

UK Government Announces Reforms to the Corporate Governance Regime

12 September 2017

On 29 August 2017, the UK Government published its response¹ (the “**Response Document**”) to its consultation on UK corporate governance reform. The consultation was launched following the Government’s publication of a green paper² (the “**Green Paper**”) on 29 November 2016. The Response Document summarizes the responses received to the consultation and sets out 12 reforms that the Government intends to make to the UK corporate governance regime.

The Government’s proposals have also been influenced by the inquiry carried out by the Business, Energy and Industrial Strategy (“**BEIS**”) Committee of the UK Parliament over the last year. On 5 April 2017, The BEIS Committee published a report detailing the findings of its inquiry and making a number of recommendations to the Government. The Response Document responds to, and adopts certain of, the BEIS Committee’s recommendations, while noting that some of the other recommendations will form part of the forthcoming consultation by the Financial Reporting Council (“**FRC**”) on potential revisions to the UK Corporate Governance Code (the “**Code**”).

The UK corporate governance regime comprises a range of binding laws and regulations and non-binding recommendations and guidance, the application of which varies by type of company. These include: (i) the Code published by the FRC, which sets out high-level principles and more detailed provisions with which companies with a UK premium listing are required to “comply or explain”; (ii) binding rules set out in the Companies Act 2006 (“**CA 2006**”) and associated regulations, some of which apply to all UK companies and some of which only apply to specific types of company (e.g. quoted companies³); and (iii) guidance published by industry bodies (e.g. the Investment Association). The Government’s proposals touch each of these sources and fall into four main areas, which are summarized below.

¹ *Corporate Governance Reform – The Government response to the green paper consultation, August 2017*, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640631/corporate-governance-reform-government-response.pdf

² Our previous alert memorandum on the Green Paper is available at: <https://www.clearygottlieb.com/~media/cgsh/files/publication-pdfs/alert-memos/alert-memo-20172-revised.pdf>

³ A UK incorporated company whose shares are admitted to the Official List, or are officially listed on an exchange in any member state of the European Economic Area, or are admitted to dealing on either the New York Stock Exchange or NASDAQ, see section 385 of the CA 2006.

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1. Executive Remuneration

A key driver of the Green Paper consultation was what the Government described as a “*widespread perception that executive pay has become increasingly disconnected from both the pay of ordinary working people and the underlying long-term performance of companies*” and that executive remuneration is “*an area of significant public concern, with surveys consistently showing it to be a key factor in public dissatisfaction with large businesses.*” The Green Paper sought feedback on a wide variety of options for addressing these concerns.

A. Addressing significant shareholder dissent on executive pay

Under current legislation, quoted companies are required to submit a directors’ remuneration policy to a binding shareholder vote at least every three years. Additionally, they are required to prepare an annual directors’ remuneration report that reports on remuneration (including incentives) paid or awarded to their directors during the preceding financial year and includes a statement describing how the company intends to implement the current remuneration policy in the financial year following the reporting period. The remuneration report is subject to an advisory shareholder vote at the annual general meeting (“AGM”) and if it is not passed, the company must re-submit the remuneration policy to shareholders for approval at the next AGM⁴.

The Green Paper noted that while there have been few instances of remuneration policies and reports being rejected by shareholders, instances of significant minority opposition are comparatively high. The Government therefore sought views on five possible options to strengthen shareholder powers on executive remuneration:

- making all or some elements of the remuneration report subject to an annual binding shareholder vote;
- introducing stronger consequences for a company losing its annual advisory shareholder vote on the remuneration report;

- requiring or encouraging companies to set an upper threshold for total annual remuneration in their remuneration policies;
- requiring or giving shareholders the power to hold the existing binding vote on the remuneration policy more frequently than every three years; and
- strengthening the Code to provide greater specificity on how companies should engage with shareholders on pay, including where there is significant opposition to a remuneration report.

While there was general support among consultation respondents for strengthening shareholder powers on executive pay, there was little consensus on the best way of achieving this. Of the five options tabled by the Government in the Green Paper, there was limited support for the first, third and fourth options, with greater support being expressed for the second and fifth options.

The fifth option will form part of the consultation to be launched by the FRC on amendments to the Code later in 2017 and so the precise steps that premium listed companies will be expected to take when they encounter significant shareholder opposition to remuneration policies and awards will not become clear for some time. However, the Government has said that the FRC’s consultation could consider requiring such companies to respond publicly to dissent within a given time period or to put the company’s existing or a revised remuneration policy to a binding shareholder vote at the next AGM (as noted above, current legislation only requires companies to do this where a majority – rather than a significant minority – of shareholders dissent to the annual advisory vote on the remuneration report).

With respect to the second option, the Government has decided to implement this in a different – and what some have described as “*watered down*” – way than had been proposed in the Green Paper. The Government had originally suggested that companies that lost the annual advisory vote on their remuneration report would have to win the backing of a ‘supermajority’ of shareholders (e.g. 75%) when their remuneration policy is put to a binding vote the

⁴ See sections 420, 439 and 439A of the CA 2006.

following year (accelerated under the current regime), or the advisory vote on their remuneration report would become a binding vote in the following year. Instead, the Government has asked the Investment Association to maintain a public register of companies receiving a dissenting vote of 20% or more to their annual advisory vote on remuneration reports along with a record of what these companies say they are doing to address concerns, with the intention of enhancing shareholders' ability to hold such companies to account.

Government Proposal 1:

The FRC to consult on revising the Code to set out specific steps that premium listed companies should take when they encounter significant shareholder opposition to executive pay.

Investment Association to maintain public register of listed companies which have encountered shareholder opposition of 20% or more to remuneration reports.

B. Broadening the role of remuneration committees

The role and composition of remuneration committees is currently governed by a number of high-level principles under the Code, including that committees should be sensitive to pay and employment conditions elsewhere in the company and that committee chairs should maintain contact as required with principal shareholders about remuneration. However, the Green Paper cites a concern that remuneration committees are not as effective as they could be in overseeing executive pay arrangements, both because in many cases they are not seen to proactively engage with shareholders and employees, and because there is a perception that they are reluctant to take positions that do not align with the executive team's expectations.

The Green Paper invited views on two possible options to address this concern:

- requiring the committees to consult shareholders and the wider company workforce in advance of preparing the remuneration policy; and

- requiring chairs of remuneration committees to have served for at least 12 months on a remuneration committee before taking up the role.

Both options will form part of the FRC's forthcoming consultation on revisions to the Code.

Government Proposal 2:

The FRC to consult on revising the Code to: (a) give remuneration committees broader responsibility for overseeing remuneration across the company and explaining how executive remuneration aligns with wider company remuneration policy; and (b) require chairs of remuneration committees to have served for at least 12 months on a remuneration committee.

C. Pay ratio reporting and transparency

There was strong support from consultation respondents and the BEIS Committee for the introduction of mandatory reporting of the ratio between CEO and wider company pay, which was one of the key proposals put forward in the Green Paper.

The Government will therefore bring forward secondary legislation to require all quoted companies to disclose this ratio as part of their annual directors' remuneration report, along with a narrative explaining changes to that ratio from year-to-year and how that ratio relates to pay and conditions across the wider workforce. While the Government is continuing to consider the methodology for calculating the ratio, the Government's preliminary view is that it should be based on the CEO's total annual remuneration (as set out in the existing 'Single Figure' in the directors' remuneration report) relative to the average total remuneration of the company's UK workforce. A draft statutory instrument will be published later this year.

Government Proposal 3:

Quoted companies will be required to disclose the ratio of CEO remuneration to the average remuneration of their UK workforce.

The Green Paper additionally invited opinion as to whether existing reporting requirements relating to performance targets triggering bonus payments and benefits under incentive plans should be reinforced. Under current legislation, such targets must be reported by quoted companies in their annual directors' remuneration reports, although 'commercially sensitive' information can be withheld. There has been considerable pressure from investor associations for companies to provide full disclosure of performance targets. The Response Document acknowledges that companies have made substantial progress towards greater and more timely disclosure in recent years as a result of this pressure and, as such, the Government does not consider further regulatory intervention necessary at this time.

D. *Long-term incentive plans*

The Green Paper highlighted the increasingly large proportion of executive remuneration accounted for by long-term incentive plans ("LTIPs") under which executives are typically awarded shares in the company at nil-cost subject to a period of continued employment and the satisfaction of specified performance targets. The Green Paper also outlined concerns that LTIPs were becoming increasingly complex and that LTIP performance targets (which are often based on share price growth and short-term returns to shareholders) do not adequately align executive remuneration with long-term company performance.

While some consultation respondents advocated the abolition of LTIPs in their entirety (either being replaced by restricted share awards granted automatically without reference to performance or limiting remuneration to fixed salary only), the Government was not convinced that their abolition is justified. Instead, the Government believes the position can be improved by LTIPs being properly designed and explained to investors. The Government will therefore introduce secondary legislation to require quoted companies to provide a clearer explanation in their remuneration policies of the potential outcomes from LTIPs (including in the event of significant share price growth).

Government Proposal 4:

Quoted companies will be required to include in their remuneration policies clearer explanations of a range of potential outcomes from LTIPs.

The Green Paper also suggested that instead of the current minimum vesting period of three years under the Code, director share awards should be subject to a total vesting and post-vesting holding period of five years, which reflects the guidelines of the Investment Association. Consultation respondents and the BEIS Committee were supportive of this proposal and so the Government has invited the FRC to consult on this as part of its forthcoming consultation on the Code.

Government Proposal 5:

The FRC to consult on revising the Code to replace minimum vesting period of three years for director share awards with minimum vesting and post-vesting holding period of five years.

E. *Encouraging investors to make full use of their existing powers on executive remuneration*

Finally, citing evidence of an apparent lack of shareholder engagement in relation to executive remuneration, the Government consulted on a number of options for encouraging investors to make full use of their existing powers in this area, including mandatory disclosure of fund managers' voting records, the establishment of senior shareholder committees and the introduction of measures to increase the engagement of individual and retail shareholders. However, the Government has decided not to take forward any new measures in these areas at this time.

2. **Strengthening the Employee, Customer and Wider Stakeholder Voice**

At present, directors of all UK companies are required, in discharging their overriding duty to promote the success of the company for the benefit of

its shareholders as a whole, to have regard to (among other things) the interests of other stakeholders, including employees, customers and suppliers⁵. This is often referred to as the “enlightened shareholder value” model. Larger UK companies are also required to prepare a strategic report detailing the ways in which their directors have discharged this duty⁶.

Notwithstanding these existing requirements, the Green Paper cited recent examples of “*particularly poor corporate conduct*” as evidence that companies may need to do more to reassure the public that they are being run with an eye to the interests of the wider stakeholder community. The Green Paper invited views on a variety of measures to strengthen the voice of employees and other stakeholders at board level.

A. Strengthening reporting requirements relating to board engagement with employees and other stakeholders

There was strong support among consultation respondents and the BEIS Committee for strengthening and broadening existing reporting requirements in this area (with which the Government agrees). While the Government is still considering the form that these new reporting requirements will take, it envisages that they would include a requirement to explain how the company has identified and sought the views of key stakeholders, why the mechanisms adopted were appropriate and how this information has influenced board decision making. The Government is also still considering which companies should be subject to the new reporting requirement, but its initial view is that it should cover companies with more than 1,000 employees.

Government Proposal 6:

All public and private companies of a (yet to be determined) significant size will be required to explain how their directors comply with their existing duty to have regard to employee and other non-shareholder interests.

⁵ See section 172 of the CA 2006.

⁶ See sections 414A-D of the CA 2006. Companies entitled to the “small companies exemption” are exempt from the requirement to produce a strategic report and the extent of

B. Stakeholder representation

Although Prime Minister Theresa May had originally announced in June 2016 plans to mandate consumer and employee representatives on company boards, the Government expressly dropped this proposal in the Green Paper (citing concerns around the practical workability of the system and its application to a wide range of companies) and instead invited views on a number of less radical options for enhancing stakeholder representation, including the creation of stakeholder advisory panels and the designation of existing non-executive directors to represent key stakeholder groups at board level.

While consultation respondents were supportive of strengthening the voice of non-shareholder stakeholders at board level, there was no consensus around the best way of achieving this. Respondents emphasised that there were examples of a wide variety of approaches being successful in different circumstances and urged the need to retain flexibility.

The Government has therefore concluded that reforms in this area should be introduced in the first instance via revisions to the Code and which would therefore apply (on a “comply or explain” basis) to premium-listed companies. The Government has invited the FRC to consult on the development of:

- a new Code principle establishing the importance of strengthening the voice of employees and other stakeholders at board level; and
- a new Code provision requiring premium listed companies to adopt (on a “comply or explain” basis) one of three employee engagement mechanisms:
 - designating a specific non-executive director who would be responsible for ensuring that employee and other stakeholder voices are heard at board level;
 - forming an employee advisory council; or
 - appointing a director from the company’s employees.

the disclosure obligations applicable to other companies varies depending on the size and legal status of the company in question (with quoted companies being subject to more extensive requirements).

Government Proposal 7:

The FRC to consult on revising the Code to strengthen voice of employee and other non-shareholder interests at board level.

C. Improving directors' understanding of the "enlightened shareholder value" model

As noted above, directors of all UK companies are already required to have regard to the interests of non-shareholder stakeholders as part of the "enlightened shareholder value" model enshrined in UK company law. While some respondents urged the Government to amend the law to enable directors to pay greater heed to the interests of employees and other stakeholders, the Government has concluded that industry-led solutions centered on giving directors more practical guidance on how they should discharge their obligation to deliver "enlightened shareholder value" would be more appropriate.

Government Proposal 8:

ICSA and the Investment Association to publish guidance on how companies can engage with employees and other stakeholders.

Government Proposal 9:

GC100 to publish new advice and guidance on the practical interpretation of the directors' duty in section 172 of the CA 2006.

3. Corporate Governance in Large Privately-Held Businesses

The UK's current corporate governance regime imposes the strongest corporate governance and reporting standards on publicly listed companies where shareholders are most distant from executives running the company. The Green Paper outlined reasons why it might be appropriate for similar standards to apply to privately-held companies, including evidence that large UK businesses are increasingly choosing to operate as private – rather than public – companies and that stakeholders other

than shareholders (including employees, suppliers and customers) have a legitimate interest in all companies adopting strong corporate governance practices. It therefore asked whether the corporate governance regime for privately-held companies should be strengthened in two key areas.

A. Corporate governance framework

First, the Green Paper invited views on whether the Code – or alternatively, a different set of corporate governance principles – should apply to privately-held businesses.

While respondents were generally supportive of improving corporate governance standards among privately-held companies, many cautioned against a rigid and inflexible approach that could impose disproportionate burdens on, and therefore harm the competitiveness of, UK businesses.

The Government has therefore invited the FRC to work with relevant trade associations (including the Institute of Directors, the Confederation of British Industry and the British Private Equity & Venture Capital Association) to develop a set of corporate governance principles for large private companies. The Government has said that compliance with these principles will be voluntary and that companies that already comply with industry-developed codes and guidance – such as the Walker Guidelines for Disclosure and Transparency in Private Equity – will therefore be able to continue to follow their existing approach if desired.

While many respondents offered views on which threshold should be used to determine which privately-held companies should be required to comply with these principles (including based on number of employees or revenue), the Government reached no conclusion on this point and we expect this to be addressed as part of the FRC's work to develop the principles.

Government Proposal 10:

The FRC to develop a voluntary set of corporate governance principles for large private companies.

B. *Transparency*

Second, the Green Paper invited views on whether corporate governance reporting requirements – which currently only apply to listed companies – should be broadened to apply to all UK companies of a significant size (regardless of their ownership structure). Respondents were overwhelmingly supportive of this concept.

The Government has therefore decided to introduce secondary legislation to require all companies of a significant size to disclose their corporate governance arrangements – including whether they follow any formal code – in their directors’ report (which forms part of their annual report and accounts) and on their website. While the Government is continuing to consider the size of company that will be subject to this new requirement, the Government’s preliminary view is that this should apply to companies with over 2,000 employees (regardless of whether they are private or public), which would cover approximately 1,400 new companies. The Government also intends to exempt from this new requirement premium listed companies (which are required to report against the Code) and other companies that are already required to publish a corporate governance statement under the FCA’s Disclosure Guidance and Transparency Rules sourcebook (DTRs).

Government Proposal 11:

All large companies not already subject to a corporate governance reporting requirement will be required to disclose their corporate governance arrangements.

4. **Other Issues**

In addition to the three specific aspects of corporate governance outlined above, the Green Paper invited broader feedback on the current UK corporate governance framework. While a clear majority of respondents were generally satisfied that the current framework provides the right combination of high standards and low burdens, a number of suggestions for improvement were made.

In particular, concerns were raised that the FRC does not have adequate powers to oversee and enforce the

UK corporate governance framework and, based on this feedback, the Government has made the following proposal.

Government Proposal 12:

The FRC, FCA and Insolvency Service to conclude new or revised letters of understanding with each other by the end of 2017 to ensure the most effective use of their existing powers to sanction directors and ensure the integrity of corporate governance reporting.

The Response Document concludes by setting out a summary of the steps that are being taken separately to address boardroom diversity, on which many consultation respondents offered views.

5. **Timing and Next Steps**

While the Response Document sets out the high-level principles of the reforms that the Government intends to make, much of the detail of the reforms will only become clear once:

- the FRC has concluded its consultation on revisions to the Code (expected later this year);
- the Government has introduced secondary legislation to implement the legislative proposals referred to above (which it intends to do in early 2018 with a view to them applying to company reporting periods commencing on or after June 2018); and
- relevant regulators and industry bodies have published the documents referred to above.

The Government has also said that it intends to monitor progress in a number of areas and will consider further action if required.

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