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UK Executive Pay & Governance

New UK Corporate Governance Code

July 2018

Introduction

On 16 July the Financial Reporting Council (FRC) published the new UK Corporate Governance Code (click for link). In this briefing note we set out the key changes that the FRC has made to the new Code following responses to the consultation on the initial version which was published in December 2017.

The Code includes a number of high-level Principles and more detailed Provisions. Companies must apply the Principles, but the Provisions continue to operate on the basis of "comply or explain." The Code applies to all companies with a premium listing on the Main Market in London, regardless of country of incorporation.

The new Code will apply to accounting periods beginning on or after 1 January 2019. In practice, this means that companies will be required to report against the Code in the annual report published in 2020. However, **the FRC has advised that it expects companies to report against Provision 4 – which relates to reporting on the response to a significant vote against a resolution at a shareholder meeting – in 2019**.

The FRC has also published an updated version of its Guidance on Board Effectiveness, which is intended to provide good practice guidance on applying the new Code. We refer to the Guidance in a number of places in this note.

Response to the consultation

The FRC received 275 responses to its consultation. It states that the majority of respondents were supportive of the overall approach of the revised Code, in particular its shorter length and the emphasis on key Principles. These Principles are structured around the following sections:

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

Although the overall approach has not changed, the FRC has made various amendments to the detail in response to comments received during the consultation stage. Key points are set out below.

Board engagement with the workforce

- There are three stated options for boards to engage with the workforce: (1) a director appointed from the workforce, (2) a formal employee advisory panel, or (3) a designated non-executive director. The FRC recognises that different approaches could be adopted. Additional wording has been added to the effect that **if the board has not chosen one or more of the three stated options, "it should explain what alternative arrangements are in place and why it considers that they are effective."**

The board chair and tenure

- Many respondents to the consultation did not support the proposal that the board chair should be effectively treated as a conventional non-executive and subject to the same tests of independence as other NEDs. A number of respondents (including ourselves) raised concerns with applying the "nine-year rule" to the board chair, highlighting the significant number of chairs who have served for longer than nine years.

- To recognise the special role of the board chair, the FRC has reverted to the wording in the current Code that he/she should be "independent on appointment," taking into account the tests of independence. However, a separate Provision has been added (Provision 19) stating that **"the chair should not remain in post beyond nine years from the date of their first appointment to the board. To facilitate effective succession**

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planning and the development of a diverse board, this period can be extended for a limited time, particularly in those cases where the chair was an existing non-executive director on appointment. A clear explanation should be provided."

- On a related point, the criteria for judging a director's independence based on tenure has been amended to reference "nine years from the date of their first appointment" instead of "first election".

Smaller company exemptions

- The December consultation proposed removing various exemptions for smaller companies (i.e. those outside the FTSE 350) from the Code. The FRC has made a partial retreat. As originally proposed, the exemption on overall board composition – which permitted smaller companies to have only two independent non-executives – has been removed. All companies are now subject to the provision that "at least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent."
- However, **the final Code permits the audit and remuneration committees of smaller companies to be comprised of two independent directors only**, thus maintaining the status quo. **One caveat is that the board chair cannot be a member of the audit committee,** a change from current practice.
- The FRC has reinstated the exemption for smaller companies on board evaluation, which means that the requirement to undertake an external board evaluation exercise at least once every three years continues to apply to FTSE 350 companies only.

Overboarding

- No explicit rules have been added to the Code regarding the maximum number of directorships that an individual should hold. However, wording has been included to the effect that significant commitments should be disclosed with an indication of the time involved. Further, the reasons for permitting any significant appointments should be explained in the annual report.

Remuneration committee remit

- The FRC had suggested expanding the remit of the remuneration committee to include the oversight of "remuneration and workforce policies and practices". This has been modified in the final Code, such that **the board – rather than the remuneration committee – is responsible for workforce policies and practices**. Furthermore, it is now the board that has reporting responsibility for explaining the company's approach to investing in and rewarding its workforce.
- Wording has been added to clarify that the remuneration of non-executives should be determined in accordance with the articles of association or, alternatively, by the board.

Remuneration practices and reporting

- Additional clarification has been added regarding holding periods for long-term share schemes, in part to ensure that deferred bonuses are not captured. The final Code states that **shares granted for the purpose of aligning executive directors with long-term shareholder interests "should be released for sale on a phased basis and be subject to a total vesting and holding period of five years or more."**
- The final Code also states: "**The remuneration committee should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares."** The Guidance on Board Effectiveness implies that these requirements should apply for a period of two to three years after an executive leaves the company.
- The FRC has toughened its stance on pensions, with the new Code noting explicitly that **"the pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce."**
- **The list of factors which remuneration committees should address when setting executive pay (Provision 40) has been expanded to specifically cover risk**. This states that "remuneration arrangements should ensure reputational and other risks from excessive rewards, and behavioural risks that can arise from target-based incentive plans, are identified and mitigated." Remuneration committee reporting should also include a description, *with examples* (our emphasis), of how the committee has addressed the factors in Provision 40 (which, in addition to risk, cover clarity, simplicity, predictability, proportionality and alignment to culture).

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Our View

- The FRC has made a number of notable changes to the Code in response to feedback. The conclusions reached on tenure as it affects the board chair may not be popular with some companies. Although some flexibility has been added to the Code, Provision 19 makes it clear that nine years is the preferred tenure length for chairs. This is underlined in the FRC's response to the consultation: "in normal circumstances we would not expect either an independent non-executive director or chair to be on a board for more than nine years in total, including in those circumstances where an independent non-executive goes on to be the chair." **What will be key is what length of period is considered by investors and proxy advisers to be an acceptable "limited time" beyond nine years that a chair can continue to serve if the company deems it appropriate**.

- The clarification of the remit of the remuneration committee should not detract from the fact that the committee will have a responsibility for reviewing workforce remuneration and related policies and ensuring they are taken into account when setting executive directors' remuneration. The Guidance explains the purpose of this review and that it can be fairly broad, covering pay principles as well as different elements of the pay package throughout the organisation.

- The committee will also need to report on what engagement has taken place with the workforce to explain how executive remuneration aligns with wider company pay policy. In addition, the committee will have formal responsibility for setting senior management pay. This all needs close consideration and, where necessary, amendments to committee terms of reference.

- The requirement for long-term share plans to have a total vesting and holding period of a minimum of five years has been retained (as expected), although we note the additional statement that awards "should be released for sale on a phased basis." Our understanding is that it is not the intention to require the staged release of awards over an extended timeframe beyond the five-year vesting and holding period.

- Post-employment shareholding requirements have gained some traction in the market but are still very much a minority practice. We expect this to change now that the Code recommends their adoption. **We suspect it may not be long before investors and proxy advisers insist on their introduction as companies renew their remuneration policies,** although it may be acceptable to apply a lower level of shareholding requirement during the post-employment period than the typical 200% of salary.

- **The reference to pension contribution rates for directors being aligned to the workforce is more direct than was perhaps expected, and is an example of the Code getting increasingly specific in terms of the granularity of pay practice**. While we have observed a reduction in contribution levels for new director hires in some companies' remuneration policies (in response to the views of BlackRock and others), it remains the case that contribution rates for most executive pensions exceed the employee average as a percentage of salary. Changing this will take time, although the Guidance suggests that grandfathering of existing contractual entitlements is permissible. Investors are alive to the potential for reductions in pension contribution to be compensated for with higher salary levels.

- It is telling that one of the three Principles in the Remuneration section of the Code relates to the exercise of judgement and discretion. This remains a critically important area for investors and regulators as well as for remuneration committees. **One suggestion of the FRC in the Guidance is for the committee to set a monetary limit on what is considered a reasonable reward for individual executives, in order to provide some predictability and guide the exercise of discretion.** We suggest that this approach is unlikely to be taken up by many companies.

- In total, the new reporting requirements on executive pay are significant and remuneration committees will need to pay close attention to the Code as well as the existing legal requirements on the contents of remuneration reports. There is some overlap between the two. **The new requirement for descriptions of how the committee has addressed the various factors highlighted as good practice by the FRC will invariably add extra length to remuneration reports**.

- Attention will now shift to reviewing governance arrangements against the new Code ahead of formal application during 2019. **We suggest that, where possible, companies consider "dry run" reporting in the 2018 annual report to be published in 2019**. We recommend that this be done alongside consideration of the changes to UK law on the requirement to publish CEO pay ratios and make other enhancements to reporting on remuneration (see our June briefing note).

- We again highlight the focus on those companies which receive a large (i.e. 20%+) vote against a resolution at a meeting. For these companies, the new Code makes it clear that an update must be provided to shareholders no later than six months after the meeting, and that this update should cover the views received from shareholders and the actions taken since the meeting. We note the FRC's expectation that this reporting starts from

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2019, i.e. a year earlier than strictly required. In practice, investors and representative bodies such as the Investment Association are already expecting clear evidence of action when a company has received a large vote against. We encourage any company that was the subject of significant shareholder opposition during this year's AGM season to provide the six-month update later this year, and not wait until 2019.

Want to know more?

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