FIT Remuneration Consultants

Revisions to the UK Corporate Governance Code

The FRC published the revised UK Corporate Governance Code on 16 July 2018.

The new Code will apply to all premium listed UK companies with accounting periods beginning on or after 1 January 2019. This means companies with 31 December 2019 year ends, reporting in 2020, will be the first to report under the new Code.

The press release accompanying the release of the new Code highlights the following remuneration elements:

> *"To address public concern over executive remuneration, the new Code emphasises that remuneration committees should take into account workforce remuneration and related policies when setting director remuneration. Importantly formulaic calculations of performance-related pay should be rejected. Remuneration committees should apply discretion when the resulting outcome is not justified."*

Remuneration-related changes

We reported on the proposed revisions to the Code in our December 2017 briefing ('Proposed Revisions to the UK Corporate Governance Code'), including a summary of the main remuneration-related changes. While most of those changes have been incorporated into the final version, there have been a number of new changes made which we have highlighted below:

- **Principles** – Consistent with the rest of the Code, the Remuneration section includes a number of key principles, which the FRC hopes will encourage "*meaningful reporting*", rather than a tick-box approach. These principles remain largely as they were in the draft consultation version. However, it is noticeable that the requirement that "*performance-related elements should be clear, stretching, rigorously applied and aligned to the successful delivery of strategy*" has been removed. This may reflect an acceptance by the FRC (as a result of consultation feedback) that some companies are moving away from a focus on performance-related remuneration, and instead using time-vested 'restricted stock'.

- **Composition of the Remuneration Committee** – The wording proposed in the draft Code has been amended to revert to the position in the 2016 version of the Code (which distinguished between 'larger' and 'smaller' companies). This means that membership of the Committee should consist of a minimum of three independent non-executive directors for FTSE 350 companies, or two in the case of smaller companies outside the FTSE 350. The reduced membership requirement for smaller companies appears to be a response to consultation feedback and is a welcome change.

- **Remuneration Committee appointments** – No change has been made to this provision. The new provision says that, before appointment as Committee chair, the appointee should have served on a Remuneration Committee for at least 12 months (i.e. not necessarily the same Committee of which he/she will become chair). Many of our clients are already acting on this provision in respect of Committee chair succession planning.

- **Remuneration Committee's remit** – No material changes have been made to this requirement from the December draft. The new 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 previous Code). This is consistent with many listed Remuneration Committee's terms of reference and therefore is likely to have little impact in practice. 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, a more significant change has been introduced in respect of the general workforce. Rather than being “*sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases*” as per the 2016 version of the Code, the new Code says that Remuneration Committees should “*review workforce remuneration and related policies and the alignment of incentives and rewards with culture, taking these into account when setting the policy for executive director remuneration*".

The supporting guidance to the Code goes on to note that the purpose of the review “*will enable the remuneration committee to explain to the workforce each year how decisions on executive pay reflect wider company pay policy*“ [our emphasis]. While the guidance is not a formal requirement to explain pay decisions, the spirit of the new Code does appear to encourage explanation to the workforce on executive pay.

How much of an impact this will have in practice remains to be seen but this is a significant development and consistent with the direction of travel in respect of the expanding remit of Remuneration Committees and the wider alignment of executive with all-employee pay.

- **Holding periods** – The final wording of the new Code differs from that proposed in December and makes reference to share awards for executive directors being “*released for sale on a phased basis and be subject to a total vesting and holding period of five years or more*” [our emphasis]. As a clear majority of companies (and almost all in the FTSE 350) already operate a two year post-vesting holding period in addition to a three year vesting period for executive directors (or are going to introduce one), we think that this change is likely to have limited impact in practice. The new reference to phased vesting appears to be an encouragement to apply vesting periods longer than five years; in our experience few companies outside the Financial Services sector currently apply this.

- **Post-employment share ownership** – The new Code includes a new provision that the Remuneration Committee develops “*a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares*”. This wording is more prescriptive than the draft (which simply mentioned that post-employment periods may be appropriate). It appears that the new language has been introduced in response to the collapse of Carillion and the concern that some directors were able to sell down their share awards immediately after leaving the business. This new provision might simply mean that some companies need to establish and communicate a clear position on what happens to share awards in the period following termination.

- **Discretion** – As expected, the new Code says that “*remuneration schemes and policies should enable the use of discretion to override formulaic outcomes*”. The importance of this new provision is underlined by the attention drawn to it in the FRC press release.

  In our experience this type of broad discretion is often included in Directors’ Remuneration Policies, but less often reflected in the relevant incentive plan rules. Companies will need to consider the terms of their annual bonus and long term incentive plans to ensure there is sufficient flexibility to allow a holistic assessment of performance, before vesting outcomes are confirmed. The impact of this on the ‘hoped-for’ incentive effect of incentive arrangements is also an important consideration for Remuneration Committees.

- **Pay caps** - The supporting guidance to the Code regarding the use of discretion notes that “*the remuneration committee may wish to consider setting a limit in monetary terms for what it considers is a reasonable reward for* *individual executives*" (i.e. pay caps). This appears to be an implicit acknowledgement of the 'Persimmon problem', i.e. uncapped pay-outs that many investors found unacceptable. While the vast majority of listed companies operate a cap on bonus payments and have limits on long-term incentive grant values, few if any of the latter are capped in respect of the amounts that can be delivered.

- **Pensions** – An explicit statement has been added in to the Code, requiring that "*pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce*". This is consistent with the views of a number of institutional investors, as reflected in recent policy updates from The Investment Association, ISS and LGIM. This is more likely to impact new joiners rather than existing executive directors.

- **Mitigation** – New wording has been added to the Code recommending that Remuneration Committees "*should be robust in reducing compensation to reflect departing directors' obligations to mitigate loss*". This also reflects general investor opinion regarding termination payments and most companies already include provisions for phased payment and mitigation within their Directors' Remuneration Policies.

- **Significant shareholder opposition** – No material changes have been made to this requirement from the draft version. This means if a shareholder vote receives "*significant*" opposition (being a vote against of 20% or more, in line with the threshold for inclusion in The Investment Association's public register), 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.

  As we have said before, this provision will apply to all listed companies (and not just those in the FTSE 350).

- **Workforce engagement mechanisms** – No change has been made to the choice of the three models included in the draft Code (and as suggested in the Government's response to the Green Paper). The revised Code states that boards should establish a method for gathering the views of the workforce (including in respect of executive remuneration) which can be one or a combination of:

  - a director appointed from the workforce;
  - a formal workforce advisory panel; or
  - a designated non-executive director.

  The most appropriate mechanism may depend on any existing processes that a company has in place, but we would expect few companies to appoint a 'worker director'.

  The accompanying Code guidance emphasises that the definition of 'workforce' is broader than just 'employees' and may include agency workers and remote workers, regardless of their location. This means that some companies will need to engage with their global 'workforce' (which can be contrasted with the recently announced pay ratio rules which only take into account UK employees). This may present a practical engagement challenge for companies with a diversified and/or international workforce. In particular, while drafted as a comply or explain matter, we expect most companies will wish to demonstrate that they are engaging with staff at some level and will need to both decide the most appropriate approach and commence its use.

This provision has also been amended to reflect the new reporting regulations that were published last month (see our previous briefing from June 2018, 'Pay ratios rules published'). Our expectation is that workforce engagement will therefore form part of the wider consideration of stakeholder interests (as required under section 172 of the Companies Act 2006).

- **Description of the Remuneration Committee's work** – No material changes have been made to this requirement from the draft version. The new version of the Code states that there should be description of the work of the Remuneration Committee in the annual report for the relevant year, including:
  - reasons why remuneration is appropriate, using measures including pay ratios and pay gaps;
  - 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.

  The reference to pay ratios and pay gaps is new, but is consistent with the pay ratio regulations that was introduced last month (see our previous briefing from June 2018).

  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.

- **Independence of the Board Chair** - The FRC has also softened its position regarding the nine-year limit on the tenure for board chairs.

FIT view

The FRC has shortened the Code but at the same time significantly increased the remit of the Remuneration Committee (e.g. the broadened remit to review workforce remuneration). The revised Code will also present an increased challenge for the Remuneration Committees at 'smaller companies' as many of the remuneration-related provisions apply irrespective of company size.

The supporting guidance will be required reading for Remuneration Committee members and poses some good 'exam questions' for members to answer. We recommend that Remuneration Committees take time to consider the implications of the revised Code (and the supporting guidance) and consider their preparations for dealing with its forthcoming application. In other words, start planning early.

If you wish to discuss anything arising from this briefing, please ask your usual contact at FIT or call us on 020 7034 1111 or email us at info@fit-rem.com.

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