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UK Executive Pay & Governance

FRC Consultation on UK Corporate Governance Code

December 2017

Introduction

On 5 December 2017 the Financial Reporting Council (FRC) published a consultation document (click for link) on proposed revisions to the UK Corporate Governance Code. In this briefing note we summarise the key changes and set out some initial thoughts.

The revised Code is shorter than the current version and is focused on a number of high-level Principles, together with more detailed Provisions. The new Code is structured around the following sections:

1. Leadership and purpose
2. Division of responsibilities
3. Composition, succession and evaluation
4. Audit, risk and internal control
5. Remuneration

Some Provisions from the current Code have been incorporated into an amended and expanded version of the FRC's Guidance on Board Effectiveness.

The Code will continue to operate under a "comply or explain" approach.

Timeline

The FRC has set a deadline of **28 February 2018** for comments on the proposed changes. The aim is to publish a final version of the new Code in early summer 2018, **with the Code formally applicable to accounting periods beginning on or after 1 January 2019**.

Key themes to emerge from the FRC's proposals are set out below.

Culture

- The new Code takes forward the FRC's previous work on the importance of company culture in delivering long-term sustainable performance. Principle A includes the statement that "**the board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned**." A separate Provision recommends that "directors should embody and promote the desired culture of the company."

Engagement with the workforce

- The new Code emphasises that companies have responsibilities to a wide range of stakeholders. **Significant focus is placed on engagement with the wider workforce**. The UK Government suggested earlier this year that the revised Code include three options for companies to engage with employees: (1) a designated NED, (2) a formal employee advisory panel, or (3) a director appointed from the workforce. The FRC has now included all three options in the new Code (although states that this is not an exhaustive list of possible approaches). The amended Guidance on Board Effectiveness (see above) includes some suggestions on how workforce engagement may operate in practice.

Engagement with shareholders

- Provisions in the current Code on how companies should respond to a significant proportion of votes against a resolution have been extended. **"Significant" is now defined as a 20% vote against**. In addition to setting out what actions the company intends to take in consulting with shareholders in such circumstances, **the new Code also recommends that an update is provided no later than six months after the vote**, with a final summary of consequent board decisions included in the following year's annual report or AGM notice.

Board and committee composition

- A notable proposed change in the new Code is the treatment of the board chair. Since 2004, the Code has assumed that the board chair is not an independent director, as the chair is a unique board role which is neither conventionally executive nor non-executive. The existing Code recommends only that the board chair be independent on appointment; **in contrast, the new Code recognises that it is possible for the chair to be considered independent during his/her full period of service**. The current provision that "at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent" has been revised to state that "independent non-executive directors, including the chair, should constitute the majority of the board."
- This Provision will also apply to smaller companies, **as the current exemption for companies outside the FTSE 350 permitting them to have just two independent non-executives will be removed**. The FRC is also proposing to remove other exemptions which currently permit smaller companies (a) to have audit and remuneration committees comprised of only two members, (b) not to be required to submit all directors for annual re-election and (c) not to hold an external board evaluation exercise at least every three years. The FRC's aim is to make it clear that even smaller companies should aim for high governance standards.
- The categories for considering non-executive director independence have not changed, although **there is now an assumption that a director who does not satisfy the criteria will not be considered independent** (rather than the board simply taking the criteria into account when considering independence). The "nine-year" guidance remains in place.

Diversity

- Principle J of the new Code states that **board appointments and succession plans should "promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths."** The nomination committee will also need to oversee the development of a diverse pipeline for succession.
- The nomination committee report has been expanded and will need to include, among other things, actions taken by the committee to oversee the development of a diverse pipeline for succession, how diversity supports the company in meeting its strategic objectives, and also **set out the gender balance of those in senior management** (i.e. the executive committee or the first layer of management below the board, including the company secretary) and their direct reports.

Remuneration

- Schedule A of the current Code has been replaced with a revised section covering executive pay. The first Principle of this section (Principle O) now states that "the board should satisfy itself that company remuneration and workforce policies and practices promote its long-term success and are aligned with its strategy and values." **The remit for remuneration committees is also expanded to include the oversight of remuneration and workforce policies and practices, with these taken into account when setting directors' remuneration policy. The committee will also be responsible for setting (not just recommending and monitoring) the pay for senior management.**
- The new Code states that before being appointed as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months. This relates to prior experience on any remuneration committee, not just the committee in question.
- As recommended by the Government in its response to the green paper consultation, the new Code includes a statement that **shares or other long-term incentives should be subject to a vesting and holding period of at least five years**.
- Provision 40 includes **a list of factors which should be addressed by the remuneration committee when determining executive pay**. These are (a) clarity, (b) simplicity, (c) predictability, (d) proportionality and reward for individual performance, and (e) alignment to culture. The Code states that "outcomes should not reward poor performance and total rewards available should not be excessive."
- The importance of discretion is emphasised, with the new Code stating that remuneration schemes and policies should provide boards with discretion to override formulaic outcomes.
- Provision 41 sets out information that should be included in the annual report on the work of the remuneration committee. This includes "whether the remuneration policy operated as intended in terms of company performance and quantum, and, if not, what changes are necessary" and "**an explanation of the company's approach to investing in, developing and rewarding the workforce, and what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company policy**."

The UK Stewardship Code

- The FRC intends to consult on changes to the UK Stewardship Code in 2018. In advance, the consultation document also includes a number of questions aimed at gathering views on the future direction of the Stewardship Code.

Our View

General

- The proposed Code encapsulates good corporate governance practice in a straightforward and succinct manner. It does not represent a fundamental change in expectations but there are plenty of areas that will require board focus ahead of implementation in 2019. Continued attention will need to be paid to how **company culture, stakeholder engagement and management for the long-term** are reflected in practice and in corporate reporting.

Implications for remuneration committees

- In the immediate term, remuneration committees (and companies more widely) may wish to consider whether they want to formally respond to the consultation document. Further out, committees will need to start planning for changes to process, policy and reporting (this is on top of complying with legislative changes in the pipeline such as CEO pay ratio reporting). Some useful initial questions to help guide discussions are set out in the FRC's Guidance on Board Effectiveness. **Key areas of focus on process will include how to set management pay appropriately (including how to ensure that the CEO feels involved in pay decisions relating to his/her direct reports), how to oversee workforce pay and practices effectively, and how best to engage with the wider workforce on pay. Terms of reference will need to be reviewed and updated**.
- On policy, remuneration committees should consider the current directors' remuneration policy against the factors set out by the FRC in Provision 40. **Among other things, committees will need to consider how incentives are aligned to culture and how this can be communicated**. Committees will also need to think about whether a broad override on formulaic outcomes for pay schemes is required to be set out explicitly in the remuneration policy. **Plans which lack a five-year vesting/post-vesting holding period will also attract greater attention**: expect the Code change to push investors and proxy advisers into taking a harder line on this issue as time goes on.
- On reporting, the "comply or explain" principle will apply to all of the Provisions in the new remuneration section. **Companies which don't wish to comply with specific Provisions will need to clearly explain why not**. Any explanation should focus on the company's specific circumstances and be sufficiently detailed not to be open to criticism of "boilerplate". Investors for their part are again encouraged not to consider explanations in a mechanistic way.
- Given that the new Code is at the consultation stage and we will not know the final outcomes until the middle of 2018, we do not recommend that companies make major changes to remuneration reporting at this stage for their 2017 annual reports (to be published in early 2018). **However, a "dry run" in the 2018 annual report (published 2019) would be advisable ahead of formal reporting in the 2019 report (published 2020)**. Ahead of the 2019 AGM – i.e. at the same time as the "dry run" reporting – remuneration committees may also wish to consider whether a new remuneration policy vote will be needed to address any relevant issues (e.g. on post-vesting holding periods) ahead of formal implementation of the new Code.

Wider considerations

- Board and committee composition will need to be reviewed in the light of the decision to permit the chair to be counted as an independent director. Many companies will view this change positively, although it does mean that **the "nine-year" guidance will apply to the board chair**; companies where the chair has served for more than nine years will need to consider the implications fully.
- Smaller companies (i.e. those outside the FTSE 350) may be concerned that the exemptions in the current Code are being removed, even if the board chair can now be counted as an independent director. **This is a specific issue for the audit committee, where the board chair will no longer be permitted to be a member**. The recommendation that all directors stand for annual re-election will have limited direct impact given that this is already common practice for smaller companies, even though the current Code provision formally applies to FTSE 350 companies only.
- **Nomination committees will need to focus more attention on how a diverse pipeline of future appointments can be developed, and report accordingly**. Given the increasing focus of investors on diversity, we anticipate this to be a popular topic for shareholder engagement.
- When a 20%+ vote against is received on any resolution at a general meeting, a clear plan will need to be devised both in terms of the initial communication which is issued when the vote results are published and the follow-up reporting expected after six months and in the following year's annual report. Companies in this position will not be able to avoid the limelight given the vote results will also be set out in the Investment Association's Public Register, due to be launched shortly.

Want to know more?

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