SLAUGHTER AND MAY/

JANUARY 2023

LISTED COMPANIES: WHAT TO EXPECT IN 2023 - PART 2

After a year shaped by geopolitical tensions, UK political turmoil, the fall-out from Covid-19 and economic volatility, we look at developments anticipated this year that will affect the rules and expectations around companies listed in the UK. In this second briefing we look at areas we expect the FCA to focus on and changes to audit and corporate reporting.

Our first briefing, in which we focussed on what we expect to see in equity capital markets, particularly in relation to encouraging companies to list in London and making it easier for listed companies to carry out secondary fundraisings, can be found here.

Inside information

Identifying, handling and announcing inside information are bound to remain areas of focus for the FCA this year. Below we pick out some particular developments and themes that companies should be aware of.

FCA enforcement action against Sir Christopher Gent: implications for disclosing inside information improperly and announcing inside information "as soon as possible"

In August 2022 the FCA imposed a financial penalty of £80,000 on Sir Christopher Gent, former Chairman of ConvaTec Group plc, for unlawfully disclosing inside information in breach of Article 10 of the EU Market Abuse Regulation. In the afternoon of Wednesday 10 October 2018 Sir Christopher disclosed to two major shareholders that the company expected to announce on the following Monday that it was revising (downwards) its guidance on revenue growth and that the CEO was retiring. In the FCA's view, the company had inside information at that point. At 7am on Monday 15 October 2018 the company announced a Q3 trading update, revised guidance and the retirement of the CEO. By market close on that day its share price had fallen by 33%. (The FCA summarised the facts of the case, relevant rules and its approach in Primary Market Bulletin 42 (PMB 42), published in December.)

Despite acknowledging Sir Christopher was not seeking to make a financial gain for himself in disclosing inside information to the two shareholders, the FCA clearly viewed the conduct as "serious" and needed to find a way to punish it. Although the case naturally turns on its facts, it is significant for what it implies about the requirement to announce inside information "as soon as possible". The FCA concluded that the information was inside information at the time of its disclosure to the two shareholders, and accepted it did not necessarily follow that the company was in breach of its obligation to announce the inside information "as soon as possible" notwithstanding that it took 2.5 working days / 4.5 calendar days to do so (from Wednesday afternoon to Monday morning).

However, the Final Notice does not provide any general guidance as to how long the FCA thinks a company can take to "clarify" inside information and prepare an accurate announcement or as to the factors or circumstances that might affect how long a company can take: in our view, it would therefore be risky for a company to take more than a day or two, or to apply this "short delay" to anything other than an "unexpected and significant event" (per the guidance in DTR 2.2.9). We discussed the implications of the case in more detail in a note sent to clients in August 2022: if you would like a copy please contact one of the authors of this briefing.

In relation to shareholder engagement, the FCA emphasised in PMB 42 and Annex B to the Final Notice that it can be legitimate to disclose inside information selectively to major shareholders - for example, where the purpose is genuinely to seek their views on the CEO's position or a potential successor. But company representatives need to ensure that (i)

the recipient agrees to keep the information confidential; (ii) the disclosure is made in the normal exercise of the discloser's employment, profession or duties; and (iii) the disclosure is reasonable in the circumstances and confined to what is strictly necessary. When considering enforcement action, the FCA will therefore focus particularly on the nature of the information shared and the rationale for doing so.

Handling and disclosure of inside information

As highlighted in editions 31, 33 and 42 of its Primary Market Bulletin, the FCA is concerned that some issuers are failing to recognise when inside information has arisen and/or incorrectly concluding that an announcement can be delayed. In light of this, we set out below some reminders of key points:

- **Policies, systems and controls**: Companies should check that their policies, systems and controls around inside information - including wall-crossing procedures, IT systems and insider lists - are robust and up to date. Insider lists should include all the items of personal information specified under UK MAR. All relevant directors and employees should be given regular training or refreshers. Ideally, policies and procedures should be tailored to the company's day to day activities and identify practical situations and behaviours that create risk.

- **Audit trail**: If in doubt whether a piece of information is inside information, companies should seek advice from their brokers and/or lawyers. Ensure that all the relevant facts are disclosed to the advisers - or the company will not be able to rely for a defence on advice it receives. Document the process that was followed and the reasons for the decision taken.

- **Protocols for delaying disclosure**: If a company decides it can delay announcing inside information, record the reasons why. Prepare a holding announcement in case there is a leak. Set up an insider list for the matter and ensure access is restricted to those who strictly need it. Generally, PDMRs and insiders should not be given clearance to deal in the company's securities until the information has been announced.

- **Financial results**: Do not assume that information to be included in periodic financial reports will always or never constitute inside information. Each piece of information should be assessed on its merits. In Technical Note 506.2, published in April 2019, the FCA provided guidance on when a company can conclude that its legitimate interests would likely be prejudiced if inside information relating to financial results were to be disclosed as soon as possible. The guidance effectively supplements the *ESMA Guidelines on Delaying Disclosure*. Broadly speaking, a company can delay announcing such information only if (i) it would be impossible for investors properly to understand the information if it were to be announced in isolation from the rest of the results; and (ii) delaying disclosure would not be likely to mislead the public. (For example, it would mislead the public if information reliably indicating that the company will fall materially short of guidance it has previously given to the market were not to be announced as soon as possible.) The bar for delaying disclosure is therefore set high.

- **Social Media**: Companies and executives must not disclose inside information via social media channels, particularly Twitter, or through WhatsApp or similar direct communications with investors. Rather, inside information must be announced to the market via a RIS. Once a RIS announcement has been made, it can be referred to in social media posts.

- **Leaks to the press**: Companies must not leak inside information to the press before it is announced – e.g. in order to influence the way a development is reported. The fact that an article is published out of market hours - e.g. in a Sunday newspaper - will not be regarded by the FCA as a suitable defence.

- **Analyst and media briefings**: Executives must ensure they do not selectively disclose inside information to people attending analyst briefings, earnings calls or media events. They need to be well prepared and avoid getting drawn off script – for example, in Q&A sessions.

- **Transactions subject to review or assessment under the National Security and Investment Act (NSIA)**: Where a transaction is subject to review or assessment, or a final or interim order is made, under the NSIA, a company will need to consider whether inside information has arisen and, if so, whether it needs to be announced as soon as possible. If a company does consider that information in an interim or final order could constitute inside information but – unusually – BEIS has prohibited, or is considering prohibiting, the disclosure of such information on national security grounds, the company should contact BEIS and the FCA to discuss how to proceed.

Disclosures relating to climate change

In Primary Market Bulletin 42, published in December, the FCA reminded companies of its rules, guidance and expectations around climate-related disclosures. In particular, companies should:

- Build out their capabilities for making climate-related disclosures (see box below).

Building out capabilities for making climate-related disclosures

In the FCA's report published in July 2022 on its review of TCFD-aligned disclosures by premium listed commercial companies, it identified various steps companies need to take in order to build out their capabilities:

- Review governance arrangements
- Refresh corporate strategy to incorporate climate change
- Know the compliance framework – both existing and new rules
- Assess existing public narrative and financial reporting of climate matters
- Identify physical and transition risks and opportunities and their impact
- Adapt corporate wide (ERM) risk management processes
- Assess the business against various climate scenarios
- Identify relevant metrics and targets
- Set up compliance review and assurance processes
- Focus on training and capabilities at all levels within the company
- Engage with investors to understand their disclosure expectations
- Ensure that financial statements reflect the requirements of all applicable accounting standards

- When determining whether climate-related financial disclosures are consistent with the TCFD Recommendations and Recommended Disclosures, assess whether they take into account the TCFD's *Guidance for All Sectors* and, where relevant, its *Supplemental Guidance for the Financial Sector* or *Supplemental Guidance for Non-Financial Groups*.

- Look to improve their forward-looking disclosures, particularly in the notoriously difficult areas of scenario analysis and metrics and targets. In relation to scenario analysis, the FCA commented that some companies falling in the TCFD Non-Financial Groups (Energy; Transportation; Materials and Buildings; and Agriculture, Food, and Forest Products), for example, "typically did not appear demonstrably to have considered 'the implications of different policy assumptions, macro-economic trends, energy pathways, and technology assumptions', as set out in the TCFD's *Supplemental Guidance for Non-Financial Groups*." And some oil and gas companies' disclosures of their hydrocarbon reserves "were based solely on current conditions and did not account for changes that might reasonably be anticipated as the wider economy decarbonises". In relation to metrics and targets, the FCA noted that sometimes these did not include forward-looking projections, including on matters such as future demand for oil and gas reserves and national climate change policies.

- In financial statements, improve disclosures around climate-related risks and opportunities and connectivity between non-financial and financial disclosures. This was also noted by the FRC as an area for improvement in its July 2022 Thematic review of TCFD disclosures.

- When making a net zero commitment, use the TCFD's *Guidance on Metrics, Targets and Transition Plans* and consider the UK Transition Plan Taskforce (TPT) *Disclosure Framework and Implementation Guidance* which was published for consultation in November 2022.

Details of the FCA's supervisory strategy in relation to climate-related disclosures were set out in Primary Market Bulletin 36, published in November 2021. Broadly, the FRC (as the regulator primarily responsible for reviewing company reports and accounts) will play the main role in supervising companies' compliance with the requirements to make TCFD-aligned disclosures, although the FCA may take enforcement action in cases of greenwashing and other forms of misleading statements / omissions.

In December, the FRC announced its areas of supervisory focus for 2023/24 for corporate reporting reviews and audit quality inspections. When selecting reports and audits for review, the FRC will prioritise sectors that are under particular economic pressure and considered to be higher risk for corporate reporting and audit. Areas of focus will also include TCFD metrics and targets, and whether net zero commitments are adequately addressed in companies' financial statements.

Future changes

Once the ISSB's standards are finalised and available for use in the UK, the FCA has said it will consult on adapting its climate-related financial disclosure rules to reference the ISSB standards. At the same time, it plans to consult on putting climate-related disclosures for listed companies onto a mandatory footing, rather than a "comply or explain" one. It also intends to consult on strengthening its disclosure expectations for transition plans, drawing on the outputs of the TPT once these have been finalised.

Further information

More information about TCFD reporting and related issues can be found in the Sustainability and Climate Change section of our website.

Avoiding enforcement action

When making climate-related disclosures, we therefore suggest companies take care to ensure that:

- They do not imply that their business model, asset values, revenue streams etc will not be adversely affected by government policies on climate change, developments in technology, changes in consumer preferences, supply chain issues etc if in fact this is unlikely to be the case.

- Their financial reports include all the TCFD information they say they do.

- Asset values and depreciation rates appropriately take into account the potentially adverse effects of climate change.

- If they make a net zero commitment, they have a credible plan to get there and reliable ways to measure progress.

Reforms to audit and corporate reporting

Although the Government published its response to its March 2021 White Paper, *Restoring trust in audit and corporate governance* in May 2022, setting out the reforms it will (and will not) introduce in due course, so far very little has happened to progress these changes. This is because a number of the reforms require the Audit, Reporting and Governance Authority (ARGA), which will replace the FRC, to have come into being. ARGA will be given wide powers in relation to corporate reporting and audit, including the ability to direct changes to company reports and accounts without a court order and the ability to investigate and sanction breaches of corporate reporting by directors. It will also be able to review the whole contents of the annual report and accounts. This will bring within the review remit the corporate governance statement, directors' remuneration report and audit committee report, as well as voluntary elements such as the CEO's and chair's reports and, in all likelihood, sustainability reports. The FRC has said it will be including corporate governance statements in its CRR process in 2023 as a precursor to ARGA having this review right in due course.

Because primary legislation is required, ARGA is unlikely to come into existence until April 2024 at the earliest - a year later than planned and with timing perhaps being liable to slip further. A proposed Audit Reform Bill, which will bring ARGA into being, was included in the Queen's Speech in May 2022 so a draft may be published in the next few months. Progress of the Bill will then depend on the availability of Parliamentary time.

However, some of the reforms will be implemented through secondary legislation, changes to codes and using other regulatory measures. In July 2022 the FRC published a Position Paper setting out how it would support the Government's reforms during its transition to ARGA. This includes making revisions and additions to its existing Codes, Standards and Guidance and the development of new standards in shadow form to allow for voluntary adoption ahead of legislation. We will see details of some of these reform measures in 2023, although none are expected to come into effect until 2024.

Draft Minimum Standard for Audit Committees

One of the CMA's recommendations in its Statutory Audit Services Market Study Final Report in 2019 was that the FRC should have "the power and a requirement to mandate minimum standards for both the appointment and oversight of auditors". This stemmed from its conclusion that there was significant variation in the performance of Audit Committees within the FTSE 350 and that selection and oversight of auditors was not always sufficiently focused on quality. This proposal has been carried through and ARGA, once created, will have oversight of audit committees along the lines proposed by the CMA.

Although the FRC has no power to set standards for audit committees, in November it published for consultation a draft *Minimum Standard for Audit Committees*. The majority of the text in the draft Standard is taken from existing FRC publications, the UK Corporate Governance Code (Code) and audit committee and audit tender guidance. But it also includes new provisions requiring audit committees to consider audit market diversity and not exclude challenger firms without good reason. Once ARGA has come into existence, compliance with the Standard will become mandatory, and a company's annual report will have to include details of the work done by the audit committee in respect of the audit and compliance with the Standard. In the meantime, the FRC is looking for FTSE 350 audit committees to comply voluntarily with the Standard, on a "comply or explain" basis, probably from the end of 2023.

Consultation on changes to the Code

The FRC will be consulting on changes to the Code in 2023. This will not be a wholesale revision as we saw in 2018, but will focus on changes required as a result of the Government decisions set out in the response document published in May 2022 and improvements the FRC deems necessary as a result of its ongoing monitoring of corporate governance reporting. We expect the FRC to publish a consultation paper at the end of Q1/early Q2. The revised Code will not come into effect before 1 January 2024. Key areas on which we expect the FRC to consult are outlined in the box on the next page.

UK Corporate Governance Code: areas for consultation

Strengthening of risk and internal control reporting

The Government's original proposal to add an attestation requirement to an annual review of internal control effectiveness (similar to, but not as onerous as, the US's Sarbanes Oxley Act requirement) was dropped. The Government concluded that a Code-based approach would be the most practical and proportionate way of strengthening boardroom focus on internal controls reporting. The FRC will be consulting on changes to the Code to do this. We are expecting to see a requirement for an explicit statement by the board about their view of the effectiveness of the company's internal control systems (financial, operational and compliance systems) and the basis for that assessment. This will be underpinned by guidance clarifying when external assurance might be considered.

Nomination Committees and succession planning

The FRC believes reporting by the Nomination Committee, particularly on succession planning, is weak. It will therefore consult on ways to strengthen reporting, although as yet we have no details of what will be suggested.

ESG / Sustainability Committees

The FRC will be consulting on whether these sit better at board or management level. If the conclusion is that they should sit at board level, provisions will be added to Code about composition etc along the lines of what is included for the Nomination and Remuneration committees.

Malus and clawback

The Government's response accepted that the original proposals in the White Paper suggesting conditions be set around malus and clawback provisions needed more clarity, and decided not to move forward with the proposal. Instead the FRC was asked to consult on how the existing malus and clawback provisions in the Code could be developed to deliver greater transparency.

Removal of viability and going concern statements

New corporate reporting requirements will come in through secondary legislation, one of which will be the requirement for Public Interest Entities (broadly, companies with 750 or more employees (globally) and an annual turnover of over £750m (750:750 PIEs) to produce a Resilience Statement as part of the Strategic Report (see further below). The Resilience Statement will replace the viability and going concern statements currently required by the Code, so the provisions in the Code relating to these will largely be removed. It is not yet clear what will be required of those premium listed companies that are not 750:750 PIEs.

Better explanations for non-compliance with the Code

A recurring theme from the FRC in recent years has been that companies need to provide better explanations through activity and outcome-based reporting, rather than reporting on process. Changes to improve this will be included in the consultation.

New corporate reporting obligations

Four new corporate reporting requirements – summarised below - will come in through secondary legislation, and we expect BEIS to publish a draft statutory instrument soon, possibly in Q1. Although we understand that the new requirements will not come into force before 1 January 2024 at the earliest, we will at least be able to see details of the new provisions soon.

- *Resilience Statement*

750:750 PIEs will be required by law to produce a Resilience Statement as part of their Strategic Report. It will require a high-level explanation of the approach a company takes to maintaining or enhancing operational and financial resilience. It will also require specific reporting on individual risks and challenges to resilience over the short and medium term. Companies will also be required to carry out at least one stress test and report on the results of this, along with

mitigating action. The Government will, in due course, consider how the Resilience Statement can provide a coherent reporting framework with wider sustainability disclosures, including under the Sustainability Disclosures Requirement regime. The FRC will publish supporting implementation guidance in due course.

- *Audit and Assurance Policy*

750:750 PIEs will also be required to publish an Audit and Assurance Policy (AAP) every three years, setting out the company's approach to assuring the quality of non-financial information it reports to shareholders beyond that in the financial statements, adopting a similar structure to that used in the area of remuneration. The original proposal that the report be put to an advisory shareholder vote was dropped. Instead companies will have to state in an annual implementation report how they have taken shareholder and employee views into account in its development.

The AAP will have include an explanation of what external assurance the Company intends to seek over next three years, including whether and how company will seek independent (external) assurance over any parts of the Resilience Statement or its internal control framework. This will include how management conclusions are challenged and verified internally. The AAP must also include a description of the company's policy in relation to the tendering of external audit services. The FRC will produce implementation guidance in due course.

- *Disclosures around distributable reserves*

750:750 PIEs will be required by law to disclose their distributable reserves and explain the board's long-term approach to the amount and timing of shareholder returns. Directors of such companies will have to make an explicit statement confirming the legality of proposed dividends and any dividends paid in-year.

ARGA, when it comes into being, will be given formal responsibility for issuing guidance on what should be treated as "realised" profits and losses for the purposes of determining distributable reserves.

- *Disclosure on actions by directors to prevent fraud*

Narrative reporting requirements will be introduced requiring directors to report on steps taken to prevent and detect material fraud. No details are yet available of what this will entail, but the FRC will publish guidance for directors.

M&A

With Sterling remaining relatively weak, UK companies will continue to be cheap, particularly for US buyers. We therefore expect M&A activity to continue this year, particularly when interest rates stabilise, debt markets re-open and investor appetite returns. Shareholder activism levels are also likely to remain fairly high, which may shake some situations into life, or at least take the credit for doing so. Further commentary on what we expect to see this year in relation to M&A, capital allocation and post-Brexit changes to the UK's financial services framework will be included in our forthcoming Horizon Scanning podcast.

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