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New corporate governance principles for large privately held companies

Executive summary

Large privately held companies – including those in groups headed by a listed company or under private equity ownership – will have to report on their corporate governance arrangements from 2020.

Legislation laid before Parliament on 11 June will, amongst other things, require large UK incorporated companies to disclose their 'corporate governance arrangements' in their annual directors' report and on a website. In a related development, the FRC has now published for consultation a set of draft governance principles, the Wates Corporate Governance Principles for Large Private Companies, that large privately held companies might apply for the purpose of these new reporting requirements.

Which companies are affected?

Any company incorporated under the UK Companies Acts – public or private – with:

- more than 2,000 employees; and/or
- a turnover of more than £200m and a balance sheet total of more than £2bn,

unless it is already required to provide a corporate governance statement under the Companies Act 2006 and FCA rules (ie broadly, listed companies), is a community interest company or a charitable company. A company that is, for example, a subsidiary of a listed company which meets these criteria will therefore be required to report. Employees are counted for this purpose wherever they work, including outside the UK. Balance sheet total for this purpose means the aggregate of the amounts shown as assets in the balance sheet.

Where a company's size varies from year-to-year above and below the relevant qualifying thresholds, that company will be subject to a 'smoothing provision' in the Regulations which provides for a two-year time lag before a company either drops out of, or is covered again, by the requirement. For example, if a company has more than 2,000 employees in the first year of reporting, it will have to report in both that year and in the second year even if it has fewer than 2,000 employees in the second year. If the company in the third year still has fewer than 2,000 employees, it will not have to report (although may choose to do so voluntarily).

What will a company have to report?

The annual Directors' Report must include a 'statement of corporate governance arrangements' which must state:

- which corporate governance code, if any, the company applied in the financial year;
- how it applied that code (ie 'apply and explain'); and
- if it departed from that code, 'the respects in which it did so, and its reasons for so departing'.

If the company has decided not to apply any corporate governance code, it must explain the reasons for that decision, and explain what arrangements for corporate governance it has applied.

The company may include this information in the Strategic Report instead of the Directors' Report so long as the Directors'

Report states that it has done so.

The corporate governance statement must be made available with free, unrestricted access on a website maintained by, or on behalf of, the company. Listed companies are already required to publish their annual reports and accounts on a website.

Does the subsidiary of a premium listed company have to prepare a corporate governance statement?

Yes. BEIS is very clear that every company meeting the qualifying thresholds must comply with the new reporting requirement, including subsidiaries. This includes subsidiaries of listed companies required to meet the UK Corporate Governance Code and subsidiaries of parent companies who prepare a consolidated group directors' report.

In its Q&A BEIS has said that a subsidiary of a listed company could, in principle, and if the circumstances warranted it, state that it did not apply a code because its parent applied the UK Corporate Governance Code which was applied throughout the group. This might shorten the statement, but the subsidiary would still need to explain how the Code actually applies to governance arrangements in the subsidiary and its directors.

How much detail will companies have to provide?

BEIS has said that companies will be expected to provide 'sufficient information to ensure that their corporate governance arrangements are explained' but has not given more detail than that. Companies that choose to adopt the Wates Principles should provide a short supporting statement for each principle explaining how it has been applied (see more below).

When do these requirements apply?

Subject to the expected Parliamentary approval, they will apply for financial years beginning on, or after, 1 January 2019 with the first reporting on this taking place in 2020.

How does 'apply and explain' work?

The 'apply and explain' framework described above differs from the 'comply or explain' approach that applies to UK listed companies under the FCA's rules and the UK Corporate Governance Code. Although under the Listing Rules, a company must state how it has applied the main principles set out in the UK Corporate Governance Code, a different approach applies to the provisions of the UK Corporate Governance Code. In relation to provisions, companies are required to state whether or not they have complied, and if they have not complied, give further information, including reasons for non-compliance.

The reason for the proposed difference in approach in the Wates Principles is because they have been drafted from a high-level approach, with sufficient flexibility to enable affected companies to adapt them for their corporate governance requirements as they see fit.

What code are companies meant to follow?

A company subject to the legislation must report against a governance code (or explain why it does not apply a code and explain what arrangements for corporate governance it has). There is, however, currently no widely adopted governance code for large privately held UK incorporated companies.

A coalition group headed by James Wates was therefore asked by the Government to develop a corporate governance code that large privately held companies might apply for the purpose of these new reporting requirements. The Government has indicated that one objective of setting up the coalition group was to develop principles that command widespread support, have business endorsement and are widely adopted. For this reason the coalition group comprises 13 different members representing a range of different stakeholders including the CBI, the BVCA, the TUC and the Investment Association. The Government hopes that the Wates Principles will become the code against which most large privately held companies will choose to report. It does, however, acknowledge that there is no requirement for a company to use the Wates Principles if other arrangements are considered by the directors to be more suitable.

The FRC has now published the draft Wates Principles for consultation (which ends 7 September 2018). We do not, however, expect the final version of the Wates Principles to be published until December, which may present a challenge for companies that wish to follow them.

How are the draft Wates Principles structured?

The Wates Principles comprise six principles, each followed by supporting guidance.

The Principles are just that: they set out high-level and non-specific standards of good practice and are described in the consultation as addressing 'fundamental aspects of business leadership and performance'. The draft emphasises that this is necessary because they have to be capable of applying to a large range of companies with different types of management and ownership structure.

As explained in the Consultation Paper, companies that adopt the Principles are expected to apply them fully and, in their corporate governance statement disclosure, to provide a supporting statement for each principle that gives an understanding of how their corporate governance processes operate and achieve the desired outcomes. The consultation notes that the guidance is non-exhaustive and, rather than being a checklist requiring a 'tick box' approach to reporting, is intended to help companies apply the Principles in practice. The guidance's necessary lack of specificity in certain areas (given that it applies to such a wide range of companies) makes it hard to predict how companies could be said to 'depart from' the Principles. In addition, the scope of the guidance is not always easy to describe and analyse and there are some variations in the language used which have the potential to cause confusion in certain areas. We expect this will be addressed in the consultation process.

The Principles

We set out below the wording of the six Principles together with details of the associated guidance.

1. Principle One – Purpose

An effective board promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.

The guidance has several areas of focus:

- key shareholders and the board should work in partnership to ensure the company operates with a clear sense of purpose; and
- it is the board's responsibility to develop, articulate and implement a strategy and business model to generate sustainable value and to support appropriate behaviours and practices within the organisation, including discouraging misconduct and unethical practices, and promoting behaviour that balances short-term needs with long-term aspirations.

2. Principle Two – Composition

Effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual directors having sufficient capacity to make a valuable contribution. The size of a board should be guided by the scale and complexity of the company.

The guidance addresses:

- the need for the board and individual directors to embrace diversity, promote accountability and provide appropriate constructive challenge in decision-making;
- the high level of competence relevant to the company's business needs and stakeholders that the directors should collectively demonstrate;
- directors' ongoing professional development and the expectation that the individual evaluation of directors should demonstrate whether each director continues to contribute effectively; and
- board size and structure. The guidance does not mandate certain sizes or structures but says that they should be appropriate to the company's strategic needs and challenges with an appropriate balance of expertise, diversity and objectivity.

3. Principle Three – Responsibilities

A board should have a clear understanding of its accountability and terms of reference. Its policies and procedures should support effective decision-making and independent challenge.

The guidance highlights that governance processes:

- should provide for clear lines of accountability and responsibility, and in particular ensure that the company's owners, board and senior management have clearly defined roles and responsibilities, with conflicts being appropriately

managed;
- could provide for board committees (eg for audit, risk, nomination, remuneration and sustainability), with terms of reference as necessary. There is, however, no express requirement for board committees to be created;
- should mitigate the risk of unfettered powers vesting in individuals; and
- should ensure that the quality and integrity of information provided to the board (eg on financial reporting, key performance indicators, workforce data, environmental data, stakeholder engagement feedback and consumer data) are reliable. This could require the design and implementation of internal control systems (eg an internal audit function) but, whatever the mechanisms, the board must be satisfied that checks and balances are sufficient.

The guidance emphasises the benefits of independent representation on the board, including providing challenge in board decision-making but does not go so far as to require the appointment of independent directors.

The guidance also states that the company's constitutional documents should set out 'the policies and procedures that govern the internal affairs of the company … [including] matters relating to the authority, role and conduct of directors'. We do not think that this means companies are expected to add new provisions to their articles of association. We expect this will be clarified in the consultation process.

The introduction to the Wates Principles emphasises that companies could apply and explain Principle Three in a variety of ways depending on the type of company. For example, a private equity-owned company with a small shareholder board might decide it would be appropriate to appoint an external consultant to provide independent advice on its corporate strategy. In its disclosure it could describe the value that independent insight has had on refining the company's purpose.

4. Principle Four – Opportunity and Risk

A board should promote the long-term success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.

The guidance expands on the board's role and responsibilities in this context:

- The board should consider and assess how the company creates and preserves value over the long term, and this should include risk mitigation. Boards should consider both tangible and intangible sources of value, and the stakeholders who contribute to it.
- The board is responsible for the overall approach to strategic decision-making and risk management. The guidance specifies that this includes:
  - developing appropriate risk management systems;
  - determining the nature and extent of principal risks and risk appetite;
  - agreeing how principal risks should be managed and mitigated; and
  - establishing internal and external communication channels for identifying risks.

5. Principle Five – Remuneration

A board should promote executive remuneration structures aligned to the sustainable long-term success of a company, taking into account pay and conditions elsewhere in the company.

The guidance has three areas of focus:

- alignment between the remuneration of directors/senior management and company performance should demonstrate a shared purpose and common objectives;
- the remuneration of directors/senior management should be developed on principles that align the company's culture, values and long-term success, including an assessment of the company's response to matters such as gender pay gap reporting; and
- transparency of remuneration structures should enable effective accountability to key shareholders and director/senior management remuneration should be considered in the company's broader operating context, including the remuneration of the workforce (including pensions and other benefits). It is important to note that the guidance does not require the disclosure of actual remuneration. Mr Wates has publicly stated that the amount individuals are paid will remain a private matter.

6. Principle Six – Stakeholders

A board has a responsibility to oversee meaningful engagement with material stakeholders, including the workforce, and have regard to that discussion when taking decisions. The board has a responsibility to foster good stakeholder relationships based on the company's purpose.

The guidance expands on this:

- companies have a responsibility to create and sustain long-term value for a variety of stakeholders and should present a fair, balanced and understandable assessment of the company's positions and prospects, and make this available to their material stakeholders on an annual basis;
- companies should identify the stakeholder relationships that are integral to their ability to preserve and generate value; and
- the board should demonstrate how the company has effectively engaged with material stakeholders and how those relationships have been taken into account in decision-making. In particular, companies should develop methods that enable them to engage meaningfully with their workforce and use these forms of engagement when taking decisions.

As is the case with the proposed new UK Corporate Governance Code for listed companies, the term 'workforce' is undefined. We expect companies to take a common-sense view of the term such that it will go beyond workers who are contractual employees but not, for example, include service suppliers with a tangential connection to the relevant company.

Conclusion

This new requirement represents a significant change for largely privately held companies. In the coming months companies will need to consider whether they wish to apply the Wates Principles or another corporate governance code. If they do not intend to apply the Wates Principles or another governance code, then they will need to be able to explain why not and what other corporate governance arrangements they have in place. We expect that given the high-level approach adopted in the Wates Principles many, but by no means all, companies will follow them. Going forward, it will be interesting to see what additional areas are covered in future iterations of the Wates Principles.

At the moment the exact role of the FRC in relation to the Wates Principles and, more generally, the new corporate governance statement requirement is not clear. The FRC is currently subject to a 'root and branch' review of its activities. The aim of that review is to make the FRC the best in class for corporate governance to help it fulfil its role of safeguarding the UK's leading business environment. It may be that ultimately the FRC is given much more extensive enforcement and investigation powers following the outcome of that review. It is certainly not yet clear that will be the case but greater powers for the FRC was one of the recommendations made in the Joint Select Committee Report on Carillion.

If you would like to discuss any of the points covered in this briefing in more detail, please do get in touch with your usual Freshfields contact. We expect to produce a client guide on this new requirement in due course.