

Proposed Revisions to the UK Corporate Governance Code

The FRC has today (5 December 2017) published its proposals for a revised UK Corporate Governance Code “to reflect the changing business environment and help UK companies achieve the highest levels of governance”

Background

The UK Corporate Governance Code applies on a “comply or explain” basis to all companies with a premium listing of equity shares, whether they are incorporated in the UK or elsewhere. It does not apply to AIM listed companies although clearly a number of provisions will be relevant and/or will reflect good practice.

The FRC has stated that now is the right time to undertake a comprehensive review of the Code to ensure it remains fit for purpose and promotes improvement in the quality of governance. The FRC is also taking the opportunity as part of this consultation to ask some high-level questions about the future direction of the UK Stewardship Code with a more detailed consultation planned for 2018 (not covered in this briefing).

In producing the revised (albeit draft) Code and to ensure a wide stakeholder focus, the FRC has drawn on its 2016 Corporate Culture and Role of Boards Report, the Hampton-Alexander Review and the Parker Review and contains a number of changes requested by the Government’s response to the Green Paper Consultation on Corporate Governance Reform. While the revised Code is significantly “shorter and sharper” than the existing Code (13 pages versus 30), the existing structure (i.e. ‘Principles’ supported by ‘Provisions’) and ‘comply or explain’ approach have been retained.

The majority of changes have been made to the early sections of the current Code which broadly correlate to Sections A (Leadership) and B (Effectiveness). Section C (Accountability) remains largely unchanged while Section E (Relations with Shareholders) has been integrated into the revised Code given that this is

considered key to good governance. Section D (Remuneration) and Schedule A (Design of performance-related remuneration for executive directors) have been incorporated into a single remuneration section. The revised Code has five sections being: 1) Leadership and purpose; 2) Division of responsibilities; 3) Composition, succession and evaluation; 4) Audit, risk and internal control; and 5) Remuneration.

Timetable

Responses to the revised Code and consultation document (structured as a list of 31 questions) have been requested by via email (to codereview@frc.org) by 28 February 2018. Following the closure of the consultation, the FRC will consider the responses and make any changes considered appropriate, with an intended publication date of the final Code in early summer 2018.

The new Code will apply to accounting periods beginning on or after 1 January 2019 (i.e. so companies with 31 December 2019 year ends will be the first companies covered by the new Code when they report in 2020).

Remuneration-related changes

A summary of the main remuneration-related changes to the revised Code, most of which are consistent with the Government’s requests in its response to the Green Paper Consultation on Corporate Governance Reform, is below:

- **Remuneration Committee appointments** – As expected, a new provision in the revised Code states that before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at

least 12 months. As currently drafted, this wording suggests that the focus is on past remuneration committee experience rather than specific experience of that company's remuneration committee. Many of our clients are already considering this provision in respect of committee chair succession

- **Holding periods** – Rather than stating that remuneration committees should “consider” the application of a holding period, the revised Code states that, for executive directors, “in normal circumstances, shares granted or other forms of long-term incentives should be subject to a vesting and holding period of at least five years”. Although a majority of companies now operate a two year post-vesting holding period in addition to a three year vesting period for executive directors, there remains a significant number of companies that will need to consider their introduction
- **Significant shareholder opposition** – The current Code provision for companies to explain what actions it intends to take to understand the reasons behind a significant vote against has been strengthened. In addition to now defining what “significant” opposition is (more than 20% of votes against, not quite in line with the Investment Association's new Public Register which states 20% or more), a company should now explain what actions it intends to take to consult with shareholders to understand the reasons behind the result, publish an update no later than six months after the vote and provide a final summary in the annual report, or in the explanatory notes to resolutions at the next meeting, on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now revised. Interestingly, the FRC was asked by the Government to consider whether this provision should be restricted to the

FTSE 350 or apply to all listed companies and it appears to have chosen the latter

- **Employee engagement mechanisms** – As expected, a new provision in the revised Code states that boards should establish a method for gathering the views of the workforce (including executive remuneration) normally by a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. The FRC has retained the choice of the three models suggested in the Government's response to the Green Paper, rather than a single mandated approach
- **Description of the remuneration committee's work** – The revised Code states that there should be a description of the work of the remuneration committee in the annual report for the relevant year, including whether the remuneration policy operated as intended in terms of company performance and quantum (and if not, what changes are necessary); what engagement has taken place with shareholders and the impact this has had on policy and outcomes; and the extent to which outcomes have been affected by Board discretion. As most companies already provide this information (either in a dedicated section of the Directors' Remuneration Report or in different sections of the Annual Statement and Annual Report on Remuneration), we think that the only real change here will be to harmonise disclosures
- **The remuneration committee's remit** – Although already consistent with many listed remuneration committee terms of reference, the revised Code states that remuneration committees should set the remuneration for the board and senior management (rather than recommending and monitoring in respect of the latter, as per the current Code). This change is likely to impact

some companies more than others. In addition, the definition of senior management has been sharpened (now defined as the “executive committee or the first layer of management below the board, including the company secretary”). However, possibly a greater change has been suggested in respect of the general workforce. Rather than saying the committee should be “sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases” as per the current Code, the revised Code states that remuneration committees should “oversee remuneration and workforce policies and practices, taking these into account when setting the policy for director remuneration”. How much of an impact this suggested change will have in practice remains to be seen but this is an interesting development and, we feel, consistent with the direction of travel in respect of the expanding remit of remuneration committees

If you wish to discuss anything arising from this briefing or would like assistance in formulating a consultation response, please ask your usual contact at FIT or call us on 020 7034 1111.

FIT Initial View

Overall, there are few surprises to the revised Code and there is a sufficient amount of time for companies to consider the changes (although we expect some early adoption here). Indeed, in our view, the revised Code contains a number of sensible suggestions (such as the disclosure surrounding the work of the remuneration committee) and we welcome the aim of “shortening and sharpening” the document. We note the absence of any requirement to disclose pay ratios (e.g. CEO pay to average UK workforce) although this will be addressed by a change in the Directors’ Remuneration Report disclosure legislation.

FIT Remuneration Consultants LLP December 2017