ALERT MEMORANDUM

FRC Consults on Significant Revisions to the UK Corporate Governance Code

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On 5 December 2017, the Financial Reporting Council (the "**FRC**") launched a consultation on its proposals for a revised UK Corporate Governance Code (the "**Code**").

The Code is one of the main pillars of the UK corporate governance regime: it applies to all companies with a premium listing of equity shares in the UK (regardless of their jurisdiction of incorporation) on a "comply or explain" basis.

The consultation forms part of a comprehensive review by the FRC of the Code, designed to ensure that the Code remains fit for purpose 25 years after it was originally launched. The consultation follows on from the UK Government's Green Paper Consultation on UK corporate governance reform, which concluded with the UK Government publishing a response document[1] in August 2017 setting out 12 proposed reforms to the UK corporate governance regime. A number of these proposals took for the form of recommended revisions to the Code and the FRC has reflected all of the Government's recommendations in its consultation.

The revised Code has been reorganized into five sections: (1) Leadership and purpose, (2) Division of responsibilities, (3) Composition, succession and evaluation, (4) Audit, risk and internal control, and (5) Remuneration. We consider below the general approach and structure of the revised Code before reviewing the principal changes in each of sections (other than Section (4) which remains substantively unchanged).

1. General approach and structure

A. *Objectives*

The revised Code strives to encourage continued improvement in the quality of corporate governance in the UK, with the dual aim of raising public trust in business and promoting the attractiveness of UK capital markets to global investors against the backdrop of Brexit. Consistent with the dominant themes of the UK Government's Green Paper Consultation, the consultation notes that reforms are required to reflect heightened public scrutiny of large companies and increased public expectation that companies should operate in the interests of a wider range of stakeholders (not just shareholders) and for the public benefit.

[1] Our previous alert memoranda on: (1) the Government's response document is available here; and (2) the Government's original Green Paper is available here.

B. *"Comply or explain"*

The "comply or explain" approach, under which companies have the flexibility not to comply with requirements of the Code that they consider inappropriate to their specific circumstances (provided that they explain the reasons for this non-compliance to their shareholders) has largely been preserved. However, the consultation notes that over time, this has become somewhat of a "tick box" exercise, with companies focusing on whether or not they meet specific detailed requirements, rather than clearly explaining to shareholders how they meet the overall principles of the Code. The revised Code therefore refocuses on the importance of the Principles and encourages companies to meaningfully explain how they meet these Principles, including how this fits into the company's strategy and business model. The objective is to facilitate shareholders' evaluation and, if appropriate, challenge of companies' overall governance practices.

C. *Structure*

The revised Code is "shorter and sharper" than the prior version and has been reduced in length from 32 to 13 pages. This has been achieved in part by moving more procedural provisions (which are now common business practice) out of the Code to supporting guidance, so that the remaining Code addresses those governance elements most important to board effectiveness and corporate purpose (including a new focus on stakeholders, integrity and corporate culture, diversity and how the overall governance of the company contributes to its long-term success).

The revised Code is divided into (high-level) "Principles" and (more detailed) "Provisions". This represents a simplification in approach from the prior Code, which comprised "Main Principles", "Supporting Principles" and "Provisions". As noted above, the revised Code refocuses on the overriding importance of compliance with the Principles.

Key changes – general approach and structure

- Shorter and sharper
- "Comply or explain" approach maintained, but companies to clearly explain how they meet overall Principles, rather than undertaking a "tick box" exercise

2. **Leadership and purpose**

A. *Company culture*

A new Principle has been added promoting the importance of company culture. The Board is required to establish the company's purpose, strategy and values, and ensure that these and its culture are aligned.

B. *Wider stakeholders*

Consistent with the UK Government's Green Paper Consultation, an area of significant focus for the revised Code is the board's responsibility for considering the interests of a wider range of stakeholders (beyond shareholders). As requested by the Government, the revised Code requires companies to establish a method for gathering the views of its workforce, which would normally be through one of three methods: (1) appointing a director from the workforce, (2) establishing a formal workforce advisory panel, or (3) designating an existing non-executive director to represent the interests of the workforce.

Recognizing the complexity of modern working practices, the revised Code deliberately uses the broad term "workforce" (rather than "employees") to ensure that companies appropriately consider the interests of all people undertaking work for them (whether as direct employees, outsourced workers or even self-employed contractors). This ties in with an increased focus on atypical working patterns and employment status following the publication of the Taylor Review of working practices and the ongoing litigation surrounding the employment status of Uber drivers and other "gig economy" workers.

Directors of UK companies are already subject to a duty under section 172 of the Companies Act 2006 to have regard (in seeking to promote the success of the company for the benefit of its shareholders as a whole) to, amongst other matters, the interests of the company's employees and to the need to foster the company's business relationships with suppliers, customers and others. The Government announced in its response to the Green Paper Consultation that in an effort to improve boardroom engagement with the workforce and other stakeholders, it would introduce secondary legislation to require all companies of a significant size to explain how their directors comply with this duty. Building on this recommendation, the FRC has proposed that the revised Code include a new Provision to require companies to explain in their annual reports how they have engaged with their workforce and other stakeholders, and how their interests influenced the board's decision-making. The FRC notes that the final wording of this Provision will be kept under review until the Government has introduced the secondary legislation referred to above.

C. *Responding to significant shareholder opposition*

One of the main reforms to come out of the Green Paper Consultation was the creation of a Public Register of companies which have received votes of more than 20% against a resolution to approve the annual remuneration report at their AGMs. The Investment Association has now launched the Public Register (available here) which goes beyond the scope of the Government's recommendation and includes details of all resolutions (not just those related to executive remuneration) in respect of which a company has received votes of more than 20% against. At launch, over a fifth of companies in the FTSE All-Share index were listed on the Public Register. A key aim of the Public Register is to focus attention on how these companies respond to the concerns of their investors, with the Public Register highlighting the public statements made by the companies on the Register on how they have addressed shareholders' concerns.

As requested by the Government in its Green Paper Consultation, the revised Code supports the aims of the Public Register by including a requirement that where a company has received significant shareholder dissent at its AGM, the company must immediately explain what actions it intends to take to consult with shareholders to understand this vote. The company should publish an update on these actions no more than six months later and should provide a final summary in the company's next annual report.

Key changes – leadership and purpose

- A new Principle on the importance of company culture
- Companies required to formally establish a method for gathering the views of their workforces
- Companies encountering significant shareholder opposition to publicly explain how they are responding to this

3. **Division of responsibilities**

A. *Independence of non-executive directors*

At present, the Code requires that, other than for smaller listed companies, at least half the board (excluding the chairman) should comprise independent non-executive directors. Independence is measured by reference to disqualifying criteria set out in the Code, which include situations where the director has been an employee of the company in the previous 5 years, has some other relationship with the company or one of its significant shareholders, or has been on the board for more than 9 years.

While the disqualifying criteria against which independence is tested remain unchanged, the revised Code appears to give boards less flexibility to conclude that a director is independent where one or more of the disqualifying criteria is met. While the current Code expressly permits boards to conclude that an individual is independent notwithstanding the existence of disqualifying criteria, the revised Code includes an affirmative statement that where any of the criteria exists, the director should not be considered independent. This stronger presumption of non-independence coupled with the absence of an expressly permitted route for the board to explain a contrary conclusion is expected to make it more difficult for boards to conclude independence notwithstanding the existence of disqualifying criteria. While a board could of course choose not to comply with this Provision and explain this to shareholders in the annual report (under the "comply or explain" principle applicable to the Code as a whole), it is clear that the FRC is seeking to discourage this approach. We expect this to be an area of significant debate as part of the consultation process, in particular whether boards will retain genuine flexibility to conclude independence notwithstanding the existence of disqualifying criteria.

B. *Independence and tenure of the chairman*

A core requirement of the Code is that the roles of chief executive and chairman should be separate and held by different individuals. The Code currently requires the chairman to be independent only on appointment. The revised Code proposes that the chairman must (like other non-executive directors) continue to meet the independence criteria on an on-going basis. As noted above, these criteria include that the individual must not have served on the board for more than 9 years since first election thus imposing a limit on the tenure of UK company chairs for the first time.

Again, we expect this to be an area of significant debate as part of the consultation process, particularly given that the 9 year cap would, as currently drafted, include time spent as non-executive director of the same company before election to chairman. Indeed, recent research by the Financial Times suggests that almost one fifth of FTSE 100 and FTSE 250 chairs would currently fall afoul of this new requirement.

Consistent with this change, the board composition requirement referred to above (which currently requires that half the board - excluding the chairman - comprises independent non-executive directors) is proposed to be replaced by a requirement that independent non-executive directors – including the chairman – should constitute half the board.

C. *Smaller listed companies*

All of the exemptions in the current Code for smaller listed companies (those below the FTSE 350) are proposed to be removed, in order to encourage smaller listed companies to raise their governance standards. These include the requirement for half the board to be independent (smaller companies are currently required to have just two independent non-executive directors), the requirement for all directors to be subject to annual re-election and the requirement for an independent board evaluation to be carried out every three years. Accordingly, some smaller listed companies will need to make significant changes to their governance arrangements to bring themselves into compliance with the revised Code.

Key changes – division of responsibilities

- Less flexibility for boards to determine a non-executive director to be independent notwithstanding the existence of disqualifying criteria set out in the Code
- Chairman required to meet independence criteria on an on-going basis and independent non-executive directors (including the chairman) required to constitute half the board
- All exemptions for smaller listed companies to be removed

4. Composition, succession and evaluation

In keeping with the FRC's general approach to the revised Code, the section has been significantly shortened, with procedural provisions around board composition and the election of directors moved for the most part to supporting guidance. The key substantive changes to the section focus on increasing diversity, and address recommendations made in the recent publication of the Parker Review of ethnic diversity of UK boards (the "**Parker Review**") and the 2017 issue of the Hampton-Alexander Review of gender balance in the leadership of the FTSE 350 (the "**Hampton-Alexander Review**").

The revised Code aims to bring diversity in the broadest sense (including diversity of gender, social and ethnic backgrounds) to the forefront of the mind of boards and nomination committees. Echoing the Parker and Hampton-Alexander Reviews, the FRC emphasises that diversity at board and executive level should be promoted not only as part of a wider drive toward social equality, but also for the commercial benefit of companies, on the basis that a diverse board fosters better decision-making and allows companies to remain competitive in a global market. A new Principle emphasises that appointments and succession planning should be based on merit and objective criteria to promote diversity.

In the revised Code, the FRC has widened the remit of the nomination committee to consider diversity in the workforce as a whole, and to oversee the development of a diverse executive pipeline. The supporting guidance supplements the general mandate with examples of types of action that nomination committees could consider, including dedicated initiatives in areas of the business that lack diversity and a commitment to more diverse shortlists and interview panels. This follows the approach of both the Parker Review and the Hampton-Alexander Review which make clear that talented individuals from a diversity of backgrounds must be identified at an early stage in order to give companies a deep pool from which a diverse board and executive team can be drawn. The revised Code introduces a new transparency obligation to reinforce these principles, requiring companies to include in their annual report (i) an account of how nomination committees have approached succession planning and the development of a diverse executive pipeline, and (ii) an explanation of how diversity supports the company in meeting its strategic objectives.

Additionally, the revised Code introduces a requirement on companies to disclose the gender balance in their board and senior management, which, for these purposes, includes the executive committee or first layer of management below board level (including the company secretary), and senior management's direct reports. This implements a recommendation made by the Hampton-Alexander Review committee in 2016, expanded to all companies subject to the Code (the scope of the Hampton-Alexander Review is limited to the FTSE 350). The disclosure obligation is, for now, limited to gender diversity. However, the FRC invites comments in its consultation on introducing an additional disclosure requirement in relation to ethnic diversity at these levels, so there may be further developments in these areas.

Key changes – composition, succession and evaluation

- Renewed focus on diversity at board and executive level
- Widened remit for nomination committee to include overseeing development of a diverse executive pipeline
- New reporting obligations in relation to diversity and gender balance in senior positions

5. Remuneration

A. *Executive share awards*

Taking its cue from the Government response to its Green Paper Consultation, the revised Code extends the minimum vesting and post-vesting holding period in relation to share awards from three to five years. The move is an attempt to combat short-termism in corporate decision-making by aligning executive and shareholder interests in the medium term and encouraging sustainable value creation. The FRC notes that this move mirrors a development already observed in market practice, and will encourage remaining companies offering equity incentives subject to shorter mandatory holding periods to raise standards.

The revised Code reflects the general rule set out in the Code that non-executive directors' remuneration should not comprise share options or other performance-related elements. It is worth noting that a Provision of the existing Code addressing a situation where, exceptionally, share options are to be granted to non-executive directors, has not been incorporated into the revised Code. This is consistent with a strengthening of the independence of non-executive directors, as noted above (see Section 3.A).

B. *Role of the remuneration committee*

The most substantive changes to the remuneration provisions of the Code focus on the composition and role of the remuneration committee. Following a Government recommendation in the context of the Green Paper Consultation, the revised Code introduces a requirement for chairs of remuneration committees to have at least 12 months' experience serving on a remuneration committee. The Government's recommendation addresses a concern around the perceived weakness of remuneration committees pitted against the interests of stakeholders within a company, and attempts to correct potential power imbalances between remuneration committees and company executives.

In addition, the remit of the remuneration committee, previously limited to overseeing the remuneration of the board of directors and the senior managers, has been expanded to cover oversight of remuneration and workforce practices across the company as a whole. The revised Code mandates that remuneration committees take into account pay in the wider workforce when it sets policy for director remuneration. The expanded scope is coupled with a new reporting obligation, which requires companies to disclose in their annual report their approach to rewarding the workforce, and what engagement has taken place with the workforce to explain how executive remuneration aligns with company policy. This ties in with a guiding principle of the Government's approach to corporate governance reform, namely to address a perceived imbalance between executive remuneration and remuneration in the wider workforce and complements the Government's plan to introduce new secondary legislation requiring companies to disclose the ratio between CEO and wider company pay.

Key changes – remuneration

- Mandatory vesting and post-vesting holding periods attaching to share awards to be increased from three to five years
- Chairs of remuneration committees to have at least 12 months' experience serving on a remuneration committee
- Remit of remuneration committees expanded to cover pay across the workforce
- New reporting obligation in relation to workforce remuneration and engagement on executive pay

6. Timing and Next Steps

The consultation is open until 28 February 2018 and the FRC aims to publish a final revised version of the Code (reflecting feedback from the consultation) by early summer 2018, which will apply to accounting periods beginning on or after 1 January 2019.

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