carrying out a dry run with company spokespeople to ensure they are comfortable with the script and Q&A
- following up on the event to handle any resulting investor or media inquiries
- providing feedback to the chief executive and senior management.

Media relations

Whether a company is seeking to enhance or preserve its reputation, increase market share, respond to competitors, shape public policy or manage a crisis, local and national news media are critical channels through which to engage key stakeholders and affirm or change public perceptions and behaviour. At the heart of effective media relations are five principles:

- a concise, compelling and relevant message
- the right people delivering the message
- strict adherence to the message
- respect for the media's role
- a deep understanding of how the media actually works.

External communications experts can help a company with its message development and media relations, often serving as the de facto news bureau for client companies and providing a first point of contact for media inquiries. The team will

identify the relevant company spokespeople, co-ordinate strategy with them, build relationships, develop talking points, and ensure timely media follow-up of messages and announcements.

Integrating PR and investor relations

If public companies are increasingly focused on corporate reputation and public trust, that is partly because social media and digital PR are increasingly influencing how the public perceives them. As a recent PwC report noted, the significance of this trend is appreciated all the way up to the top of the corporate hierarchy: "The social media phenomenon has made the leap from the consumer world to the boardroom. Directors are faced with sorting out how social media impacts the firms that they oversee and their own roles on Boards."
('Social media — The new business reality for board directors', PwC, 2012)

As a result of the free and very public airing of opinions, detrimental as well as favourable, companies now need to speak to more people more of the time. And that means integrating corporate and financial communications so that messages take into consideration all key stakeholders:

- shareholders and other investors
- board members
- employees
- business partners
- customers
- regulators and political leaders
- the media.

Communicating to manage corporate reputations

The greatest fear among many companies is reporting bad news. This worry often spreads, infecting communications professionals, senior management and members of the board of directors. While we do not want to minimise the risk that is sometimes posed by full and open disclosure, our perspective is somewhat different.

The vast majority of people view the process of financial and non-financial reporting as a journey. As long as they are brought along on the journey in a transparent and genuine manner (and given the opportunity to provide input), they usually accept temporary setbacks and missed opportunities. Companies seen as leaders in stakeholder relations — such as General Electric, Marks & Spencer, Aviva Investors and Philips Electronics — work with their audiences in an effort to be more sustainable and transparent in their public disclosures.

Establishing an open dialogue with the public is, in fact, one of the most effective approaches a company can take in improving governance and risk management. Rather than being surprised by the demands of their audience, companies employing a disclosure process that includes measures such as materiality assessments (discussed towards the end of this chapter), an ongoing dialogue and regular reporting will allow the companies to know what is expected of them and what steps must be achieved to meet those expectations. By failing to engage the public regularly, it is likely a company will never learn of reputational risks until the damage is done. Rather, such a company is perpetually doomed to find itself reacting to risk.

Companies must also view reporting on financial and non-financial performance as a process, not a product. An integrated process — one that addresses the concerns of all stakeholders by placing a company's strategy and performance in a social, environmental and economic context — will lead to the production of a report whose "predominant value lies in the preparation: the selection of metrics, the scrutiny and analysis of the business impacts and risks, the resultant insights, and the

subsequent adjustments to operations and even strategy. Additionally, a properly designed set of performance measures reported on as part of regular financial management gives the incentive and ability to improve performance." ('Integrated Reporting: A better view?', Deloitte, 2011)

Beyond risk management, there is a growing body of evidence to show that making and communicating efforts to become a more sustainable company generates a higher rate of return for investors. In May 2012, professors Robert Eccles and George Serafeim of Harvard Business School and Ioannis Ioannou of the London Business School published a working paper entitled 'The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance'.

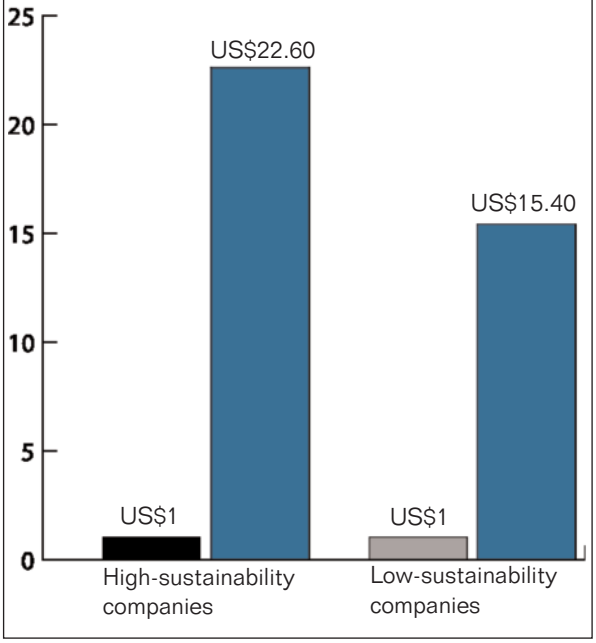
The authors looked at 180 companies, evenly divided between 'high sustainability' and 'low sustainability', and compared the rate of return for investors. They found that a portfolio of firms in the first group — organisations with a long and consistent track record of making and disclosing efforts to operate with economic, social and governance policies in mind — would have far outperformed a portfolio of firms following more traditional corporate policies (see chart).

Stephen Dubner, the journalist and author famed for co-writing the book 'Freakonomics: A Rogue Economist Explores the Hidden Side of Everything', was quoted on his reaction to the study: "It may be that being a good corporate citizen is good for business in the long run — or it may be that the kind of company that's more likely to be a good citizen in the first place is also more likely to be a profitable company. Whichever direction the arrow was pointing, however, which we don't really know yet, it does look like at least one truism in the business world is actually true, which is that you really can do well by doing good."

Sustainable performance delivers a high return on investment

When the rate of return on investment in 90 so-called 'high sustainability' companies was matched to the rate of return for their 90 'low sustainability' peers, 'The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance' found that:

- Investing US$1 at the beginning of 1993 in a portfolio of firms with a focus on sustainable operations would have grown to US$22.60 by the end of 2010
- Investing US$1 at the beginning of 1993 in a portfolio of traditional firms that paid little attention to long-term sustainability would have grown to US$15.40 by the end of 2010.



(American Public Media, Marketplace, April 18, 2012)

We propose one caveat to his astute observation: if a company wants to do well by doing good, and gain the reputational credit for doing so, it must bring the public along on its journey through an effective and honest communications effort that encompasses both financial and non-financial reporting.

Integrating business, financial and non-financial reporting

Corporate reporting practices are in flux now, and new requirements will have lasting implications for how companies disclose performance and communicate with the public. This trend is illustrated by the Johannesburg Stock Exchange's requirement from March 1, 2010 that all listed companies produce an integrated report in which the companies tie together their financial and non-financial performance, or explain why they have not done so.

Such changes in reporting requirements, however, present many opportunities for strengthening reputation, managing risk and generating a stronger return on investment.

Most publicly traded companies around the world have long placed a premium on communicating with their investors, and with social media's rapid growth in recent years, those communications techniques have become more sophisticated. Public companies must also actively engage with regulators — both in government and in the various exchanges around the world — as they seek to remain in accordance with applicable rules and laws.

An emerging theme in corporate communications and investor relations is the effort made by companies to demonstrate broad-based value creation that goes beyond profits and losses to encompass the various economic, social and governance (ESG) initiatives that they undertake in order to act in a more sustainable and responsible manner. Many companies hope that the path they map out to a sustainable future will generate numerous other benefits — including stronger profits, higher returns on investment, increased brand awareness and reputational goodwill.

The importance of demonstrating sustainable value creation is driven by a myriad of public forces. For example, customers and consumers are holding corporations to an ever-increasing set of expectations that they act in a responsible and ethical manner, while regulators — most prominently in continental Europe and the UK, and increasingly in the US — are calling for greater disclosure on a variety of ESG performance metrics such as labour practices and carbon emissions. Perhaps the most powerful forces in the move to greater transparency are institutional investors, which want a detailed account of how a company's ESG efforts affect bottom-line performance and reputational value.

In other words, publicly traded corporations can no longer expect platitudes about corporate citizenship and 'feel good' reports on corporate social responsibility (CSR) to be taken at face value. In an article about the importance of integrating financial and non-financial performance when discussing responsible corporate behaviour, Professor Eccles said: "If you really think that how you're managing environmental, social and governance issues is at the core of what you do, if those things are core to how you create value, you need to explain [those efforts]. It's not, 'here's my financial report and here's my green strategy'. Or, 'here's my financial report and here are my human rights policies'. Integrated means that you're not thinking of these larger efforts as simply an appendage, but in terms of how they support the company's value creation strategy."
('Get Ready: Mandated Integrated Reporting Is the Future of Corporate Reporting', *MIT Sloan Management Review*, March 13, 2012)

Thus, to demonstrate value creation effectively and persuasively, companies must look to expand and enhance their communications and disclosure efforts. They cannot rely on static reports placed on their websites accompanied by a basic press release to satisfy the demands of shareholders or broader public audiences. Moreover, leading companies such as Philips Electronics, Novo

Nordisk, United Technologies, Natura Cosméticos and Pepsi are raising the bar not only for communicating about their financial and non-financial performance, but also for using those communications to establish a dialogue with the public and gain positive reputational credit for doing so.

Keeping stakeholders informed and engaged

Companies listed on stock exchanges are required to disclose their financial performance on an annual basis along with a variety of indicators. But while fulfilling the obligations for financial reporting continues to be a relatively straightforward process — based on a set of accounting standards that define what information needs to be presented —the growing demand for ESG reporting has created a paradox.

As the journalist and environmental writer Eric Roston observed: "If non-financial data, such as greenhouse gas emissions per dollar of revenue, is included in a financial report for investors, how can it still be called non-financial? Institutional investors and companies aren't yet making the leap to calling greenhouse gas emissions, percentage of female executives or other ESG metrics 'financial'. But they are increasingly considering them to be material."
(Eric Roston, 'Non-Financial Data is Material: the Sustainability Paradox', Bloomberg, April 13, 2012)

To help companies not only disclose non-financial data but, perhaps more fundamentally, assess what is and what is not material reporting, frameworks such as the Global Reporting Initiative (GRI) and the Carbon Disclosure Project (CDP) have gained prominence. Although these do not have statutory or regulatory authority, they are additional mechanisms that companies should consider using when reporting on their various activities.

Frameworks such as GRI and CDP are also representative of another important trend: the growing inability of country- or region-specific reporting structures to fully account for all of the activities of global corporations. As a result, a market-driven model is coming into greater use, where public audiences such as NGOs are increasingly using social media and the democratisation of information facilitated by the internet to police corporate behaviour.

The outcome is a shift in how companies report on their activities. As the Deloitte paper, 'Integrated Reporting: A better view?', asserted: "By accepting that business sustainability is about how a company creates value, rather than just about how it achieves compliance or avoids harmful effects from its activities, a different perspective of sustainable value creation emerges, along with a different perspective on how companies should report on value creation and protection."

Regardless of the framework that companies use to assess or disclose financial and non-financial performance, they must solve the paradox of what information is material to the public. And the only way a company can find this out is to talk to the public — and listen to their responses. This means that an internally focused process whose outcome is a static report produced once a year must be replaced with one in which public audiences are given the opportunity to weigh in at any time on what is important.

Perhaps the most significant point is that the mindset around sustainability efforts is gradually changing. Companies are moving away from seeing sustainability communications as a marketing tool primarily used to bolster corporate reputations. Rather, the approach is evolving to one where reports simply lay out the facts with a minimum of interpretation so that, in the words of Jim Nail of the analyst Verdantix, "stakeholders can make their own judgments" (Jim Nail, 'Plan

Sustainability Communications, Not Green Marketing', Environmental Management & Energy News, November 16, 2010).

In other words, companies are required on a regular basis to disclose information about operations to regulators, policymakers and other audiences. But the process of determining what information must be disclosed, and how, involves communicating with the public.

This communication can take many different forms, ranging from an interactive website, to a survey of key audiences asking a series of questions about material issues, to one-on-one meetings. Many companies must also do a better job communicating internally. We often encounter situations where sustainability work remains the purview of a relatively siloed team with little insight into — let alone an ability to influence — decisions affecting global operations.

Effective reporting of financial and non-financial performance requires collaboration among a myriad of departments, including communications, investor relations, legal, accounting, sustainability and those more focused on company operations. Given the sharpening focus of regulatory bodies on non-financial reporting, there is a need for some kind of formal validation to be given to the report, and this is most often done through an auditing firm.

Even starting the process to determine what information is material can be daunting. Companies are increasingly turning to a process called a materiality assessment, in which the relevant internal and external audiences are brought together to decide collectively on what issues are relevant and must be disclosed. Such an assessment will help prioritise a company's attention and resources so that it can be confident it is communicating the information that the public wants.

www.pwc.com/gx/en/corporate-reporting

Getting the edge

pwc

Good corporate governance is part of the DNA of your organisation. We can help you to communicate this successfully.

To find out more visit www.pwc.com/gx/en/corporate-reporting.

© 2012 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

23. Corporate governance — towards best-practice corporate reporting

John Patterson, PricewaterhouseCoopers LLP

Reporting is a fundamental part of the UK Corporate Governance Code (the Code). It is through appropriate reporting of governance that companies earn the right to the flexibility that a principles-based framework allows.

It is expected that companies will comply with most of the provisions of the Code most of the time — and indeed a report from the Financial Reporting Council (FRC) in December 2011, 'Developments in Corporate Governance', showed 50 per cent of FTSE 350 companies claiming full compliance and 80 per cent of the remainder complying with all but one or two of the Code's provisions. However, the UK framework crucially allows boards to exercise their judgement in respect of their governance arrangements as long as they explain their reasons for non-compliance with the Code. This judgement is not generally challenged by regulators; it is the responsibility of shareholders to consider the judgements and the explanations that are provided when a company does not follow a certain provision.

The FRC's proposed revisions to the Code for years beginning on or after October 1, 2012 include a number of measures that are intended to enhance engagement and stewardship by building the confidence of stakeholders in company reporting. The hope is that this will encourage the taking of a long-term view in decision-making and counteract the risk of a repeat of the short-termism that is often seen as a root cause of the financial crisis.

Governance reporting is an integral part of the FRC's proposals, which include enhanced audit committee reporting. But governance reporting also has a wider role to play in building investor confidence and encouraging the taking of a long-term view. Governance is not just about confidence in the financial statements; it is about confidence in the company in general. It is about showing how the company's business model, strategy and objectives, risk, performance and reward are governed.

The European Commission and 'comply or explain'

"There is some scepticism in Brussels about the effectiveness of the 'comply or explain' approach to corporate governance, and the willingness and ability of shareholders to hold boards to account. Some in the UK may feel that its track record should speak for itself, but in the current environment there is a need to demonstrate that 'comply or explain' continues to deliver strong and effective governance, and is taken seriously by companies and investors. Failure to do so could result in an approach which could be more prescriptive about the way companies organise themselves, and could give more power to regulators at the expense of shareholders."
FRC: 'Developments in corporate governance'

Governance reporting is a real opportunity to reap the benefits of the good practice that exists within companies, and to build the confidence of investors and other stakeholders and therefore company value. Few companies take this opportunity successfully.

Current governance reporting practice — why companies are missing their opportunities

With a few exceptions, despite the huge potential benefits outlined above, the reporting of corporate governance in the UK could do more to embrace

Personal reporting

"Chairmen are encouraged to report personally in their annual statements how the principles relating to the role and effectiveness of the board (in Sections A and B of the new Code) have been applied. Not only will this give investors a clearer picture of the steps taken by boards to operate effectively but also, by providing fuller context, it may make investors more willing to accept explanations when a company chooses to explain rather than to comply with one or more provisions. Above all, the personal reporting on governance by chairmen as the leaders of boards might be a turning point in attacking the fungus of 'boiler-plate' which is so often the preferred and easy option in sensitive areas but which is dead communication."
FRC: Preface to the Corporate Governance Code

The role of auditors

The role of auditors in 'reviewing' the corporate governance statement is set out in the Listing Rules and under auditing standards. The responsibilities are restricted to reviewing nine specific provisions of the code (C.1.1, C.2.1, and C.3.1 to C.3.7) and the going concern statement that is required of UK incorporated companies under Listing Rule 9.8.6R (3). Other than this responsibility, auditors read the corporate governance statement for consistency with the financial statements and for any material mis-statements of fact based on the knowledge they obtain from their other audit work. They will not want to be associated with any misleading statements in the governance report, but this does not mean they will look for disclosures relating to every provision of the Code.

the spirit of the Code. The FRC has recognised this and in the Preface to the Code (see the panel above) it recommends personal reporting by the chairman of the company as a way of improving the situation.

Why are companies missing the opportunity for effective communication with stakeholders that governance reporting represents? Why are boards risking the flexibility to exercise their judgement that the UK framework affords?

The Listing Rules and the 'checklist mentality'
Although relatively few of the detailed provisions of the Code require specific disclosures (and these are listed in Schedule B to the Code), the Listing Rules require companies to provide a narrative statement of how they have applied its Main Principles. Many companies find that the easiest way to demonstrate this is to explain how they have complied with each of the provisions that relate to the Main Principles. The result of this approach is often apparently standardised disclosure, as companies repeat the wording of the Code provisions. This leads to a lengthy report that reads like 'boiler-plate' and can make it difficult for the reader to identify important information from mere procedure — to 'see the wood for the trees'.

Reinforcing this, many companies have also experienced a negative reaction from shareholder groups or proxy advisers that take a mechanistic approach to checking compliance if they attempt to omit mention of a specific provision. Our advice on this is to resist. A number of leading governance reporters do not run through each and every provision of the Code in their disclosures. Similarly, external auditors have no mandate to insist on a 'box ticking' report (see the panel above).

Corporate reporting challenges
A number of the challenges that apply to corporate reporting in general play out in governance, and

there are also a number of specific challenges in governance reporting:

- Standardised disclosures are seen as a safe option in corporate reporting. To give company-specific information — for instance, about particular events or challenges that the company faces — is seen as potentially risky even where it is not obviously commercially sensitive
- It takes courage to 'lead the way' in reporting, moving away from precedent in the form of similar disclosures published previously by others. Of course larger organisations may have more resources at hand to allow them to do this, but there are many examples of creative approaches outside the FTSE 100
- Corporate reporting is used by a number of different audiences, each with differing needs; companies worry that too much customisation will mean their reporting fails to meet the needs of a particular group
- The various elements of the front half of the annual report are often drafted separately, leading to differing approaches and styles and also to a lack of integration, perhaps beyond some basic cross-references. This is particularly limiting for corporate governance as it can be related to many areas of the organisation — in fact to almost everything in the annual report
- Governance deals with particularly sensitive areas: board-level governance focuses specifically on the activities of the directors, and their individual characteristics, relationships and even the evaluation of their performance.

To help address these challenges it pays for there to be oversight that ranges across the whole annual report. Assemble a group who will be aware of the overall plan and messaging.

Cutting clutter

Those preparing annual reports should refer to the FRC's 'Cutting Clutter' publication. This includes a specific disclosure aid on governance reporting, but its real importance lies in its emphasis on only reporting information that is material, and in a way that is open and honest, clear and understandable, and interesting and engaging.

Also ensure that the project plan allows enough time for initial mapping out of the content and for review and integration after the content is drafted.

Most importantly, corporate reporting needs to be owned by those able to see the big picture and who have a vested interest in making sure it is communicated; the directors should be involved early enough to be able to influence the process. The FRC's encouragement of personal reporting on governance by the chairman recognises this, and governance reporting particularly benefits from these strategies.

The FRC's proposed changes to the Code from October 1, 2012 also include a requirement that the board, with the advice of the audit committee, should set out the basis on which they consider that the whole annual report is "fair, balanced and understandable" and "provides the information necessary for users to assess the company's performance, business model and strategy". If they are introduced, these changes will emphasise the direct responsibility of the board and the audit committee for good reporting.

Going beyond compliance – starting to take the communication opportunity

Because current governance reporting is often uninspired, it's not difficult to make an impression. Here are some quick wins to consider:

Figure1: Towards best-practice reporting: the 'backbone' of the annual report

Don't just report on process
Meaningful governance reporting does not *just* report governance processes. It reports how governance activities have been applied to the 'backbone' of the annual report.

Useful tips include:

- Don't just list what the board and its committees are responsible for; explain what they actually did
- Give real-life examples of what they did; mini case-studies can work well
- Explain how governance was applied to key challenges or events in the year. Do this particularly where there has been controversy; readers will not be impressed by silence on subjects they expect to see covered.

Go beyond the bare facts
To take one example, in order to comply with the Code, every company has to give information about the roles of directors and the composition of the board and its committees. The biographies of directors generally show that they are well-qualified and experienced individuals and, following the FRC's 2012 revisions to the Code, companies will also have to explain their policies on diversity and their progress towards any measurable objectives set.

Companies can go beyond these bare facts by:

- explaining the directors' most relevant skills or experience for the particular board
- showing how the skills and experience of the directors complement each other
- when reporting on the board evaluation, explaining why a particular conclusion was reached and what actions arose; not just setting out the process and reporting the overall conclusion.

All of this can make a real contribution to building the confidence of stakeholders in the robustness and effectiveness of the board.

Communicate what makes the company distinctive
The business model is part of what makes a company distinctive — it should capture the essence of the commercial proposition. Establishing the business model is very much part of governance.

Ensure also that challenges and issues in particular industries are addressed; too many governance reports could be picked up from one annual report and dropped into the report of another company in a different industry.

Focus on the key messages and use structure to help with this
To start with, decide on a small number of key messages for the reader to 'take away' and ensure that they are clearly communicated. To help do this, think about how the report can be structured. Consider communicating key messages separately from the other required disclosures and 'standing data'. This can be done simply by 'boxing out' from the rest of the text. Increasingly, these messages are introduced in the chairman's personal reporting

rather than in the main body of the governance report.

A number of the disclosure requirements in the Code may be met by placing information (such as the terms of reference of committees) on the company's website. The provisions that allow for this are listed in Schedule B to the Code.

Towards best-practice reporting of corporate governance

Achieving good practice in governance reporting is the first step. Really to build stakeholder confidence means tackling matters of importance that are rarely addressed properly in governance reporting or that continue to be particularly sensitive, such as some aspects of remuneration reporting.

The challenge for companies is to move the game on. The Code and the guidance around it need to be applied in a wide range of circumstances, so they do not deal with the 'content' of disclosures in detail. This allows companies to add real value; best-practice corporate reporting gets to the heart of what stakeholders want to know and governance reporting should be a part of this.

Building confidence in the annual report as a whole

Following the financial crisis, the FRC has been behind two initiatives related to building confidence in not only financial reporting but the annual report as a whole:

Revisions to the Code

As discussed above, under the FRC's proposed revisions to the Code after October 1, 2012, boards will have to set out the basis on which they consider that the whole annual report is "fair, balanced and understandable" and "provides the information necessary for users to assess the company's performance, business model and strategy". If this is to go beyond a description of process, boards will need to disclose the key points considered in arriving at their conclusion.

To help them with this, the audit committee is to report on "the significant issues that it considered in relation to the financial statements and how these issues were addressed". Currently, only a few best-practice reporters discuss the key judgements and estimates made by the board in the preparation of the financial statements; this will in future be part of the Code itself.

The Sharman Inquiry into going concern and liquidity risk assessments

Going concern disclosures have often been viewed as a technicality, particularly where there is no perceived problem within the usual time horizon of 12 months (in the UK) from the date of signing the financial statements. Currently, although the FRC issued guidance in 2009 designed to improve the quality of going concern disclosures, relatively few companies have taken this fully on board.

The Sharman Inquiry, which reported in 2012, signalled a move away from the current model — where a company only highlights going concern risks when there are significant doubts about the entity's survival — to one that integrates the

directors' going concern reporting with the other elements of their discussion of strategy and principal risks. It also signalled a move away from the current 'three category model' for auditor reporting to an explicit statement in the auditor's report that the auditor is satisfied that, having considered the assessment process, there is nothing to add to the disclosures made by the directors.

These are both real opportunities to build confidence in the annual report, and we encourage companies to embrace them when they become applicable.

Getting to the heart of what stakeholders want to know — 'applied governance'

Stakeholders are interested in each element of the content 'backbone' of the annual report, and they are also interested in how governance has been applied to each of them. But they are not interested in mere descriptions of process. To build their confidence in the board and in the company as a whole, stakeholders should be provided with information on how governance has been applied. This is not to confuse governance with 'management' or 'control'; the focus is on how the board and its committees have been involved in the right things, and at the right time.

The particular content of 'applied governance' disclosures will of course vary from company to company and it is beyond the scope of this chapter to go into detail, but we have provided illustrative examples below for each element of the backbone.

Business model — people and relationships

Many organisations rely on the expertise of their people, built up over many years in some cases, leading to close working relationships that create value in the business. In our experience, the importance of people and relationships is seldom recognised in annual reports in any depth, though in such businesses we would expect it to be a high priority year in, year out for the board and perhaps the nomination committee.

People and relationships: reporting to build confidence in the company and the board:

- recognition that this is a key feature of the business model
- discussion of employee satisfaction, including retention and professional development
- evidence that there is succession planning and a pipeline of talent
- appropriate recognition of the relationship between diversity in the company and understanding the customer base.

Strategy and objectives — mergers and acquisitions activity

A lot of time is devoted to the financial reporting issues around M&A activity, such as acquisition accounting and impairment reviews, and there is generally extensive disclosure of underlying and adjusted profitability numbers, exceptional items, and even tracking the financial benefit of

M&A activity: reporting to build confidence in the company and the board:

- the key issues that went to board level
- significant risks that the board considered in relation to the deal (price and terms, for example)
- how the board is monitoring/driving synergies (restructuring decisions, for example)
- the outcome of post-investment reviews.

synergies. The financial statement disclosures are often accompanied by commentary in the front half of the annual report, typically including some indication of future developments. However, there is rarely much discussion of how the underlying decisions and judgements were reached by the board, or of how they continue to monitor outcomes.

Risk — appetite and management

Although there has been an improvement in recent times in the quality of the disclosures of principal risks and uncertainties in annual reports, there is rarely any meaningful connection between these disclosures and the governance of risk. This is despite the re-emphasis of the board's responsibility for risk in the Code (see the panel above).

This reworded principle focuses on 'risk appetite' without using the specific term. In the narrative disclosures of how the main principles of the Code have been applied, it is therefore particularly important to focus on this aspect of risk, which is the key link between risk and strategy and very much a board responsibility.

The Turnbull Guidance, published by the FRC in October 2005, provides more information on how the board's responsibilities around risk management and internal control should be addressed. However, it has not tended to generate disclosures that cover everything stakeholders would be interested in.

Risk appetite and management: reporting to build confidence in the company and the board:

- how the board engineers 'risk resilience' into the company, including resilience against 'black swans', or unforeseen risk events
- how risk is measured and reported to the board and how governance is applied to it.

Board responsibility for risk

"The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems."

FRC: UK Corporate Governance Code, Main Principle C.2

Example — supply chain governance. An example of how reporting could be improved is governance of the supply chain, which is fundamental to the operation of companies and is frequently partially outsourced or dependent on joint ventures or associates. This brings with it a number of governance challenges that are rarely addressed in the annual report. The Turnbull Guidance requires disclosure where joint ventures or associates are excluded from the risk and internal control systems of the group but nothing more specific than this. There is also a tendency for such issues to be seen as 'below board level' and not part of the governance to which the annual report disclosures relate.

To build confidence in the company and the board, reporting might detail how a decision to outsource or place reliance on a third party was seen by the board as consistent with the company's risk appetite. It could also address the question of what the board has done to make sure it's clear where the responsibilities of the company stop and start — avoiding the risk of 'falling between stools'.

Group and subsidiary governance: reporting to build confidence in the company and the board:

- how the structure of the group/business maps to territories or legal entities
- how the governance structures inter-relate
- an outline of where responsibilities lie.

Control — group and subsidiary governance

Annual report governance disclosures tend to focus on the group, but there can be a disconnect between the group governance structures and those that operate in (often very significant) individual territories. This can lead to a lack of clarity around responsibility for matters that do not map easily to the group structure, such as local legal or regulatory requirements (including tax and pensions), and also to uncertainty as to the responsibilities of directors in local statutory entities.

Control — anti-bribery measures

The UK Bribery Act 2010 came into force in the middle of 2011 after much initial uncertainty and delays in guidance on the expectations for 'adequate procedures'. With its widening of liability to those acting on a company's behalf worldwide, the Bribery Act represents a major source of ongoing reputational risk that boards should be measuring and managing.

Anti-bribery measures: reporting to build confidence in the company and the board:

- how the board tracks the group's response to the new anti-bribery regime — is it part of ongoing monitoring?
- continuous reassessment of the risks based on experience.

Many companies currently note that processes have been put in place (as the Bribery Act requires) but few provide disclosures beyond the bare facts.

Performance — governance over non-financial measures

Non-financial measures are intrinsically bound up with governance, and this will become more significant as corporate reporting moves towards integrated reporting, driven by initiatives launched by groups like the International Integrated Reporting Council to link financial performance with non-financial areas such as the environment and corporate social responsibility. A number of companies are already providing performance statements on environmental issues such as the consumption of finite resources.

Governance over non-financial measures: reporting to build confidence in the company and the board:

- Does the board consider these issues throughout the elements of the 'backbone' of the annual report, from business model to reward?
- Are the issues dealt with by the board or are they wholly delegated to a subcommittee?

As these developments continue, stakeholders will become more and more interested in how the board has engaged with them.

Reward

Reward — reporting remuneration

The reporting of directors' reward is part of the 'backbone' of the annual report, and there is a particular focus on its alignment with the rest of that backbone. This alignment is a key concern for many investor groups, including proxy advisers, who regularly recommend that shareholders vote against or consider withholding their votes on the remuneration report at the annual general meeting. In respect of the remuneration policy part of the report, this is to change to a binding vote from 2013, when it is planned that the Enterprise and Regulatory Reform Act will come into force.

Remuneration: reporting to build confidence in the company and the board:

- showing that the remuneration committee and its chairman have been active during the course of the year, including taking advice from appropriate parties and engaging with stakeholders on a timely basis
- being clear about the performance-reward link in all variable elements of remuneration, and particularly the alignment of that performance with business objectives
- providing clear disclosure of amounts earned in the year and the entitlements for future years
- dealing head-on with specific known issues — especially where these have been raised by shareholders
- recognising any industry-specific challenges, and discussing how they have been addressed, but being careful not to imply over-reliance on market benchmarks
- dealing with the remuneration of senior employees below board level
- clear disclosure of potential or actual exposure to compensation for loss of office.

Companies' remuneration policies will come under even more scrutiny and careful disclosure will be one way to avert a crisis. It is certainly not in anyone's interest to create uncertainty, which may give rise to unnecessary questions.

Reporting for newly listed, Standard Listed and smaller listed companies

A number of specific challenges can arise for newly listed or smaller listed companies, though some of these may also apply to any company.

Newly listed companies

Although adequate financial reporting procedures should be in place prior to listing, it may take time for companies to work towards full compliance with the Code (or compliance to the extent thought appropriate for the particular organisation).

As all Premium Listed companies must now apply the Code, those that are incorporated overseas and are therefore accustomed to other governance frameworks may take time to adjust their arrangements. This may result in a need to explain more departures from the Code than is the case with other companies and — for those provisions of an ongoing nature where arrangements were put in place during the year — the periods of non-compliance and compliance.

We recommend that this is done clearly in the governance report, with areas of non-compliance at the end of the period being identified separately. Strictly speaking, all instances of non-compliance for provisions of an ongoing nature should be included in the compliance statement required under Listing Rule 9.8.6 (6), but we believe that it is adequate for them to be mentioned in the narrative statement under LR 9.8.6 (5), provided that the non-compliance is clearly described and the compliance statement identifies those provisions that have still not been complied with at the end of the period.

‘Comply or explain’: explanations

Where appropriate, companies should take into account the FRC’s February 2012 guidance on the three elements of a meaningful explanation:

“It should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken to address any additional risk and maintain conformity with the relevant principle. The explanation should indicate whether the deviation from the Code’s provisions is limited in time and, if so, when the company intends to return to conformity with the Code’s provisions.”

Standard Listed companies

Although Standard Listed companies (regardless of their place of incorporation) do not have to report against the Code under the Listing Rules, if they apply any code (one applicable in their country of incorporation, for instance) on either a voluntary or mandatory basis, they must report against it to comply with the Disclosure and Transparency Rules.

Smaller quoted companies

The Quoted Companies Alliance (QCA) issues guidelines for smaller quoted companies on how they may implement the Code appropriately. The Code still applies to all Premium Listed companies, and the only relaxations from it are for those provisions that the FRC has applied exclusively to FTSE 350 companies, mainly around the composition of audit and remuneration committees, the re-election of directors and external facilitation of board performance.

Our recommendation is that smaller companies aim to implement the Code to the extent that it applies to them, and refer to the QCA guidelines where they believe that a specific provision does not suit their circumstances.

CONFIDENCE is on the agenda.

D&O insurance solutions from Chartis.

Today's directors and officers face more risk than ever, due to a growing breadth of regulations and heightened enforcement. Having the right coverage is critical. At Chartis, we offer cutting-edge insurance solutions built to meet the challenges of D&O risk today—and will keep innovating to meet the challenges of tomorrow. Learn more at **www.chartisinsurance.com**

CHARTIS®
Your world, insured

Chartis Europe Limited is authorised and regulated by the Financial Services Authority (FSA number 202628). This information can be checked by visiting the FSA website (www.fsa.gov.uk/ Pages/register). Registered in England: company number 1486260. Registered address: The Chartis Building, 58 Fenchurch Street, London, EC3M 4AB.

24. Protection for directors and their companies

Grant Merrill, Chartis Europe Limited (an AIG Group Company)

The fallout from the global financial crisis has caused significant changes in both the overall level of risk and the specific nature of those risks. As a result, being a director or officer brings with it a wider and more complex range of risks than at any other time — all of which come with potentially serious financial and reputational consequences.

This chapter will look at where and why these changes have occurred and how individual directors, as well as their companies, are being affected as regulators, shareholders and the general public increasingly look to hold business leaders accountable for their actions.

Directors in the spotlight

Recent shareholder activism, and media and public debate over executive pay and ongoing financial scandals, show that boardrooms are coming under increased scrutiny against the backdrop of a tough economic climate. Directors and officers — particularly of multinational businesses — are facing heightened exposure as shareholders and regulators increasingly look to hold individuals to account.

An illustration of the increasing levels of oversight is the number of fines handed out to individuals by the Financial Services Authority (FSA), which increased 47 per cent in 2011 compared with 2010, while there was a slight dip in the number of corporate fines in the same period. There is a distinct trend towards the 'personalisation' of claims, with individual directors and officers increasingly being named either as sole defendants or as co-defendants alongside their company.

Given these levels of individual exposure, directors and officers need to know the areas of concern that ought to be on their radar, including the latest developments in the national and international legislative arenas, as well as where trends are developing in terms of claims against them.

A changing legislative landscape

One of the key issues is the range of recent legislation that, along with more rigorous enforcement of existing laws, will potentially put the actions of board members under more intense scrutiny in the future. Relevant UK legislation includes:

- **The Companies Act 2006**. This is the primary source of legislation governing UK companies and outlines directors' duties, including their fiduciary duty to the company itself and to promoting its success
- **The UK Corporate Governance Code 2010**. This outlines principles of good corporate governance for companies listed on the London Stock Exchange. The Listing Rules and the Disclosure and Transparency Rules require companies with a Premium Listing to provide annual disclosures of both their compliance and non-compliance with the Code and to explain why and where the company has not adhered to aspects of the Code
- **The Bribery Act 2010**. In force since July 1, 2011, this has made companies liable for failure to prevent bribery within their organisation. A company will be held liable for the wrongdoing of its representatives, but the Bribery Act affords a defence if the company can demonstrate that it had adequate procedures in place to prevent acts of bribery. Directors can also be found guilty if they consent to or connive in bribery on the company's behalf by an employee or agent. Essentially, the onus of

guilt has shifted, with the burden being placed on boards to prove that no wrongdoing has occurred. The Act has extra-territorial scope as it applies not just to UK-incorporated entities, but also to any multinational conducting business in the UK

- **The Enterprise Act 2002**. This criminalised cartels and empowered the Office of Fair Trading to investigate anti-competitive activities such as price-fixing, bid-rigging and market sharing
- **The Health and Safety at Work Act 1974**. This Act makes directors and managers personally liable if they actively consent to a health and safety breach, or neglect their duties. In addition, the Corporate Manslaughter and Corporate Homicide Act 2007 enables the prosecution of larger organisations when a management failing has led to a death.

In addition, some companies may be exposed to developments on the other side of the Atlantic:

- **The Dodd-Frank Wall Street Reform and Consumer Protection Act 2010** gave the Securities and Exchange Commission (SEC) new powers to pursue financial fraud and ensure US markets are safe for investors. It includes a controversial whistleblower provision that encourages the reporting of securities violations, and rewards the whistleblower with up to 30 per cent of the funds recovered, which could be a significant driver for new investigations
- There has been dramatically increased enforcement activity in recent years under the US **Foreign Corrupt Practices Act 1977**, with fines in excess of US$100 million not being uncommon.

The landscape of UK financial services regulation is also changing, with three new regulatory authorities being introduced in 2013. The Financial Policy Committee is to regulate the UK financial system as a whole; the Prudential Regulation Authority is taking on the oversight of financial institutions that carry significant risks on their balance sheets; and the Financial Conduct Authority is taking over from the FSA, with a core purpose of protecting and enhancing the confidence of all consumers of financial services.

Finally, the current economic slowdown — coupled with banks' shrinking balance sheets and uncertainty in the capital markets — is putting pressure on healthy and already-stressed balance sheets alike, leading to higher refinancing costs and a rise in insolvencies. Bankruptcy claims are increasing as debts cannot be refinanced, with common complaints including asset stripping, mismanagement and breach of fiduciary duty.

Regulatory enforcement

There is also regulation and enforcement activity from national regulators to consider. For example, the UK's Serious Fraud Office (SFO) handled in excess of 100 cases in 2011 compared with 50 in 2006. Another growing trend is for greater international co-operation between governmental bodies such as the FSA, SEC and the US Department of Justice (DOJ).

One of the most high-profile risks faced by directors at present is that of extradition to face justice in a less 'friendly' jurisdiction, as highlighted in the press by the extraditions to the US of the 'NatWest Three' several years ago and, more recently, the British businessman Christopher Tappin.

An increased appetite for class actions

Another area of concern is the developments in class (or group) actions. In the UK, for example, these can be brought in a variety of ways. They can be initiated under the English Civil Procedure Rules, where a Group Litigation Order enables cases alleging common issues to be managed as a

single case. Claims related to securities fraud can be made under common law principles (such as those for fraud or deceit) or under the Financial Services and Markets Act 2000 (for liability relating to statements made in a prospectus). Shareholders are also permitted to bring derivative claims for director negligence, default, breach of duty or breach of trust under the Companies Act 2006. In the future, the increased use of litigation funding in the UK may make securities group claims more viable.

Historically, US securities claims against foreign issuers have been a key area of concern, but more non-US securities actions could take place in the future. This follows a US Supreme Court decision in the case of *Morrison v National Australia Bank* (2010). The judgment dramatically limited the extra-territorial application of US securities laws, not only barring plaintiffs from asserting claims in the US over a multinational company traded on a non-US exchange, but also limiting the extent to which claims can be made involving non-exchange-based securities transactions. As a result, plaintiff attorneys are likely to seek other venues to bring these cases, not least in the UK and continental Europe.

Multinational exposures

In addition, as companies expand globally, they can be exposed to new risks and regulatory regimes. Local laws and regulations differ from country to country, and some are evolving in a way that may make it easier to bring actions against directors and officers.

Among these regulations may be a requirement for locally admitted insurance and restrictions on the movement of money. In many countries, there are laws that make it illegal to make a payment under a non-admitted insurance policy, so companies should take this into account when purchasing cover.

Prospectus liability

The decision to raise capital — either by listing shares on an exchange through an initial public offering (IPO) or in a follow-on equity or debt offering — creates its own particular set of risks for directors and officers.

A key part of the offering is a company's need to issue a prospectus, which details the terms and rights attached to the security and includes a description of the company's business, financial position, strategy, future prospects and any other information that could be deemed material to the offering. The omission of any material facts from this document is as prejudicial as providing false or misleading statements. In addition, if any material information changes between the approval of the prospectus and the point at which shares start to trade, anyone responsible for the prospectus must notify the company and sponsor of any new factor or inaccuracy as soon as they become aware of it and the company must publish a supplementary prospectus. While there are risks associated with the prospectus, there are also potential pitfalls to be found in the documents or statements made directly in connection with the offering — including during the investor roadshow.

Although the information in a prospectus is similar across jurisdictions and exchanges, the document is ultimately governed by a specific regulatory body. In the UK, the issuance of securities follows the Prospectus Rules, which implement the European Prospectus Directive. Ultimately, in its capacity as the United Kingdom Listing Authority (UKLA), the FSA must approve the prospectus. Similarly, in the US a prospectus has to be filed with the SEC and the listing may not move forward until it has been declared effective. This level of scrutiny highlights the potential risks for directors and officers.

The financial institution underwriting the offering is also an integral part of the process, given its role

in the preparation of the prospectus, managing the subscription orders ('book-building'), the roadshow and, ultimately, issuance. As such, an issuer can be liable for any indemnities it has provided to the underwriter.

Finally, investors base their decisions on the prospectus and information received in conjunction with the offering. If the securities' performance is not in line with expectations and they suffer a loss, there is a risk to the directors and officers, as well as the company.

The risks and rewards associated with a public offering are high. Directors and officers can be exposed to potential civil and criminal liabilities regarding the accuracy of their statements, and people responsible for false representation in a prospectus may be liable under the Fraud Act 2006, punishable by a fine or imprisonment of up to 10 years. There are also potential monetary penalties for both directors and officers and the company. Finally, actions against the people responsible for prospectuses can be brought years after the offering, up to the statute of limitations in that jurisdiction.

Putting safeguards in place

It is worth considering the cost of defending a claim, particularly as legal conflicts can lead to separate counsel being retained for individual defendants and companies, so increasing costs. The global nature of business can also mean there is a need for local representation in different countries, further highlighting the importance of multinational programmes and access to global resources.

Directors and officers face a range of formal penalties. Those of a monetary nature can include settlements and fines, while non-monetary penalties include disqualification and imprisonment, as well as enforced changes to boards and organisational strategies.

While the financial costs are significant, there may also be a big personal price to pay. An ignominious departure and loss of reputation can have an impact on a director's or officer's career.

In the case of both individuals and corporates, insurance can hold the key to managing an increasing range of exposures. Prevention is better than cure, but controls and a robust governance structure do not guarantee comprehensive protection. Therefore, for the whole range of risks that individuals face, directors' and officers' (D&O) liability insurance, including public offering of securities insurance (POSI), is a key safeguard. Insurers offer specific coverage to address the needs of individual board members, most importantly protecting their personal assets and covering defence costs in the event of a claim.

25. Board evaluation

Dr Tracy Long, Boardroom Review Limited

The requirement for boards of directors to evaluate their own effectiveness has developed within the UK regulatory framework over the last 20 years. Following the report in 1992 from Sir Adrian Cadbury's committee on the financial aspects of corporate governance, the concept of board effectiveness was developed further in 2003 by Sir Derek Higgs, who noted: "Performance evaluation of the board, its committees and its individual directors should be undertaken at least once a year. The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, appointing new members to the board or seeking the resignation of directors. The board should state in the annual report whether such performance evaluation is taking place and how it is conducted." ('Review of the Role and Effectiveness of Non-Executive Directors'.)

In 2009, Sir David Walker refined the guidance on evaluation in his review of corporate governance in UK banks and other financial institutions, stating: "The board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year." In the years since, these recommendations have been endorsed by the Financial Reporting Council, and the UK Corporate Governance Code now provides that FTSE 350 companies conduct externally facilitated board evaluations at least every three years.

In one sense, the purpose of an evaluation is very simple: to assess the board's contribution, individually and collectively, to the health and success of the company. However, there is no single template for an effective board, and likewise, there is no single template for an effective evaluation. There are a number of methodologies that can achieve this purpose, and the approach taken will partly depend on why the evaluation is taking place — whether on the grounds of compliance, to respond to external pressure or regulation, to benchmark the board's performance, to facilitate change, or to enhance the board's long-term efficacy. There are a number of variables to take into account: factors such as business complexity and life cycle, board size and contribution, the number of participants, the board's timetable and the available budget will all influence the design and impact of the evaluation.

Most evaluations are instigated annually by the chairman and/or the senior independent director, although an external evaluation, commissioned every three years, may involve the approval of the whole board. Information is gathered from the board directors (both executive and non-executive), which ensures that all the participants start with an holistic and comprehensive view of the work, dynamics and processes of the board. However, if there are very few executive directors — the chief executive and chief financial officer, for example — it can be helpful to include the company secretary and one or two key executives below the board, such as the chief risk officer, head of internal audit or human resources, and outside parties such as the external auditor, particularly if they know the directors well. Retiring, or newly appointed, directors can also offer useful perspectives. However, those who do not regularly attend board meetings, or do not have good communication channels to all the directors, will probably not be able to add an informed view.

What to review

The role of the plc director is changing. Board responsibilities have widened from meeting basic legal obligations to providing competences that advance a plethora of corporate objectives. Directors are expected to contribute to the

development of strategy, the evaluation of performance, the oversight of risk and control, and the communication of corporate messages, standards and values. They are encouraged to contribute to a healthy boardroom dynamic, in which executive directors can talk candidly and without fear of retribution, and non-executive directors can respond with challenge and support in equal measure. It is assumed they will promote good governance and proper process, understand the intricacies of board composition and tenure, and take on dedicated, time-consuming roles such as chairman, committee chairman and senior independent director.

Given the breadth and depth of the board's role, the possibilities for an evaluation framework are endless (see the panel on the right). However, it is likely that the review will investigate aspects of the board's approach to its work, its culture and dynamics, and its structure and processes. There are a number of influences to take into account, and no right or wrong answers. For example, some companies operate in slow-moving and transparent industries, and can dedicate an annual board session to examining strategic options, while others operate in fast-moving and opaque industries, and have to address strategic options as they arise throughout the year. Several boards have delegated risk committees and chief risk officers; others divide the oversight of risk between the audit committee and the board. A number of companies have shareholders on the board or activists in the register, and will design their communication channels differently to those with unchanging registers and long-term, anonymous shareholders.

Likewise, there are many influences on the development of board culture and dynamics. Small boards will benefit from an intimate and familiar dialogue, but may suffer from a lack of challenge or breadth of view; boards with large numbers of directors may gain from the diversity of perspective, but lose from the lack of time within which those views can be aired. Strong chairmen will promote contribution and clarity, while weak chairmen will inhibit involvement or fail to orchestrate the board's dialogue. Equally, open and transparent chief executives will welcome challenge and interaction, whereas defensive chief executives will strive to limit the board's influence. Inappropriate composition, or uneven tenure, may result in the board's contribution lagging behind the business, or dramatic and untimely changes to important relationships.

Board processes and structure also adapt to the needs of the company over time. International companies may hold fewer board and committee meetings than their localised counterparts, but their meetings may extend over many days and locations. Some chairmen schedule a board dinner before every meeting, with careful alternation of attendees and agendas, while others prefer to hear the board's views in formal meetings. Meetings themselves can vary: a number of agendas focus on executive presentations and Q&A sessions, while others dedicate time to collaborative debate and conversation.

Internal evaluations

Internal evaluations are designed to incorporate written questionnaires (often with quantitative rankings) and/or internal interviews. Questionnaire responses are returned on a confidential basis, usually to the commissioner of the review or to the company secretary, and are collated to provide the basis of discussion for an individual interview or a collective board debate. If the intention is to track responses over time, a common set of questions (either quantitative or open-ended) can be used every year. There are some important considerations: questions require careful phrasing, so that respondents interpret them in a similar way; the number and order of the questions should be designed to encourage thoughtful responses (handwritten, emailed or

Factors to take into account in designing the board evaluation

Factors influencing the work of the board

- The company's history and stage in its life cycle (operational complexity and location)
- Rate of sector growth or decline
- Speed of corporate decision making and levels of bureaucracy
- Changes in the business model and access to internal and external resources, including finance
- Maturity of the strategic process, and involvement of the board
- Changing markets (the competitive landscape, customer profiles, supply chains, technology and regulation)
- Quality of risk management and internal control
- Oversight of performance and reward
- Maturity of executive succession planning and leadership development
- Shareholder structure and unity of objectives
- Visibility of stakeholders, and levels of engagement
- External interest and pressure, and relationships with advisers

Factors influencing the use of board time and process

- Structure of board and committee calendar and agendas
- Quality of executive and non-executive preparation
- Transparency, presentation and timeliness of corporate information
- Separation of strategic and operational issues
- Division of presentation and debate
- Balance of formal and informal time
- The level of board and committee support
- Availability of induction and development

Factors influencing the culture and dynamics of the board

- Corporate culture and context
- Clarity of board and committee roles, and levels of delegation
- Style of leadership (chairman, chief executive, committee chairmen)
- Quality of relationships between executives and non-executives
- Board size, composition and tenure
- Collective understanding and relevant experience
- Quality of contribution, debate and decision making
- Levels of trust and respect
- Openness and transparency of issues
- Degree of challenge and the management of conflicts

Adapted from 'This Year's Model: influences on board and director evaluation', Long, TE, 2006

through the internet); repetition should be avoided; and individual confidentiality should be protected and explained.

Internal evaluations offer an acceptable methodology for most companies two years out of three: they are quick and cheap to conduct; they provide a basic understanding of the board's strengths and weaknesses; they can involve a large number of people; and answers and/or rankings can be compared year on year. There are disadvantages: questionnaires are blunt research instruments (partly because the questions are linear and often repetitive, and partly because directors are reluctant to write down confidential and complex views and concerns); there are no independent perspectives or recommendations to consider; and the board cannot benchmark itself against others.

External evaluations

External evaluations vary from the use of an online questionnaire to an in-depth psycho-analytical assessment. Likewise, the evaluator is interpreted by some chairmen as providing a simple service, and by others as a valuable adviser and critical friend to the board. There are contrasting approaches: some evaluators work with a template, which predetermines the role of the board and best practice for directors; others design a bespoke evaluation for every company. Some attend to the historic and/or current effectiveness of the board; others are forward looking, testing the board's preparation for the future. Several methodologies are focused on tangible, visible outcomes such as board papers, processes and structures; others explore less tangible influences such as behaviour, relationships, culture and dynamics.

It is important, therefore, that chairmen have the right to choose, in consultation with colleagues, an appropriate methodology for the board and the company, including to what extent the focus of the evaluation is on the board's current performance and/or its future needs, whether individual contribution is assessed (peer review), whether the effectiveness of committees is included in the evaluation, and how the findings from previous evaluations are to be incorporated. There are no right or wrong methodologies, but there are different and decisive board requirements, levels of engagement, required skills and competences (from the evaluator), and necessary outcomes.

In many companies, it is the company secretary who is asked to prepare a shortlist of potential evaluators and make an initial recommendation to the chairman. Although this can be a helpful filter, it is imperative that the chairman, who is responsible for the effectiveness of the board, does not delegate the final decision. Experience, skill and chemistry are important, and the chairman has to be comfortable that an individual or firm will be able to maximise the long-term benefits of an evaluation for the board and the company, and be satisfied that the evaluator can conduct the work with sufficient objectivity and independence.

It is also important that all the directors are supportive of the process; good communication with the board on the approach and purpose, the process and the time commitment — with the necessary level of candour and feedback — will enhance the quality of input and level of engagement. Occasionally, potential evaluators are invited to address the board, or a smaller group including the senior independent director and committee chairmen, before the evaluation begins, which provides an opportunity to raise and address directors' questions and concerns. It is also advisable, if possible, to seek references on the quality and integrity of the evaluator's work from previous clients.

With regard to timing, partly due to a lack of planning, and partly due to reporting pressures,

evaluations are often commissioned at the end of a company's financial year, and at the beginning of the drafting session for the annual report. Inevitably this leaves inadequate time to engage directors in a meaningful evaluation, particularly one that involves extensive interviews, observation and debate. An external evaluation will take more time to organise and conduct than an internal evaluation, and the chairman will need to plan the process to suit the board's calendar; it is advisable to commission an external evaluation when there is adequate time to discuss its findings and recommendations, rather than to meet a disclosure deadline.

Given that most evaluations are a snapshot of the board's effectiveness, it is useful to conduct the interviews and observations within a limited and defined period; this enables directors to describe the same experiences and refer back to the same incidents, such as the last board meeting, remuneration committee or strategic away day. There are often logistical difficulties with directors' diaries, and therefore forward planning is vital; it is always helpful to schedule the evaluation several months in advance.

The use of interviews

The effectiveness of the board depends on intangible as well as tangible factors, and is difficult to measure quantitatively. Consequently, many evaluators will conduct qualitative research through the use of interviews and observation. Interviews can produce high-quality evidence and tend to work well on a semi-structured basis where the interviewer has a framework of topics to be covered (and therefore a basis for comparison between directors), but enough flexibility to vary the emphasis. This framework should be discussed with the chairman at the beginning of the review, and will be influenced by, inter alia:

- the company's stage in its life cycle, its size and its geographical reach
- the company's shareholding structure
- current and future issues facing the board, the company and the sector
- board size, composition changes, and the profile of individual directors
- the degree to which individual contribution will be assessed.

The quality of information provided and retained within an interview depends heavily on the interpersonal skills and experience of the interviewer. A properly contextualised interview requires substantial forethought; the interviewer should know enough about the company, the external environment within which it is operating (for example, the impact of changing regulation, a fast-moving competitive landscape or a sector in decline), and the director's background and role on the board, to be able to maximise the relevance of the questions, and understand the context of the answers. The interviewer may require a separate briefing from the chairman and chief executive, as well as a review of the company's documentation, such as the annual report and analysts' reports, before the evaluation begins.

An experienced interviewer will help directors feel at ease at the start of the interview, usually by explaining the context of the review, the framework for the discussion, and the parameters of confidentiality and anonymity. The skill of the interviewer lies in the ability to listen to what is said and what is not said, to distinguish certainty from uncertainty, and to understand the range of factors shaping nuance and interpersonal dynamics. These skills are vital if sensitive material and candid responses are to be handled correctly. In assessing the suitability of a potential individual or firm, the chairman may want to consider the following questions:

- Has the interviewer worked or studied in relevant fields, and been involved in

information gathering, analysis and presentation? In a comprehensive review, a huge amount of evidence is gathered, demanding high-quality analysis, and skilled written and verbal presentation
- Has the interviewer spent a significant amount of time in board and committee meetings, either as a director, an attendee or an adviser? It is helpful for directors to know that the evaluator understands the context within which they are operating, is knowledgeable about the board environment, and can empathise with the issues that arise
- Can the interviewer communicate difficult messages in a constructive way? Most boards demonstrate areas of both strength and weakness, and the emergent themes need to be presented in a way that encourages the directors to discuss issues and agree resolutions
- Is the interviewer independent and objective? Ongoing business relationships with the company or ties with particular board members — most importantly with the chairman — may inhibit directors from candid discussion and influence the evaluator's interpretation of the findings.

Observation

A comprehensive evaluation will often include observation of the board and committee meetings, and/or a strategy day; this helps the evaluator to form a dispassionate view of the board (rather than relying solely on personal accounts), triangulate the evidence given during the interviews, review the relevant documentation, and prioritise the board's strengths and weaknesses.

Observation also facilitates important perspectives on, for example, the physical characteristics of the boardroom, the interplay between directors, and the relationship between the information provided to directors in advance of the meetings, and the related discussion. Current papers and standard documents, including those provided for board and committee meetings, and terms of reference, will also provide context and an opportunity to benchmark against the practices of others.

Occasionally, directors are concerned that colleagues will behave differently while being observed. This is rare, as external advisers and attendees are present at most board meetings, and directors are not usually self-conscious. More important is to have the confidence to trust the evaluator with highly sensitive information; confidentiality is paramount, and the chairman should have assurance that the information will be used only within the context of the evaluation.

Communication

At the conclusion of the evaluation, the chairman and the evaluator will need to consider how the findings should best be communicated to the board in the interests of improving its effectiveness. There are a number of options, including whether:

- the evidence should be presented to the directors as an unadulterated mirror image, or as a perspective to which the evaluator has contributed context, judgement and recommendations
- quotes should be used in specific contexts and maintain appropriate anonymity
- recommendations and/or action plans are to be offered
- concerns regarding individuals should be identified (not normally recommended).

Depending on the approach taken, the key themes emerging from an evaluation, and any associated recommendations and potential changes, can be communicated in a number of ways. Written documents, board presentations, individual meetings and collective discussions will promote

different levels of constructive criticism and debate. Although written documents are an important reference point for the board, a collective discussion provides a better catalyst for directors, allowing issues to be raised within a confidential forum. The success of this discussion often depends on the chairman; an effective chairman will engage directors in an open and honest debate, and facilitate the identification of priorities, agreed actions, responsibilities and timeframes.

The length of a collective discussion is often difficult to determine at the beginning of an evaluation. Occasionally, very few issues arise and the discussion can be quite short. In some cases, evaluations reveal two or three significant themes for debate and warrant several hours. The chairman can choose whether a short conversation at a board meeting, or a lengthy discussion over dinner, is the right forum to maximise the benefits of the evaluation. Confidential feedback to individual directors can also be helpful if issues arise relating to, for example, contribution and approach or the effectiveness of delegated committees.

Disclosure

The external evaluation process provides an inimitable opportunity for directors to debate the value and impact of their contribution on a confidential basis with an independent adviser. However, the disclosure of this debate to the outside world is problematic. Given the variety of evaluation methodologies available, shareholders and stakeholders rely on clarity and transparency of reporting. Although there is guidance relating to disclosure within the UK Corporate Governance Code, the most comprehensive guidance is in the Walker review of 2009:

"The evaluation statement should either be included as a dedicated section of the chairman's statement or as a separate section of the annual report, signed by the chairman. Where an external facilitator is used, this should be indicated in the statement, together with their name and a clear indication of any other business relationships with the company and that the board is satisfied that any potential conflict given such other business relationship has been appropriately managed …

"The evaluation statement on board performance and governance should confirm that a rigorous evaluation process has been undertaken and describe the process for identifying the skills and experience required to address and challenge adequately key risks and decisions that confront, or may confront, the board. The statement should provide such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the process, including an indication of the extent to which issues raised in the course of the evaluation have been addressed. It should also provide an indication of the nature and extent of communication with major shareholders and confirmation that the board were fully apprised of views indicated by shareholders in the course of such dialogue."

Part of this disclosure is easily communicated in writing, specifically the name of the individual and/or the firm conducting the review, any existing relationships between the firm or individual and the company and board (and potential conflicts of interests), and a description of the process undertaken; this is often disclosed in the chairman's statement and the corporate governance section in the annual report.

More difficult is the description of any confidential or sensitive themes that may have emerged, particularly if they relate to individual directors (including the chairman) and the culture and dynamics of the board. The chairman

and the senior independent director may decide to give major shareholders and regulators a verbal update on these issues, and any agreed changes, when appropriate. Occasionally, the evaluator may also be asked to contribute to these meetings.

Conclusion

Although much progress has been made, these are early days; even the most experienced directors and external evaluators in the UK have been assessing board effectiveness for less than a decade, and best practice is still emerging.

However, there is growing evidence that evaluation can act as a catalyst for improving the board's effectiveness and its ability to prepare for future challenges. For chairmen, the ability to establish a confidential forum — where directors can speak frankly and without fear of inappropriate disclosure, and yet which provides an objective and contextualised view — is unique.

As this new discipline develops, directors, shareholders, stakeholders and regulators will become more knowledgeable and discerning about the range of options available, and appreciate the integrity and value of this essential process.

Part V: An international perspective

Chapter 26 Comparison of UK and US corporate governance considerations Page 203

Chapter 27 Comparison of UK and Hong Kong corporate governance considerations Page 213

BAKER & McKENZIE

A STRATEGIC PARTNER FOR GLOBAL GROWTH

When it comes to complex cross-border listings, you need advisers with deep knowledge, vast experience and global reach.

Our more than 300 securities lawyers work collaboratively across 70 jurisdictions – enabling us to quickly bring the right talent to every issue and seamlessly navigate regulatory complexities across borders. Our London-based Capital Markets Group offers investment banks and corporates a full range of securities law services relating to all types of capital markets transactions.

www.bakermckenzie.com/crossborderlisting

Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

26. Comparison of UK and US corporate governance considerations

Daniel Ro-Trock and Bryce Linsenmayer, Baker & McKenzie LLP

As more and more businesses and legal practitioners in the UK do business with US public companies, it becomes increasingly important to understand the similarities and differences between the corporate governance regimes and practices in these countries.

The foundation and basic framework of UK and US corporate governance practices are similar in many respects. Both regimes emphasise the rights of shareholders to vote on major company decisions and to elect a board of directors that sets the policy and direction of the company. UK and US laws also have a fundamental goal of protecting investors and providing certainty and uniformity in applying securities and corporate governance laws to the companies subject to their respective jurisdictions.

This chapter is a high-level summary of certain key similarities and differences between UK and US law and practice with respect to corporate governance matters. It is not intended to be a complete summary of the material similarities or differences between UK and US law, nor does it detail, within each topic discussed, all of the material or other matters necessary for a complete understanding of each topic.

Regulatory regimes

In the UK, the principles of good corporate governance for companies with a Premium Listing on the Main Market of the London Stock Exchange (LSE) are set out in the UK Corporate Governance Code (the Code). Such companies may also be subject to the Companies Act 2006 (for companies incorporated in the UK), the Financial Services and Markets Act 2000, the Criminal Justice Act 1993, the Insolvency Act 1986, Prospectus Rules, Listing Rules (the LR, including the Model Code), Disclosure and Transparency Rules (the DTR, as contained in the Financial Services Authority's 'Disclosure and Transparency Rules Sourcebook'), the LSE Admission and Disclosure Standards, the City Code on Takeover & Mergers, and the company's articles of association (which, for companies incorporated in the UK, governs the internal management of the company and the rights of its shareholders).

The US regulatory framework for public companies is somewhat more diverse than the UK framework, in that it consists of federal and state laws and may differ depending on the jurisdiction where the company is incorporated, the exchange on which the company is listed and, in certain situations, the jurisdiction of the company's shareholders and management.

Unlike the UK, the US has not adopted a corporate governance code. Instead, corporate governance requirements are imposed primarily by various state and federal corporate and securities laws, including the common law. The following provide the general framework for US corporate governance and securities laws:

- The statutory law of the state in which a company is incorporated has an impact on certain governance practices, as well as the rights, duties and responsibilities of the company's shareholders, directors and officers. Most large US public companies are incorporated in the state of Delaware. Unless otherwise noted, references to state corporate law in this chapter refer to the General Corporation Law of the State of Delaware
- US public companies are subject to US federal statutory laws, including the

Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, and the regulations, rules and other guidance promulgated by the Securities and Exchange Commission (SEC)

- US public companies must comply with the listing standards published by the stock exchange on which the company's shares are listed. Most US public companies are listed either through the NYSE Euronext or the Nasdaq OMX
- Similar to a UK company's articles of association, a US company's certificate of incorporation and bylaws govern its internal management and provide certain shareholder rights.

US securities laws provide that certain non-US companies are considered to be "foreign private issuers" and are not required to comply with all of the same rules and regulations that apply to US issuers. Instead, such companies may follow the rules and regulations of their jurisdiction of formation with respect to certain corporate governance matters. A non-US company is considered to be a foreign private issuer unless:

- more than 50 per cent of its outstanding voting securities are held by US residents; and;
- the majority of the executive officers or directors are US residents or more than 50 per cent of the issuer's assets are located in the US or its business is administered principally in the US.

Unless otherwise noted, references to US companies in this chapter refer to companies that are not foreign private issuers.

Corporate governance practices

The UK Code is a principles-based system known as the 'comply or explain' regime. The Listing Rules require a company incorporated in the UK with a Premium Listing on the London Stock Exchange to set out in its annual financial report the extent to which it has complied with the UK Code during the relevant period and to explain (and justify) non-compliance. Furthermore, the Prospectus Rules also require a company seeking a Premium Listing on the London Stock Exchange to state whether or not it complies with the corporate governance regime of its country of incorporation and, to the extent it does not do so, the reason for such non-compliance.

As discussed above, corporate governance matters in the US are addressed primarily by state and federal laws, and the rules, regulations and other guidance promulgated by the SEC. Stock exchange rules also provide specific corporate governance practices that listed companies must follow. US companies listed on NYSE Euronext must comply with a broad range of corporate governance standards and annually certify their compliance. Such standards include the requirement that a company maintain an audit committee, a nominating/corporate governance committee and a compensation committee, each consisting entirely of independent directors.

Again as mentioned above, foreign private issuers with shares listed on NYSE Euronext are exempt from certain listing standards, though they must generally explain and summarise the areas in which they do not comply. For example, the chief executive officer of a US company listed on the NYSE Euronext must annually certify that he or she is not aware of any violation by the company of the exchange's corporate governance standards, but the chief executive officer of a foreign private issuer is not required to provide this annual compliance certification.

Other common examples of where the practices of UK foreign private issuers differ from applicable NYSE Euronext rules include:

- the application by UK companies of standards of 'independence' for directors based upon UK law, rather than the test required under NYSE Euronext rules
- since there is no UK requirement for a separate corporate governance committee of the board, as there is in the US, certain governance issues that would otherwise be determined by a corporate governance committee pursuant to NYSE Euronext rules may be decided upon by the full board or another committee tasked with such responsibilities.

Governance structures

The governance structures of UK and US companies are similar in most material respects. The boards of directors in both countries are elected by the shareholders (with limited exceptions) and are generally responsible for setting the policy and direction of the company. Both UK and US companies operate under a unitary board structure.

In both countries, the control and management of a public company is divided between the board of directors and, for certain major corporate actions, the shareholders. Such major actions include the modification of the articles of association or certificate of incorporation, the election of directors, and the approval of certain business transactions.

In the US, the board of directors is responsible for appointing the management or officers of the company, but in the UK, certain senior management will often serve as executive directors on the boards of UK public companies. Individuals holding equivalent positions in the US would normally be classed as 'officers' but not directors of the company. For example, the functions of the managing director and finance director in a UK company are typically undertaken in a US company by the chief executive officer and chief financial officer, respectively (who in these roles are officers, and not directors), who are responsible for the day-to-day operation of the business under powers delegated by the board.

Independence of directors

In the UK there are different requirements for FTSE 350 companies, compared with those for smaller companies, regarding the minimum number of independent directors. For FTSE 350 companies, independent directors must make up at least half of the board, while smaller companies are only expected to have at least two independent directors. The UK Code requires the board to identify in the annual report each non-executive director it considers to be independent.

While US state laws do not, subject to certain limitations, govern director independence requirements, US securities laws generally require a majority of the board of a public company to be independent. US public companies must also identify their independent directors and, under NYSE Euronext rules, disclose the basis for that determination. This disclosure is usually contained in the company's annual report or proxy statement filed with the SEC.

US stock exchange listing rules include definitions for 'independence' that, at a minimum, require that the director should not currently be (or within the past three years have been) an employee of the company. Under NYSE Euronext rules, a director also may not qualify as independent unless the board affirmatively determines that the director has no material relationship with the company.

Both NYSE Euronext and Nasdaq OMX require that there are regularly scheduled board meetings (referred to as executive sessions) at which only independent directors or non-executive directors are present. Similarly, the UK Code recommends that the chairman hold meetings with the non-executive directors without the executives being present.

The UK Code recommends that the roles of chairman and chief executive should not be exercised by the same individual. While there is no similar limitation under US law, the trend among US public companies is for a move towards separating these roles.

Nomination and election of directors

A UK company's articles of association generally provide the basis for the rules governing the election of the company's directors, who are typically proposed by the company's nomination committee and elected by the shareholders by an ordinary resolution carried by a simple majority of those voting.

In the US, the laws of a company's state of formation, applicable securities laws and stock exchange rules, along with the company's certificate of incorporation and bylaws, provide the basis for the rules governing the election of directors. Generally, directors of US public companies are nominated by the board for election by shareholders at the annual shareholders' meeting. Depending on the exchange on which a company is listed, the proposed directors may first be identified by the nominating committee, which would recommend that the full board nominate those individuals for election.

Most state corporate laws provide that directors are elected under a plurality vote system, with the nominee who receives the highest number of votes cast for an open director's seat being elected to that position — these are the only votes that count; withheld votes have no effect. There has been a significant movement toward adoption of majority voting standards for election of directors in the past few years, and several US public companies have modified their corporate governance practices to require a director to resign if he or she did not receive a majority of votes cast.

In the US, a company's certificate of incorporation or bylaws will typically provide that board vacancies may be filled by a majority of the directors then in office, even if there are fewer than the required quorum for board action.

Action at board of director meetings

Under English law, there is no requirement for a fixed notice period in a company's articles of association regulating the calling of a meeting of the board of directors or of a board committee. Instead, the board decides the length of notice required and how notice may be given (whether in writing or by word of mouth). Similarly, the quorum required for a board meeting is usually left to the board to decide, although it is common for the articles to provide a default position of a quorum of two if no figure is set by the board. Typically a company's articles of association will provide that a vote of the majority of the directors present at a meeting at which a quorum has been established is required to take any action.

Under Delaware corporate law, a majority of the total number of directors constitutes a quorum, and a vote of the majority of those directors present at a meeting is required to take any action. However, with certain limitations, these requirements can be altered by the company's certificate of incorporation or bylaws. The directors may also act by written consent in lieu of a meeting unless the certificate of incorporation or bylaws provide otherwise. Unlike under UK law, Delaware law does not permit a director to appoint a proxy or other individual to act on behalf of the director at board meetings.

Limitation of liability and indemnification for directors

Under English law, there is a basic prohibition that directors cannot be exempt from liability nor can they be indemnified by the company for liability that would otherwise attach to them in connection with negligence, default, breach of duty or breach of trust in relation to the company, subject to three specific exemptions addressed below.

In the US, state laws govern the ability of a company to limit the liability of and indemnify a director. Most states allow a company to eliminate or limit directors' personal liability to the company and its shareholders for breach of their fiduciary duty. However, there are often restrictions on this limitation of directors' liability. Many companies also provide contractual indemnities to their directors, in addition to the indemnification provided by state law.

While there are differences with respect to liability and indemnity concepts under UK (English) and US (Delaware) law, most protections are similar except with respect to two concepts under Delaware law that are not applicable under English law:

- the elimination of liability in the company's certificate of incorporation or bylaws; and
- the availability of indemnity for regulatory and criminal claims (noting that such indemnity is generally only available in Delaware if the director had no reasonable cause to believe the relevant conduct was unlawful).

English law does not permit elimination of liability for a breach of a statutory duty, negligence or certain other matters, while Delaware law permits elimination of liability for breach of fiduciary duties of directors (subject to certain limitations). In order to limit or eliminate the liability of directors of a US company, the certificate of incorporation must provide for such limitation.

As mentioned above, there are essentially three exemptions to the indemnity prohibition under English law:

- **Purchase of directors' and officers' liability insurance**. The UK Code provides that companies with a Premium Listing of equity shares should arrange appropriate insurance cover for (1) the liabilities of the directors for acts committed in their capacity as directors of the company; and (2) the liability of the company in relation to claims made by directors under indemnities entered into between the company and the directors
- **Indemnification against qualifying third-party liability**. This is an indemnity against liability to a third party (not the company or an associated company) except for liability incurred (1) to pay a fine imposed in criminal proceedings or a penalty imposed by a regulatory authority; and (2) in defending any criminal proceedings in which the director is convicted, in defending any civil proceedings brought by the company (or an associated company) in which judgment is given against the director, or in connection with any application under the Companies Act 2006 where the court refuses to grant relief
- **Indemnification against qualifying pension scheme liability**. A director of a company that is a trustee of an occupational pension scheme can be indemnified against liabilities incurred in connection with the company's activities as trustee, provided the indemnity does not cover (1) any liability to pay a fine imposed in criminal proceedings or a penalty imposed by a regulatory body; or (2) any liability incurred in defending criminal proceedings in which the director is convicted.

Under Delaware law, with certain exceptions:

- US companies may pay a director's losses (including fines) in connection with a regulatory or criminal claim unless the act was intentional, fraudulent or wilful
- the director would generally not be required to repay the company any expenses advanced in connection with a criminal claim.

Compensation of directors and officers

In both the UK and the US, subject to conflict of interest considerations and directors' duties, the

boards of directors of public companies may determine the compensation of individual directors. Under the UK Code, a remuneration committee should be responsible for setting the remuneration of all executive directors and the chairman, and for recommending and monitoring the level and structure of remuneration for senior management. The board itself (or if required by the articles of association, the shareholders) should determine the remuneration of non-executive directors. It is common US practice, however, for the compensation committee of the board to determine the compensation of all directors for their service in such capacities.

In the UK and the US, compensation may include cash and equity. Unlike UK companies, US companies may make equity awards to both executive and non-executive directors for nil consideration (ie, directors are not required to pay the nominal value of the equity award).

In the UK, most employee share schemes and other long-term incentive schemes need to be approved by shareholders. Share options or other equity compensation for non-executive directors should also be approved by the shareholders. Similarly, NYSE Euronext and Nasdaq OMX listed companies must obtain shareholder approval of all equity remuneration plans in which directors and officers participate. Applicable UK and US laws require shareholder approval of significant/material revisions to such plans. NYSE Euronext provides a specific list of what are considered to be 'material revisions', which include, among others, an increase in the number of shares available for issuance under the plan, an extension of the term of the plan, and an expansion of the types of awards under the plan. In general terms, rules around 'golden parachutes' are more relaxed in the US than the UK, but shareholders in US companies would still, for instance, be entitled to vote on 'golden parachute' arrangements in connection with certain change-of-control transactions.

Most UK and US public companies must disclose in their annual report and accounts information on directors' remuneration. The directors' remuneration report required for UK listed companies is similar to the US requirement that companies disclose their directors' and executive officers' compensation and share ownership in a proxy statement or annual report filed by the company with the SEC. Similar to the requirements of a director remuneration report, US securities laws require a description of the company's compensation practices with respect to directors and officers, and a detailed discussion and analysis of the company's decisions and philosophy on compensation.

Regarding shareholder approval, the UK Code requires companies to submit a non-binding resolution to the shareholders for the approval of the directors' remuneration report. This is similar to the US requirement that gives US shareholders a non-binding vote on executive compensation.

Financial information

Both UK and US companies are required to publish annual and semi-annual financial reports. A UK listed company must publish its annual financial report with audited financials not later than four months after the end of each financial year. It must also publish a half-yearly financial report with unaudited financials covering the first six months of the financial year as soon as possible but, in any event, no later than two months after the end of the period to which it relates. A UK listed company that does not publish quarterly financial reports is currently required to release an interim management statement during the first six-month period of any financial year and also during the second six-month period.

US securities laws provide that US public companies are required to file with the SEC an annual report on Form 10-K with audited financials and other required company information within 60, 75 or 90 days of the company's fiscal year-end, depending on the size of the company. Quarterly reports with unaudited financials and other required company information must be filed with the SEC on Form 10-Q within 40 or 45 days after the end of each fiscal quarter, depending on the size of the company.

Foreign private issuers are required to file with the SEC annual reports on Form 20-F and semi-annual reports on Form 6-K, which generally require the disclosure of the information required by the issuer's jurisdiction of formation or domicile or the non-US stock exchange on which the company is listed with respect to the annual and semi-annual reporting of financial and other company information. The timing of the filing requirements differs for foreign private issuers filing Forms 20-F and 6-K from US issuers filing Forms 10-K and 10-Q. The annual report on Form 20-F must generally be filed within four months after a company's fiscal year-end, and the semi-annual report on Form 6-K must be filed promptly after the filing or publishing of the semi-annual financials pursuant to the issuer's jurisdiction of formation or domicile or non-US stock exchange requirements.

Acquisition and disposition of company shares

Neither UK nor US law requires a company's directors to own shares in the company. However, the laws of both countries impose restrictions on the acquisition and disposition of company shares owned by directors.

Where the company's shares are traded on the London Stock Exchange's Main Market or on AIM, UK insider trading laws would apply. These laws are similar to the US prohibition against a director or officer trading in company shares while in possession of material, non-public information about the company. In addition to applicable securities laws, US public companies typically have insider trading policies that regulate trading in company shares by their directors and officers.

Applicable UK law requires companies to restrict the times at which persons discharging managerial responsibility (PDMRs) and their connected persons can trade in their company's shares during a prohibited period (ie, during 'close periods' or any period where any matter exists that constitutes 'inside information'). Similarly, US securities laws provide that officers and directors may not trade in their company's stock during 'blackout' periods, which are periods designated by the company and typically coincide with a company's periodic earnings releases.

In the UK, the DTR require PDMRs of UK public companies and their connected persons to notify the company in writing of the occurrence of all transactions conducted on their own account in the shares of the company. In addition to the obligations under the DTR, the LR require the annual financial report of a listed UK company to contain details of the interests of the directors and their connected persons in the capital of the company, together with any change in those interests since the end of the relevant period.

Directors and officers of US public companies generally must make a filing with the SEC upon any acquisition or disposition of company shares. In addition, when a director or officer acquires more than 5 per cent of the company's shares, certain additional disclosures must be made.

US securities laws also provide restrictions on public resale of securities acquired by a director or officer. Rule 144 of the Securities Act 1933, as amended, allows the public resale of such securities if certain conditions are met, which include a six-month holding period and limitations

on the volume of securities to be sold and the manner of sale.

New issuances of shares

Under applicable UK law, shareholders generally have pre-emptive rights to acquire shares in connection with new issuances unless those rights have been disapplied by special resolution of the shareholders at a general meeting. Such disapplication must be limited in time to the length of the directors' general authority to allot shares (for cash or otherwise). UK law permits shareholders to disapply such rights for a period not to exceed five years. These pre-emptive rights also apply to non-UK companies with a Premium Listing on the Main Market.

Shareholders of most US public companies do not have pre-emptive rights to acquire company securities. These rights are typically either excluded as the default rule of most state laws, or are expressly limited or excluded in a company's certificate of incorporation. Subject to stock exchange and other limitations, a board of directors of a US company may issue shares without shareholder approval. For example, NYSE Euronext prohibits companies from issuing securities that will account for at least 20 per cent of the company's total voting securities without shareholder approval.

Treasury shares

There is a general rule prohibiting UK companies from acquiring their own shares. On- and off-market purchases by UK-incorporated listed public companies are permissible if carried out in accordance with the strict requirements of the Companies Act 2006 and the LR, which include obtaining shareholder consent, with certain additional limitations.

Subject to restrictions, a UK public company that is listed on the London Stock Exchange may acquire its own shares and hold them in treasury, unless the company's articles of association prohibit such shareholding or otherwise require any shares repurchased to be cancelled.

US law does not restrict a US company from acquiring and holding its shares. In fact, it is typical practice for US public companies to maintain treasury shares for several purposes, including for equity compensation awards, acquisitions and other corporate purposes.

問 責
Accountability.

Our work for a wide range of listed companies, regulators and stock exchanges means we are ideally placed to advise on best practice and trends in corporate governance.

"Excellent teamwork."
"Spectacular lawyers who are a pleasure to work with."

CHAMBERS ASIA, 2012

SLAUGHTER AND MAY
司力達律師樓

www.slaughterandmay.com

27. Comparison of UK and Hong Kong corporate governance considerations

Laurence Rudge and Benita Yu, Slaughter and May

This chapter considers the legal and regulatory framework of corporate governance in Hong Kong. It compares the UK and Hong Kong corporate governance codes and highlights key differences between the two regimes. It examines in particular the roles and responsibilities of the directors and the company secretary in relation to corporate governance, as well as the mandatory disclosures that a listed issuer must make in its annual report to shareholders. This chapter also comments on the particular additional issues for an issuer with shares listed in London and Hong Kong.

The Hong Kong Corporate Governance Code

The regulatory framework

The regulatory framework for the corporate governance regime in Hong Kong is set out in the Hong Kong Listing Rules. In addition to specific requirements relating to directors and board committees, Hong Kong listed issuers must have regard to the Corporate Governance Code (the HK Code), which is contained in Appendix 14 of the Hong Kong Listing Rules.

The HK Code sets out the principles of good corporate governance and two levels of recommendations in the form of Code provisions (CPs) and recommended best practices (RBPs). The HK Code is somewhat less detailed than the UK Corporate Governance Code (the UK Code) but there is still a lot of common ground and overlap with the UK regime.

The significance of a corporate governance requirement being a Listing Rule, CP or RBP is as follows:

Listing Rules

Corporate governance provisions in the Listing Rules are mandatory for all issuers, and breaches may lead to sanctions. As a general point, the Hong Kong Listing Rules do not currently have a statutory basis, so there are no civil or criminal sanctions for failure to comply; possible sanctions for non-compliance range from a private reprimand to public censure to the ultimate sanction of delisting.

Code provisions

A key principle of the corporate governance regime in Hong Kong is, as in the UK, that an issuer is allowed the flexibility to adopt the HK Code or, if it does not, to explain the reasons for that non-compliance in its corporate governance report to shareholders. If an issuer does not comply with a CP, it is not in breach of the Listing Rules and there is no sanction. However, a failure to explain non-compliance would constitute a breach. Issuers must state whether they have complied with the CPs for the relevant accounting period in their interim reports (and summary interim reports, if any) and annual reports (and summary financial reports, if any).

Recommended best practices

These are desirable best practices, and issuers are encouraged to comply with them. However, compliance is not mandatory and, if an issuer chooses not to comply, it does not need to explain why.

Differences between the HK Code and the UK Code

The HK Code contains CPs and RBPs relating to:

- directors
- remuneration of directors and senior management
- accountability and audit

- delegation by the board
- communication with shareholders
- the company secretary.

Although there is significant overlap between the HK Code and the UK Code, key differences include:

The board
The UK Code provides that the board should meet sufficiently regularly to discharge its duties effectively. This is a non-prescriptive 'qualitative' test. By contrast, the HK Code prescribes that board meetings must be held at least four times a year at approximately quarterly intervals. Notice of at least 14 days should be given of board meetings. The HK Code requires an issuer to maintain, both on its own website and on the Hong Kong Stock Exchange's website, an updated list of its directors identifying their role and function and whether they are independent non-executive directors.

Corporate governance functions
Since April 1, 2012, the HK Code has provided that the terms of reference of the board must include responsibilities in relation to the issuer's corporate governance policies. The board can delegate responsibility for performing its corporate governance duties to a committee.

Directors' time commitments
The HK Code provides that the board should regularly review the contribution of directors and whether they are devoting sufficient time to their duties. It is a CP that directors inform the issuer of any change to their significant commitments in a timely fashion.

Independent non-executive directors
The UK Code requires at least half the board to be independent non-executive directors (and that companies below the FTSE 350 have at least two independent non-executive directors). The HK Code currently requires a balanced composition of executive and independent non-executive directors so that there is a strong independent element on the board. However, the Hong Kong Listing Rules require at 3.10 that the board of directors include at least three independent non-executive directors.

Accountability and audit
The accountability and audit provisions of the HK Code are more detailed than those of the UK Code. For example, it is a CP that management provide all members of the board with monthly updates giving a balanced and understandable assessment of the issuer's performance, position and prospects. The UK Code requires the board to review the issuer's internal control systems annually and report to shareholders that they have done so. The HK Code goes further in prescribing that issuers include a narrative statement in the corporate governance report detailing how they have complied with internal control CPs during the reporting period. Since April 1, 2012, the HK Code has contained a provision similar to the UK Code that the audit committee's terms of reference include arrangements for employees to raise concerns about financial reporting improprieties.

The company secretary
Unlike the UK Code, the HK Code contains a specific section on the role and responsibilities of the company secretary. This provides that: the secretary should be an employee of the issuer; selection, appointment or dismissal of the company secretary should be a board decision; the company secretary should report to the chairman and/or chief executive; and all directors should have access to the advice and services of the company secretary.

Mandatory disclosures
The HK Code also sets out mandatory disclosure requirements and recommended disclosures for the corporate governance report that must be

included in a listed issuer's annual report and accounts. The mandatory disclosures include:

- the composition of the board, the number of board meetings held throughout the year and the attendance by each director
- how each director has complied with the HK Code's continual professional-development requirements
- details of the remuneration, nomination, audit and any corporate governance committees, including their composition and a summary of their work during the year
- information on auditors' remuneration
- any significant changes made to the issuer's constitutional documents during the year
- information on shareholders' rights, including the way to convene an extraordinary general meeting, and the procedures for sending enquiries to the board and for making proposals at shareholders' meetings.

Corporate governance obligations of dual-listed companies

General

As of September 2012, there were six companies that were listed on both the Main Market of the London Stock Exchange and the main board of the Hong Kong Stock Exchange. Dual-listed companies must have regard to both the UK and Hong Kong corporate governance regimes.

As noted elsewhere in this guide, the content of the UK corporate governance requirements is partly a function of whether the UK listing is a Standard Listing or a Premium Listing. The Hong Kong requirements are largely driven by whether the Hong Kong listing is primary or secondary. A dual primary listing is one where, in effect, the issuer seeks to treat each listing venue as a 'main' or 'principal' market. The alternative is to elect for a more limited status on one of the markets. So, in Hong Kong, a company with a primary listing on an overseas exchange can opt to join the Hong Kong market as an issuer with a 'secondary' listing.

Three of the six dual-listed companies have a dual primary listing, one has a primary listing in Hong Kong but a secondary listing in London, and two companies have a primary listing in London and a secondary listing in Hong Kong. The obligations on issuers with a secondary listing in Hong Kong are more limited than would be the case if that issuer had a primary listing in Hong Kong.

The Hong Kong Stock Exchange is also likely to be more open to considering reasoned requests for waivers from a secondary listing applicant, because the foundation for the waiver is often that the issuer is subject to equivalent, if not identical, requirements by reason of its primary listing elsewhere. For example, the trading group Glencore obtained waivers from the strict requirements of the HK Code when it listed in Hong Kong in 2010 — its primary listing being a Premium Listing in London, with Hong Kong being a secondary listing. However, issuers find a primary listing attractive because it allows them to seek inclusion in the Hang Seng Index, the main indicator of overall market performance in Hong Kong.

Corporate governance obligations

One of the key considerations for a company looking at a dual listing on the London and Hong Kong stock exchanges is what its continuous obligations will be as a Hong Kong listed company.

In our experience, it has not been unduly burdensome for these companies to comply with the corporate governance regimes in both the UK and Hong Kong. The following are the key areas where the Hong Kong corporate governance regime may be onerous for an issuer that already has its shares listed in London but is considering Hong Kong as an additional listing venue:

Management presence
Under Rule 8.12 of the Hong Kong Listing Rules, a new applicant for a primary listing must have a sufficient management presence in Hong Kong. This normally means that the issuer must have at least two executive directors who are ordinarily resident in Hong Kong.

However, it is possible to obtain a waiver from strict compliance with this requirement, which is otherwise one of the basic conditions for listing. The Hong Kong exchange produced a guidance letter for new applicants in 2009 (HKEx-GL9-09) setting out the conditions that it would ordinarily expect a waiver application to include. The letter stressed that decisions would be made on a case-by-case basis having regard to all the relevant facts and circumstances. The conditions specify the following arrangement for communication with the Hong Kong Stock Exchange, which is the rationale behind the management presence requirement:

- The new applicant's authorised representatives will act as the principal channel of communication with the Hong Kong Stock Exchange
- The authorised representatives should have means for contacting all directors promptly at all times as and when the Hong Kong Stock Exchange wishes to contact the directors on any matter
- Each director who is not ordinarily resident in Hong Kong possesses or can apply for valid travel documents to visit Hong Kong and can meet with the Hong Kong Stock Exchange within a reasonable period
- The compliance advisers will act as an additional channel of communication with the Hong Kong Stock Exchange
- Each director will provide their respective mobile phone numbers, office phone numbers, email addresses and fax numbers to the Hong Kong Stock Exchange.

Company secretary
The qualification requirements for the company secretary of a new applicant form another provision from which dual UK/HK-listed companies commonly seek a waiver. Rule 3.28 requires an issuer to appoint as its company secretary an individual who, by virtue of academic or professional qualifications or relevant experience, is, in the opinion of the Hong Kong Stock Exchange, capable of discharging the functions of a company secretary.

Note (1) to Rule 3.28 contains guidance on what the Hong Kong Stock Exchange would consider to be acceptable "academic or professional qualifications" — eg, being a Hong Kong qualified solicitor or a member of the Hong Kong Institute of Chartered Secretaries. Note (2) to Rule 3.28 explains what the Hong Kong Stock Exchange would regard as "relevant experience" — eg, familiarity with the Hong Kong Listing Rules and the securities law regime in Hong Kong, and participating in relevant training.

The Hong Kong Stock Exchange has in the past granted a waiver to certain dual UK/HK-listed issuers to allow the new applicant to appoint an assistant company secretary who possesses the relevant qualifications or experience. This enables the existing company secretary to continue in his/her current role in the home jurisdiction with assistance provided by the assistant company secretary to ensure compliance with the Hong Kong requirements.

When there is a change of company secretary or assistant company secretary, it is necessary to submit a fresh waiver application to the Hong Kong Stock Exchange.

Independence requirements for independent non-executive directors
Currently, the Hong Kong Listing Rules require that the board of directors include at least three

independent non-executive directors. The Hong Kong Stock Exchange can require an issuer to have a higher number of independent directors if, in the opinion of the Hong Kong Stock Exchange, the size of the board or other circumstances of the company justify it.

A new Rule 3.10A of the Hong Kong Listing Rules is due to come into effect from December 31, 2012 under which a minimum of one third of the board of directors should be independent.

Even though UK-listed companies would not have a problem satisfying the minimum number requirement for independent non-executive directors, a check still needs to be made to ensure the directors meet the Hong Kong independence criteria set out in Rule 3.13 of the Hong Kong Listing Rules. This rule sets out the factors that the Hong Kong Stock Exchange will take into account in assessing the independence of an independent non-executive director. None of these factors is necessarily conclusive, but independence is more likely to be questioned if, for example, the director:

- holds more than 1 per cent of the shares of the company
- is a director, principal or partner of a professional adviser that has within the past year provided services to any member of the issuer's group
- is or has been, within the last two years, connected with a director or substantial shareholder of the issuer.

The independence tests are ongoing requirements and so are relevant not only at the time of listing or at the time of the appointment of a new independent director. Each independent non-executive director must provide an annual confirmation of his/her independence to the listed issuer. For its part, the listed issuer must confirm in its annual reports that it has received such confirmation and say whether it still regards the directors as independent.

The Hong Kong Model Code

The last main area where dual UK/HK-listed issuers experience notable differences in the corporate governance regimes is in respect of the Hong Kong Model Code for Securities Transactions by Directors of a Listed Issuer, as set out in Appendix 10 of the Hong Kong Listing Rules.

The rationale for regulating securities transactions by directors is broadly the same in both the UK and Hong Kong. The difference arises, however, in the number and scope of exceptions from the general principle that directors should not transact in shares (a) when in possession of price-sensitive information and (b) during a close or 'blackout' period prior to the release of financial information.

For example, Hong Kong does not have an equivalent to the exception in paragraph 23 of the UK Model Code relating to trading plans. Paragraph 23 permits a director to deal in an issuer's securities during a close period if he/she has entered into a trading plan for the acquisition and/or disposal of those securities with an independent third party outside the close period.

Conclusion

There are differences between the corporate governance regimes in the UK and Hong Kong. However, the gap is narrowing. This is particularly so in light of the recent changes to the Hong Kong Listing Rules and the HK Code. Issuers and their directors and company secretaries will need to ensure that they are familiar with the recent changes, and that they take their continuous obligations into account when deciding whether to seek a primary or secondary listing on the Hong Kong Stock Exchange.

Author biographies

Author biographies

Baker & McKenzie LLP
Pennzoil Place, South Tower, 711 Louisiana, Suite 3400, Houston, Texas, USA 77002
Tel + 1 713 427 5000
Fax +1 713 427 5099
Web www.bakermckenzie.com

Other offices 69 offices worldwide

Bryce Linsenmayer
Partner, Houston, Texas
Email Bryce.Linsenmayer@bakermckenzie.com
Previously serving as head of the AIM Practice Group at Haynes and Boone LLP, Bryce Linsenmayer joined Baker & McKenzie's Houston office in July 2011. Mr Linsenmayer's practice focuses on securities law and mergers and acquisitions. He has represented private equity funds in their formation and acquisition programmes.

His experience includes representation of domestic and international public and privately held companies, primarily in the energy, environmental and high-tech industries. He routinely represents public and private clients in mergers, stock and asset acquisitions and divestures, and joint ventures, and regularly advises issuers and investment bankers in various public offerings, domestic and foreign private placements of debt and equity securities. He also handles general corporate planning and representation.

Mr Linsenmayer has been recognised as a leading practitioner in his field in the 'Texan Rising Stars' edition of *Texas Super Lawyers*.

Daniel Ro-Trock
Senior Associate, Houston, Texas
Email Daniel.Ro-Trock@bakermckenzie.com
Daniel Ro-Trock is a senior associate in the Houston office of Baker & McKenzie. He represents clients in a broad range of domestic and international business transactions. He is admitted to the State Bar of Texas.

Mr Ro-Trock's practice focuses on the areas of corporate and securities law, mergers and acquisitions — including equity and asset acquisitions and dispositions, inversion and re-domestication transactions, and public and private securities offerings — and the formation and financing of joint ventures. He prepares and reviews US Securities Act and US Exchange Act filings and counsels public companies regarding periodic reporting, corporate governance, proxy solicitation, and other requirements of the US federal securities laws.

Bank of America Merrill Lynch
2 King Edward Street, London EC1A 1HQ
Tel +44 20 7628 1000
Web https://corp.bankofamerica.com

Craig Coben
Head of Equity Capital Markets —
Europe, Middle East and Africa
Email craig.coben@baml.com

Craig Coben is one of Europe's most active equity capital markets bankers and has led some of the most important and innovative equity and equity-linked offerings in Europe in recent years. Under Mr Coben's leadership, Bank of America Merrill Lynch has won numerous industry accolades, including 'EMEA Equity House of the Year 2011' from *International Financing Review*. It also issued the widely praised 'A Set of Guiding Principles for IPOs' in July 2011.

Mr Coben is also currently chairman of the Equity Capital Markets division of the Association for Financial Markets in Europe.

Prior to working in ECM, Mr Coben served as law clerk to Judge Douglas Ginsburg on the United States Court of Appeals, District of Columbia Circuit, and practised securities and corporate law at Sullivan & Cromwell as a corporate lawyer.

He holds a Bachelor of Arts from Yale University and a Juris Doctor degree from Harvard Law School, and is fluent in Spanish, French, Italian and Portuguese.

Mr Coben is active in a wide range of philanthropic activities and is currently a member of the board of governors at Tower Hamlets College.

Oliver Holbourn
Managing Director, Head of ECM Syndicate —
Europe, Middle East and Africa
Email oliver.holbourn@baml.com

Oliver Holbourn has more than 12 years' industry experience, all acquired at Merrill Lynch and subsequently Bank of America Merrill Lynch.

Since 2007 he has been in charge of the syndicate function for the Equity Capital Markets business in Europe, the Middle East and Africa. During that time he has led the execution on around 200 equity and equity-linked transactions, raising total proceeds of more than US$300 billion.

He holds a BA in jurisprudence from Oxford University.

Boardroom Review Limited
12 Horbury Mews, London W11 3NL
Tel +44 20 7229 8365
Fax +44 20 7727 0779
Web www.boardroomreview.com

Dr Tracy Long
Founder
Email info@boardroomreview.com
Boardroom Review was founded in 2004 by Dr Tracy Long, and is a leader in the field of board evaluation: between 2004 and 2012, Dr Long conducted over 90 evaluations and 1,000 interviews with executive and non-executive directors, across plc, mutual, privately owned and public sector organisations.

Dr Long currently serves on the board of the UK government's Department for Culture, Media and Sport, where she is chairman of the audit and risk committee. She has served as an executive and a non-executive director on more than 20 UK listed and unlisted company boards, often as a shareholder or a shareholder representative, and is an Hon ARAM of the Royal Academy of Music.

Her doctoral research on the role of the non-executive director won the Keith MacMillan Prize for Research in 2005.

Chartis Europe Limited
The Chartis Building, 58 Fenchurch Street, London EC3M 4AB
Tel +44 20 7954 7000
Fax +44 20 7954 7001
Web www.chartisinsurance.com/uk

Grant Merrill
Chief Underwriting Officer
Email grant.merrill@chartisinsurance.com
Grant Merrill is chief underwriting officer, Commercial Institutions, Financial Lines for Chartis Europe, an AIG Group Company and a leading insurance organisation serving more than 70 million clients around the world.

Cobbetts LLP

70 Gray's Inn Road, London WC1X 8BT
Tel +44 161 833 3333
Fax +44 161 833 3030
Web www.cobbetts.com

Other offices Birmingham, Leeds, Manchester

Daniel O'Gorman

Partner
Email daniel.o'gorman@cobbetts.com

Daniel O'Gorman is a partner in Cobbetts' Corporate and Capital Markets team and advises quoted and private companies, investment banks and funds on a range of international and UK corporate transactions. He has particular expertise in public and private M&A, initial public offerings and other equity fundraisings. He also has wide experience of boardroom and shareholder issues and advising on corporate governance matters.

Mr O'Gorman is ranked as a "key individual" in the 2012 editions of the Chambers & Partners and *Legal 500* directories.

Shubhu Patil

Associate
Email shubhu.patil@cobbetts.com

Shubhu Patil is a senior associate in Cobbetts' Corporate and Capital Markets team and advises clients on public and private transactions, with a particular emphasis on corporate acquisitions and disposals and equity fundraisings. She advises clients on the UKLA Listing Rules, the Disclosure and Transparency Rules, the Prospectus Rules and the AIM Rules, as well as advising generally on corporate governance issues.

Ms Patil joined Cobbetts in 2012, having previously worked for six years at Addleshaw Goddard and Slaughter and May.

Covington & Burling LLP

265 Strand, London WC2R 1BH
Tel +44 20 7067 2000
Fax +44 20 7067 2222
Web www.cov.com

Other offices Beijing, Brussels, New York, San Diego, San Francisco, Silicon Valley, Washington DC

John Rupp

Partner
Email jrupp@cov.com

During his nearly 40 years at the firm, John Rupp has advised on compliance matters, including assisting companies in revising their compliance policies and procedures, and structuring and undertaking internal investigations involving trade control issues, bribery, money laundering and accounting irregularities.

Mr Rupp routinely interacts with senior enforcement officials in multiple jurisdictions on anti-bribery and money laundering matters. He has also written extensively on such issues.

Earlier in his career, Mr Rupp spent several years at the US Department of Justice. More recently, he has chaired several international anti-bribery conferences, presented extensively at such conferences and taught courses on anti-bribery and money laundering issues.

Robert Amaee

Of Counsel
Email ramaee@cov.com

Robert Amaee advises companies and individuals on issues arising under the UK Bribery Act, the US Foreign Corrupt Practices Act and various country-specific anti-corruption laws, as well as proceeds-of-crime matters. This work includes conducting risk assessments, helping design and strengthen compliance programmes, developing and delivering tailored training programmes, leading internal investigations, and, when necessary, interacting with enforcement authorities.

Dr Amaee is the former Head of Anti-Corruption

and Head of Proceeds of Crime at the UK Serious Fraud Office. He also served as the SFO's Head of International Assistance and represented the SFO on the Attorney General's Working Group on the prosecutors' guidance to the Bribery Act, and the OECD Prosecutors' Forum.

Dr Amaee led the negotiations that resulted in civil settlements in the cases of Johnson & Johnson/De Puy International, MW Kellogg/KBR and Macmillan Publishers.

Prior to joining the SFO, Dr Amaee practised as a criminal barrister. He is an accomplished litigator, having prosecuted and defended clients in the UK criminal courts. He also has a wealth of practical business experience, having worked for over seven years in business development roles across Europe, the Middle East and Africa for US-headquartered organisations.

Dr Amaee holds a PhD in medical research and a degree in biological sciences.

Ian Redfearn
Associate
Email iredfearn@cov.com
Ian Redfearn is an associate in the Dispute Resolution Practice Group of the firm's London office. Mr Redfearn's practice encompasses a range of contentious and quasi-contentious matters, including arbitral proceedings and internal corporate investigations. He also advises clients on the design, implementation and evaluation of global compliance programmes.

Davis Polk & Wardwell London LLP
99 Gresham Street, London EC2V 7NG
Tel +44 20 7418 1300
Fax +44 20 7418 1400
Web www.davispolk.com

Other offices New York, Menlo Park, Washington DC, Sao Paulo, Paris, Madrid, Tokyo, Beijing, Hong Kong

Simon Witty
Partner, London
Email simon.witty@davispolk.com
Simon Witty is a partner in Davis Polk's Corporate Department, practising in the London office. His practice focuses on public and private securities offerings, listed public company matters and mergers and acquisitions. He is listed as one of London's leading equity capital markets lawyers in several legal industry publications, and has been in the top tier of rankings in the past four editions of *Chambers UK*.

Sapna Dutta
Associate, London and New York
Email sapna.dutta@davispolk.com
Sapna Dutta is an associate in Davis Polk's Corporate Department, practising in the firm's London and New York offices. Her practice includes a range of international capital markets offerings, public and private mergers and acquisitions, and other strategic corporate transactions. She also advises US and non-US companies on corporate governance, securities law compliance and other corporate matters.

ENVIRON International Corp
Box House, Box, Wiltshire SN13 8AA
Tel +44 1225 748 420
Fax +44 1225 748 421
Web www.environcorp.com

Other offices ENVIRON has dozens of offices serving clients throughout the world. Please visit the website to find a location.

Lisa Nelowet Grice, CIH
Sustainability Practice Leader,
Denver, Colorado, USA
Email lgrice@environcorp.com
ENVIRON's practice leader for sustainability, Lisa Grice is an internationally known expert in sustainability and greenhouse gas (GHG) management. She has more than 25 years' experience advising private companies and industry associations in extraction, manufacturing, retail, media and entertainment, construction, transport and services sectors.

She has advised at board level, with environment departments and with public affairs and communications divisions on developing, implementing and communicating sustainability strategies.

Her expertise is in grounding strategic objectives with tactical deployment, engaging technical practices as far-ranging as life-cycle assessment, water accounting and efficiency, and other elements. Prior to joining ENVIRON as a principal, she was a vice president at CH2M HILL, where she led the Sustainability and GHG Management Services market segment.

F&C Investments
Exchange House, Primrose Street, London EC2A 2NY
Tel +44 20 7628 8000
Web www.fandc.com

Karina Litvack
Director, Head of Governance and Sustainable Investment (GSI)
Email Karina.Litvack@fandc.com
Karina Litvack joined F&C Investments in 1998. She leads the GSI team, which undertakes shareholder engagement and voting for F&C's £100 billion in assets (as of December 31, 2011) in internally managed funds and on behalf of over 20 investment institutions whose assets total a further £59 billion.

Prior to joining F&C, Ms Litvack managed the redevelopment of derelict inner-city properties for the City of New York and worked for Paine Webber in corporate finance and private debt placements. She started her career as a foreign exchange analyst at the global commodities company Continental Grain.

Ms Litvack represents F&C at: the London Stock Exchange Primary Markets Group; the board of directors of the Revenue Watch Institute, sponsored by the Open Society Institute; the Sustainable Development Advisory Panel at Lafarge; the Sustainable Development Advisory Panel at SAP; the Independent Advisory Panel of the Access To Nutrition Index; and the Transparency International-UK Advisory Council.

She has previously served on: the Sustainable Development Advisory Panel of Veolia; the Association of British Insurers' Investment Committee; the board of the Extractive Industries Transparency Initiative; the Transparency International Steering Group on Business Principles for Combating Bribery; the Corporate Leaders Group on Climate Change, commissioned by the UK prime minister to advise on climate change policy; the ExxonMobil Independent Advisory Panel; and the Independent Advisory

Panel of the International Petroleum Industry Environmental Conservation Association.

Ms Litvack holds an MBA in finance and international business from Columbia University Graduate School of Business, a BA in political economy from the University of Toronto, and a diploma in Italian Translation and Interpretation from the UK's Royal Society of Linguists.

Eugenia Unanyants-Jackson
Associate director
Email Eugenia.Unanyants-Jackson@fandc.com
Eugenia Unanyants-Jackson joined F&C in 2010. Her responsibilities include corporate governance and business ethics engagement, policy development and proxy voting.

Prior to joining F&C, Ms Unanyants-Jackson worked for Governance for Owners as stewardship services manager, responsible for governance and engagement analysis, policy development and client reporting; for Manifest Information Services as a policy analyst; and for Pension Investments Research Consultants (Pirc) as a researcher. She also produced a report on corruption practices in the road infrastructure and transport sector of Georgia for the Transnational Crime and Corruption Center.

Ms Unanyants-Jackson has a Masters degree in public administration from the Georgian Institute of Public Affairs, a diploma with honours in English and German from Tbilisi State Institute of Western Languages and Culture, and the CFA UK Level 3 certificate in investment management. She is fluent in English and Russian.

Financial Reporting Council
Aldwych House, 71-91 Aldwych, London WC2B 4HN
Tel +44 20 7492 2300
Fax +44 20 7492 2301
Web www.frc.org.uk

Chris Hodge
Director of Corporate Governance
Email c.hodge@frc.org.uk
The Financial Reporting Council is the UK regulator responsible for promoting high-quality corporate governance and reporting. Chris Hodge is responsible for updating and monitoring the effectiveness of the UK Corporate Governance Code, which sets governance standards for companies listed in the UK, and for related guidance to boards on topics such as risk management and internal control and the role of audit committees.

Mr Hodge chairs the European Corporate Governance Codes Network, a group of organisations responsible for their national corporate governance codes in European Union countries.

Freshfields Bruckhaus Deringer LLP
65 Fleet Street, London EC4Y 1HS
Tel +44 20 7936 4000
Fax +44 20 7832 7001
Web www.freshfields.com
Other offices Austria, Bahrain, Belgium, China, France, Germany, Hong Kong, Italy, Japan, Netherlands, Russia, Saudi Arabia, Spain, UAE, US, Vietnam

Vanessa Knapp OBE
Principal Consultant, London
Email vanessa.knapp@freshfields.com
Vanessa Knapp is a principal consultant in the firm's London office. She specialises in company law and corporate governance. She was a member of the European Commission's expert advisory group on corporate governance and company law and of the reflection group set up by the European Commission on company law. She was awarded an OBE for services to corporate law in 2007.

Glass, Lewis & Co LLC
One Sansome Street, Suite 3300,
San Francisco, CA 94104, USA
Tel +1 415 678 4228
Fax +1 415 357 0200
Web www.glasslewis.com

Other offices New York, Washington DC, Australia, Ireland

Robert McCormick
Chief Policy Officer
Email rmccormick@glasslewis.com
Robert McCormick oversees the analysis of 20,000 research reports on shareholder meetings of public companies in 100 countries. Before joining Glass Lewis, he was the director of investment proxy research at Fidelity Investments, where he managed the proxy voting of over 5,000 global securities worth in excess of US$1 trillion.

Mr McCormick serves on the board of the Northern California Chapter of the National Association of Corporate Directors and the Shareholder Rights Committee of the International Corporate Governance Network. He frequently speaks at industry conferences and has appeared on NPR, CNBC, Fox Business News, Business News Network, the BBC, Swiss TV, CBC and Bloomberg television.

Mr McCormick was named one of the 100 most influential people on corporate governance by *Directorship* magazine from 2008 through 2011. He was a panellist on the Public Consultation on Corporate Governance and the Financial Crisis at the OECD.

Herbert Smith LLP
Exchange House, Primrose Street, London EC2A 2HS
Tel +44 20 7466 2013
Web www.herbertsmith.com

Other offices Abu Dhabi, Bangkok, Beijing, Belfast, Brussels, Doha, Dubai, Hong Kong, Jakarta, Madrid, Moscow, Paris, Saudi Arabia, Shanghai, Singapore, Tokyo

Carol Shutkever
Partner, London
Email carol.shutkever@herbertsmith.com
Carol Shutkever is a partner in the firm's Corporate Division. She has wide experience of corporate and commercial transactions, equity fundraising, takeovers and financial services regulation. She now concentrates on providing technical advice on company and corporate finance law issues, analysing new law and regulation and ensuring that the firm is at the forefront of corporate law and practice.

Ms Shutkever is a graduate of Cambridge University. She is a member of a number of working parties of the Law Society Company Law Committee. She led the Companies Act 2006 team within Herbert Smith, including providing education and know-how for the firm and its clients and analysing the Act's practical implications for companies. Ms Shutkever is a member of the advisory board for *Gore-Browne on Companies* and a contributor to *Buckley on the Companies Acts*.

Hill + Knowlton Strategies
222 Merchandise Mart Plaza, Suite 275, Chicago, Illinois 60654, USA
Tel +1 312 255 3129
Web www.hkstrategies.com

Other offices 85 offices in 46 countries

Claire Koeneman
Executive Vice President, Chicago
Email Claire.Koeneman@hkstrategies.com
Claire Koeneman has focused her career on helping public and private companies achieve their strategic, financial and business goals. She is known for her sophisticated c-suite advice, refined people skills, deep expertise in investor relations, and financial and corporate communications. Additionally, she is a leading spokesperson for the industry, quoted frequently in the financial and trade press.

Ms Koeneman brings nearly 20 years' expertise to Hill & Knowlton. She serves as a strategic adviser to chief executives and boards of directors on all types of capital markets issues, including corporate positioning, shareholder activist challenges, crisis communications and management changes.

Throughout her career, she has counselled dozens of companies facing difficult situations, and worked to craft proactive stakeholder communications.

Hill + Knowlton Strategies
607 14th Street, NW Suite 300, Washington DC 20005, USA
Tel +1 202 333 7400
Web www.hkstrategies.com

Robert Ludke
Senior Vice President, Washington DC
Email Robert.Ludke@hkstrategies.com

Robert Ludke provides strategic public affairs, media relations and messaging counsel for a variety of national and international clients in financial services, energy, international trade, sustainability and other areas.

Mr Ludke's recent work on behalf of the firm's clients includes: working with industry experts to develop and implement 'best in class' practices to help clients operate in a more sustainable manner while strategically communicating information about key performance metrics to public audiences; leading the public affairs efforts on a number of major domestic and international mergers and acquisitions; and assisting a variety of clients in expanding their relationships with environmental, public health and corporate governance organisations.

He also is the leader of the team that provides strategic communications counsel to one of the world's most prominent and successful precious metal investors, successfully securing profiles in media outlets such as *The Wall Street Journal*, *Bloomberg BusinessWeek* and *Forbes*.

International Corporate Governance Network
16 Park Crescent, London W1B 1AH
Tel +44 20 7612 7098
Fax +44 20 7612 7047
Web www.icgn.org

Michelle Edkins
Chairman of the Board of Governors
Email michelle.edkins@icgn.org

Michelle Edkins is chairman of the Board of Governors of the International Corporate Governance Network (ICGN). She is also the head of BlackRock's Corporate Governance and Responsible Investment team, which is responsible for engagement with companies on a range of governance issues that affect long-term shareholder value.

The ICGN has over 600 members in 50 countries; its investor members manage assets with a combined value of over US$18 trillion. The membership also includes practitioners from the corporate sector, the advisory professions, regulatory and policymaking bodies and academia.

The ICGN's mission is to promote high standards of corporate governance worldwide through influencing public policy through regulatory engagement and best practice guidance; connecting members to exchange corporate governance perspectives; educating market participants on integrating environmental, social and governance (ESG) information into investment decision-making; and informing members on emerging issues via a blog, the ICGN Yearbook, conferences and newsletters.

Linklaters LLP
One Silk Street, London EC2Y 8HQ
Tel +44 20 7456 2000
Fax +44 20 7456 2222
Web www.linklaters.com

Other offices Linklaters has 27 offices in 19 different countries

John Lane
Partner, London
Email john.lane@linklaters.com
John Lane is a partner in the Corporate Department of Linklaters in London. He specialises in equity capital markets transactions, having done so for over 19 years while based in London. He has extensive experience of equity capital raisings and international public M&A transactions. Recently, he has advised both issuers and underwriting banks on primary and secondary equity capital raisings on the London Stock Exchange.

Lucy Fergusson
Partner, London
Email lucy.fergusson@linklaters.com
Lucy Fergusson is a partner in the London office of Linklaters with over 25 years' experience of advising companies and banks on equity capital raisings, public M&A, corporate governance and general corporate law issues.

She is a member of the Law Society Company Law Committee, the City of London Law Society Company Law Committee and the Confederation of British Industry Companies Committee.
Ms Fergusson frequently writes and presents on topics related to listing requirements, securities regulation and corporate governance developments.

London Stock Exchange Group
10 Paternoster Square, London EC4M 7LS
Tel +44 20 7797 3429
Web www.londonstockexchange.com

Alastair Walmsley
Director, Equity Primary Markets
London Stock Exchange
Email
ukcompanyservices@londonstockexchange.com

Alastair Walmsley joined London Stock Exchange Group in June 2012 as head of Primary Capital Markets with responsibility for all companies listing on the group's exchanges.

Prior to joining the LSE Group, Mr Walmsley was a founder member of the Corporate Broking team at Morgan Stanley, where he spent seven years advising listed UK and international companies on all aspects of their interaction with the equity markets. His clients spanned a wide spectrum of industry sectors, geographies and market capitalisations, and he advised on day-to-day issues, equity capital raisings and a variety of M&A transactions. Mr Walmsley began his career at Merrill Lynch, where he worked in the Equity Capital Markets department between 1999 and 2004.

Mr Walmsley has a degree in modern and medieval languages from Cambridge University and is a member of the Overseas Promotion Committee at TheCityUK and of the Listing Authority Advisory Committee.

Patterson Associates LLP (a Pearl Meyer & Partners practice)
Clifford House, 15 Clifford Street, London W1S 4JY
Tel +44 20 3384 6711
Fax +44 20 7287 8944
Web www.pattersonassociates.co.uk, www.pearlmeyer.com

Other Pearl Meyer & Partners offices
New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles, San Francisco and San Jose

Simon Patterson
Managing Director
Email simon@pattersonassociates.co.uk
Simon Patterson manages the London office and is a member of Pearl Meyer's Operating Committee.

Mr Patterson was a worldwide partner in Mercer's London office and co-founded SCA Consulting in Europe. Patterson Associates is focused on delivering business results by linking remuneration and reward systems to business needs.

Fiona Bravery
Senior Associate
Email fiona@pattersonassociates.co.uk
Fiona Bravery is a senior associate with Patterson Associates and has worked with a variety of clients in the UK, continental Europe and the Middle East, focusing on development of tailored incentive compensation programmes.

In 2012, Patterson Associates was acquired by US firm Pearl Meyer & Partners (PM&P), an independent compensation consultancy of over 20 years' standing. PM&P serves as a trusted adviser to boards and their senior management in the areas of governance, strategy and compensation programme design.

Ms Bravery has previous experience in operations management and financial planning/analysis within the food industry, as well as five years as a strategy and supply chain consultant, working within the retail and consumer goods market. She graduated with a Masters in engineering from Cambridge University.

Pinsent Masons LLP
30 Crown Place, London EC2A 4ES
Tel +44 20 7418 7000
Fax +44 20 7418 7050
Web www.pinsentmasons.com
Other offices Aberdeen, Belfast, Birmingham, Edinburgh, Glasgow, Leeds, Manchester, Beijing, Doha, Dubai, Falklands, Hong Kong, Munich, Paris, Shanghai, Singapore

Martin Webster
Partner, London
Email martin.webster@pinsentmasons.com
Martin Webster has practised as a corporate lawyer for 30 years, acting for both Main Market and AIM companies. He heads the firm's Corporate Governance unit, advising companies and their boards on governance and other compliance concerns. He has acted as a 'skilled person' under Section 166 of the Financial Services and Markets Act, reporting on board effectiveness issues.

Mr Webster is the editor and lead author of *The Director's Handbook*, the Institute of Directors' guide to a director's duties, responsibilities and liabilities (3rd edition, May 2010). He regularly works with boards and senior management as a facilitator and trainer on all aspects of corporate compliance and governance.

PricewaterhouseCoopers LLP
1 Embankment Place, London WC2N 6RH
Tel +44 20 7583 5000
Fax +44 20 7822 4652
Web www.pwc.co.uk

John Patterson
Consultant, Assurance Risk & Quality, London
Email john.t.patterson@uk.pwc.com
John Patterson works in a consultant role on corporate governance matters within the Assurance Practice of PwC, providing advice and updates on corporate governance developments to client management and boards as well as to PwC teams. He has 15 years' experience with UK public companies, including AIM, small cap and mid tier organisations.

Much of Mr Patterson's work focuses on the reporting of corporate governance, and he has contributed to a number of PwC's publications on corporate reporting. He has also developed the firm's responses to consultations from the Financial Reporting Council, the UK government and the European Commission, including revisions to the FRC's UK Corporate Governance Code.

Alpesh Shah
Director, Actuarial Risk Practice, London
Email alpesh.shah@uk.pwc.com
Alpesh Shah is a director in PwC's Actuarial Risk Practice. He has over 13 years' experience working with a variety of insurance companies, public sector organisations and private sector companies, advising on a variety of insurance and risk management related issues.

Mr Shah has a focus on providing advice to a range of clients on the development and implementation of effective risk management processes. He has supported clients in defining corporate risk appetite, identifying and quantifying high-impact risks and developing effective mitigation mechanisms, including the use of insurance and alternative risk transfer techniques.

Quoted Companies Alliance
6 Kinghorn Street, London EC1A 7HW
Tel +44 20 7600 3745
Fax +44 20 7600 8288
Web www.theqca.com

Tim Ward
Chief Executive

Email Tim.Ward@theqca.com

Tim Ward is chief executive of the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. His past roles have included head of issuer services at the London Stock Exchange, finance director at FTSE International, the index company, and various management roles at a smaller quoted company.

Rothschild
New Court, St Swithin's Lane, London EC4N 8AL
Tel +44 20 7280 5000
Web www.rothschild.com

Other offices in 40 countries worldwide

Adam Young
Global Head of Equity Advisory

Email adam.young@rothschild.com

Adam Young has been with Rothschild since 1998. In 2008 he founded Rothschild's equity advisory business, now the most active global independent adviser on equity offerings.

Prior to this, Mr Young was chief executive of ABN Amro Rothschild, the two firms' previous equity capital markets joint venture.

He has 27 years' experience in equity offerings of all types across 20 equity markets, and has run teams in London, New York and Hong Kong.

Sarah Blomfield
Director, Specialist Advisory

Email sarah.blomfield@rothschild.com

Sarah Blomfield is a qualified lawyer and joined Rothschild in 2001. She is Head of the Specialist Advisory team and a member of the UK Risk Committee.

She advises on a range of transactions from pitch to execution, specialising in on-market M&A and capital markets including the UK Takeover Code, Listing and Disclosure Rules and financial regulation.

Ms Blomfield is also responsible for formulation and implementation of global best practice and lectures on corporate governance.

Shepherd and Wedderburn LLP
Condor House, 10 St Paul's Churchyard, London EC4M 8AL
Tel +44 20 7429 4900
Web www.shepwedd.co.uk
Other offices Edinburgh, Glasgow, Aberdeen

Walter Blake
Partner, London
Email walter.blake@shepwedd.co.uk
Walter Blake is a corporate partner based in the firm's London office. He has acted on numerous corporate transactions, including IPOs, secondary issues and M&A, involving UK and international companies. His clients include corporates from a range of industry sectors, as well as a number of investment banks.

As part of his role, Mr Blake regularly advises companies and boards on corporate governance issues.

Slaughter and May
One Bunhill Row, London, EC1Y 8YY
Tel +44 20 7600 1200
Fax +44 20 7090 5000
Web www.slaughterandmay.com

Frances Murphy
Partner, London
Email frances.murphy@slaughterandmay.com
Frances Murphy heads the Corporate practice at Slaughter and May, a leading international law firm headquartered in the City of London. She advises corporate clients generally on day-to-day corporate and corporate governance matters. She also acts for corporate clients and investment banks, on corporate finance and M&A transactions, both in England and overseas. She has wide experience of mergers and takeovers, private acquisitions and disposals, joint ventures, restructurings, demergers, and equity and debt financing structures.

She has been named as "highly regarded" in *The International Who's Who of Corporate Governance Lawyers* in 2011 and 2012, and has spoken on corporate governance in M&A at international seminars. Ms Murphy, a partner at the firm since 1990, is listed as a leading individual in the M&A section of *The Legal 500*, 2011, and in the Corporate/M&A: High-end Capability section in *Chambers UK*, 2012, and *Chambers Europe*, 2011. She is also mentioned for Corporate/M&A in *Chambers Global*, 2012. Ms Murphy was awarded 'Best in mergers & acquisitions' at *International Financial Law Review*'s 'Euromoney LMG Europe Women in Business Law Awards', 2012.

Ms Murphy is a vice-chair of the International M&A Joint Venture Committee of the Section of International Law of the American Bar Association.

She also chairs Network for Knowledge, a City-wide forum for women in the legal and compliance fields, and is a trustee of the National Foundation for Educational Research and a member of the Law School Advisory Board at the University of Sheffield.

She holds an LLB (Hons) and an honorary LLD from the University of Sheffield.

Padraig Cronin
Partner, London
Email padraig.cronin@slaughterandmay.com
Padraig Cronin is a partner in the firm's Corporate team, with a broad practice covering public and private mergers and acquisitions, equity capital markets and private equity.

A partner since 2001, he has recently returned to London from the firm's Hong Kong office where highlights included advising:

- Prudential on: its proposed US$35.5 billion merger with AIA Group, and the sale of its agency distribution insurance business in Taiwan
- GE Capital on the sale of its Hong Kong consumer mortgage and personal loans business
- Cazenove on its investment banking joint venture with JP Morgan Chase, and JP Morgan Cazenove on the subsequent disposal of Cazenove Asia to Standard Chartered Bank
- Stark Investments on a series of structured finance investments in the PRC, Indonesia and Australia.

Mr Cronin is listed as a leading individual in the Corporate/M&A section of *Chambers Global*, 2012.

Slaughter and May
47th Floor, Jardine House,
One Connaught Place, Central Hong Kong
Tel +852 2521 0551
Fax +852 2845 2125
Web www.slaughterandmay.com

Laurence Rudge
Partner, Hong Kong
Email laurence.rudge@slaughterandmay.com
Laurence Rudge has been involved in a wide range of transactions in the corporate, capital markets and financing fields, and has worked on business and share acquisitions, takeovers, listings, loan transactions, bond issues, debt issuance programmes and general corporate advisory work.

Mr Rudge is listed as a leading individual in the Hong Kong 'Mergers and Acquisitions' and China 'Mergers and Acquisitions – Foreign Firms' sections of *IFLR 1000*, 2012, and in the China 'Capital Markets: Debt (International Firms)' section of *Chambers Asia*, 2012.

Mr Rudge recently advised Prada on its US$2.14 billion IPO and listing on the Hong Kong Stock Exchange and CIMB Group on its acquisition of Asian businesses from RBS.

Benita Yu
Partner, Hong Kong
Email benita.yu@slaughterandmay.com
Benita Yu has substantial experience in securities transactions, including cross-border listings and share offerings by overseas corporations and PRC state-owned enterprises, corporate finance transactions, mergers and acquisitions, and joint ventures. She also advises on banking and international debt securities transactions.

Ms Yu is qualified in Hong Kong and English law, and speaks fluent English, Mandarin and Cantonese. She is a member of the Takeovers and Mergers Panel and the Takeovers Appeal Committee in Hong Kong.

Highlights of her work include advising the underwriters on the Hong Kong IPO of

Alibaba.com (raising US$1.5 billion), Bank of Communications (raising US$1.8 billion) and Fosun International (raising US$1.7 billion), and the dual/triple listings and global offerings of Sinopec, China Unicom and Aluminum Corporation of China (raising between US$450 million and US$5.6 billion). She also advised the sole global co-ordinator and the joint sponsors, joint bookrunners and joint lead managers on the US$3.1 billion global offering and listing on the Hong Kong Stock Exchange of China Pacific Insurance.

The Zygos Partnership
15 Sloane Square, London SW1W 8ER
Tel +44 20 7881 2900
Fax +44 20 7881 2901
Web www.zygos.com

Laura Sanderson
Associate Partner
Email laura@zygos.com

Laura Sanderson is an associate partner with The Zygos Partnership. She specialises in chairman and non-executive director searches.

Ms Sanderson has 10 years' experience of board advisory work, having previously worked with a boutique executive search and consultancy firm, providing chairmen with strategic advice on a range of issues, including corporate governance.

Ms Sanderson has an MA in English and an MPhil in medieval and renaissance literature from Cambridge University, where she was awarded three scholarships.

Julia Budd
Founding Partner
Email julia@zygos.com

Julia Budd is a founding partner of The Zygos Partnership. She specialises in chairman, chief executive and non-executive director searches and board succession planning.

Ms Budd was previously with Egon Zehnder International for 15 years. There she ran the board practice, focusing on chairman and non-executive director appointments. Before that, she was a senior consultant with Bain & Company. In 2012 she was appointed to the board of the Jockey Club.

Ms Budd served as a non-executive director of Wilson Connolly, until its agreed takeover by Taylor Woodrow, and was a member of the committee that produced the government-commissioned Tyson Report (2003), exploring how a broader range of non-executive directors could be identified and recruited.

She has a BA in experimental psychology with statistics from Oxford University and an MBA from INSEAD.

Glossary of terms and useful sources

Action Plan The first steps taken by the European Commission (EC), in 2003, to establish a harmonised approach to corporate governance across the European Union (EU).

Active managers Investment funds that use analytical research and the judgement of investment professionals to buy and sell shares in specific sectors or individual companies with the aim of outperforming a stock market index.

AIM The London Stock Exchange's international market for smaller, growing companies. Businesses on AIM operate under a more flexible regulatory environment than the Main Market of the Exchange.

AIM Rules for Companies The regulations and responsibilities applying to companies on AIM.

Boiler-plate In the context of compliance with the UK Corporate Governance Code, the term 'boiler-plate' describes governance statements that simply tick boxes to signal compliance, rather than demonstrating a company's commitment to transparency about aspects such as the business model, strategy, risk management, performance and remuneration.

The Cadbury Report A forerunner of the UK Corporate Governance Code, the report was produced in 1992. Among its recommendations were that the roles of chairman and chief executive should be separated, and that boards should have at least three non-executive directors.

Capital Requirements Directive Introduced by the EC in 2006 to combat excessive risk in the EU financial services industry and to protect consumers' savings. A revised directive, scheduled for implementation on January 1, 2013, is seeking to improve corporate governance through provisions for risk and remuneration committees, and an independent risk management function, in some companies.

Carbon Disclosure Project A non-profit organisation that promotes sustainability governance and works with companies and investors to reduce greenhouse gases and improve the disclosure of environmental information.

Committee of Sponsoring Organizations of the Treadway Commission (COSO) A joint initiative by five financial and accounting organisations in the US, the COSO provides guidance to companies on managing risk.

Companies Act 2006 The Act is the primary source of UK company law and was introduced in phases, with implementation being completed in 2009. Among other provisions, it codified what used to be common law principles, such as those related to directors' duties.

Company Reporting Directive The EU law, enacted in 2006, requiring all companies whose securities are admitted to trading on a regulated market to include a corporate governance statement as a specific section in their annual report.

Corporate Governance Guidelines for Smaller Quoted Companies Published by the Quoted Companies Alliance, the guidelines are designed for the needs of growing businesses for which the principles of the UK Corporate Governance Code may not be entirely relevant.

Corporate social responsibility (CSR) A form of self-regulation and best practice, under which companies are encouraged to use CSR reports to explain the social and environmental effects of their activities, as well as their impact on stakeholders, such as local communities, and their adherence to ethical standards.

D&O liability insurance Policies that provide protection for a company's directors and officers in the event of legal claims being brought against them by shareholders or other parties for alleged wrongful acts.

The Directors' Remuneration Report Regulations 2002 The requirement for companies listed in the UK to disclose the remuneration of all their executive directors.

Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 Passed in the US in response to the financial crisis, the Act tightened the regulation of financial markets and strengthened the protection of investors and consumers though measures such as incentives for whistleblowers where companies commit violations.

Enterprise and Regulatory Reform Bill 2012-2013 One of the provisions of this proposed UK law, still pending at the time of going to press, is a reform to the Companies Act that would give shareholders a binding vote on executive remuneration.

Enterprise risk management ERM provides a framework in which companies can tailor approaches to risk based on their own circumstances.

ESG The benchmarks of environmental, social and governance performance by which investors evaluate corporate behaviour.

Financial Reporting Council (FRC) The FRC is the UK regulator responsible for promoting high-quality corporate governance and reporting.

Financial Services Authority (FSA) The City of London's financial regulator, the FSA is being disbanded and its functions taken over by a new Financial Policy Committee, Prudential Regulation Authority and Financial Conduct Authority. In its capacity as a securities regulator, the FSA is known as the UK Listing Authority and has made and enforces the Listing Rules, the Prospectus Rules and the Disclosure and Transparency Rules.

GC100 An association comprising the legal officers of Britain's biggest companies.

Global Reporting Initiative A non-profit organisation that promotes economic, social and environmental sustainability and provides reporting guidance to companies around the world.

General Corporation Law of the State of Delaware The source of corporate law in Delaware, where more than 50 per cent of US public companies are incorporated.

The Higgs Report An independent review of the role and effectiveness of non-executive directors, published in 2003.

International Integrated Reporting Council (IIRC) A grouping of representatives from across the corporate, investment, accounting and regulatory sectors, the IIRC exists to promote harmonised reporting that encompasses a company's financial performance and non-financial governance measures such as CSR and the environment.

Main Market The London Stock Exchange's market for larger, established companies.

Model Code An annex in the Listing Rules, the Code is designed to combat insider dealing in companies by placing restrictions on securities dealing by 'persons discharging managerial responsibilities'.

Nomad A firm approved by the London Stock Exchange as a nominated adviser to support companies during the admission process and throughout their life on AIM.

Passive managers Investment funds that track the performance of stock market indices rather than switching in and out of specific shareholdings according to performance.

Premium Listing The segment of the Main Market available to issuers that meet the highest UK standards of regulation and corporate governance.

Regulatory information services Newswires officially authorised by the FSA to relay company announcements to investors.

'Say on pay' The right of shareholders to vote on the remuneration of a company's executives. The outcome of this vote is not binding, though at the time of going to press, that was subject to change pending the enactment of the relevant provisions in the Enterprise and Regulatory Reform Bill.

Sharman Inquiry An investigation launched by the FRC in 2011 with the aim of identifying lessons for companies and auditors addressing going-concern and liquidity risks.

Standard Listing The section of the Main Market where companies need only comply with EU minimum requirements for listing.

Turnbull Guidance Recommendations on internal controls and risk management for UK-listed companies—published by the FRC.

Turner Review A report on banking regulation produced in 2009 in the aftermath of the financial crisis. Among its recommendations was that remuneration policies should be designed to avoid incentives for undue risk-taking.

UK Corporate Governance Code The Code, first issued in 1992 and overseen by the FRC, is a set of principles of best practice in areas such as board composition, risk management and remuneration. Companies with a Premium Listing on the London Stock Exchange are expected to comply with the provisions of the Code or explain where and why they have not done so.

UK Stewardship Code Good practice, published by the FRC in 2010, for institutional shareholders in engaging with companies where they hold stakes.

Walker Review A report on the corporate governance of banks, published in 2009. Its recommended reforms included increased time commitment from non-executive directors and enhanced disclosure of remuneration of all high-earning employees,

Useful sources

Copies of the of the **UK Corporate Governance Code** can be obtained free of charge from the FRC. Tel: 020 8247 1264.
Email: customer.services@cch.co.uk.
Or go online at: www.frcpublications.com.
To read/download the **Companies Act 2006**, go to: www.legislation.gov.uk/ukpga/2006/46/contents

The **Listing Rules** are available at:
http://fsahandbook.info/FSA/html/handbook/LR
the **Disclosure and Transparency Rules** at
http://fsahandbook.info/FSA/html/handbook/DTR
and the **Prospectus Rules** at
http://fsahandbook.info/FSA/html/handbook/PR

For a list of **regulatory information services**, visit www.fsa.gov.uk/doing/ukla/ris

The world's capital market

The London Stock Exchange Group is Europe's leading diversified exchange business, with over 3,000 companies quoted across its markets, the Group operates the largest and most liquid equity marketplace in Europe.

The London Stock Exchange's Primary Markets team put UK and international companies in touch with one of the world's deepest pools of global capital. Our markets are home to companies from all over the world, ranging from start-ups to some of the world's largest corporations.

For further information, please contact our team on +44 (0) 20 7797 3429 or visit www.londonstockexchange.com

London Stock Exchange

Copyright © September 2012 London Stock Exchange plc. London Stock Exchange and the coat of arms device are registered trademarks of the London Stock Exchange plc.