

FRC consultation on the UK Corporate Governance Code

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The Financial Reporting Council (FRC) has issued its long-awaited [consultation](#) on the UK Corporate Governance Code (the Code).

The FRC has undertaken a comprehensive review of the Code, including consulting a broad range of stakeholders. It is seeking to ensure that it remains fit for purpose, continues to improve the quality of corporate governance and achieves long-term success and trust in business.

Whilst retaining those elements of the current Code that are still relevant, the proposed Code has been significantly re-structured and looks very different.

As has been well-trailed, key areas of the Code being added or updated include:

- Stakeholder, especially workforce, engagement
- Remuneration
- Culture
- Succession planning and diversity

There are also a few other significant proposed changes that companies should consider. In particular, a strengthening of the independence provisions is proposed as regards when a non-executive director, including the chairman, will not be considered independent.

This client briefing covers the key areas of change to the Code and what it may mean for companies. It also notes briefly the revised Guidance on Board Effectiveness and some high-level questions on the Stewardship Code, both published by the FRC at the same time.

Background

House of Commons BEIS Committee Inquiry into Corporate Governance	September 2016
Government Green Paper on Corporate Governance Reform	November 2016
BEIS Committee report on its Inquiry	April 2017
Government response on its Green Paper	August 2017
Government response to BEIS Committee report	September 2017

TIMING

The consultation period runs until 28 February 2018. The FRC aims to publish a final version of the Code by early Summer 2018, to apply to accounting periods beginning on or after 1 January 2019.

STRUCTURAL CHANGES

Shorten and sharpen

Recognising that the current Code has evolved over time often incrementally due to specific events, the FRC feels that it no longer fits together as it would wish. Also, although there are new areas to be inserted into the revised Code, following the various inquiries (see Background above), the FRC does not want to add to its overall length. It has therefore set about producing a revised Code that is shorter, sharper and fit for purpose.

Principles v provisions

Companies are very familiar with the structure of the current Code with its Main Principles, which embody best practice and operate on a comply basis. Companies are required by the Listing Rules to state how they have applied the Main Principles in a manner that enables shareholders to evaluate how they have been applied (LR 9.8.6 (5)). This compares with more detailed Provisions of the Code, which operate on a comply or explain basis, with companies either confirming their compliance or explaining their non-compliance (LR 9.8.6(6)). Supporting Principles occupy a space between Main Principles and Provisions.

The FRC has said that companies have put too much focus on ticking the box as regards Provisions and not done enough hard thinking about what they need to do to apply the Principles. It is seeking to address this.

Structure - key proposed changes	
Removal of Supporting Principles	To be removed and either built into the Principles (no longer to be called Main Principles), the Provisions or the Guidance on Board Effectiveness.
Focus on Principles	The revised Code contains an updated set of Principles that emphasise the value of good governance to long-term success in the wider context. It focuses on application of the Principles and asks for meaningful reporting that avoids boiler-plate reporting and instead focuses on how the Principles have been applied, articulating what actions have been taken and the resulting outcomes.
Reduction in number of Provisions	Reduction in the number of Principles by just under a third.

For existing listed companies, if parts of the Supporting Principles will instead feature in the Principles together with the addition of some new Principles as proposed, there will be more for them to report on as regards how they apply the Principles. They will need to consider afresh whether their Annual Reports contain all the necessary disclosures. It is likely that some

additions, at least, will be needed, and also that they may want to consider some restructuring of the corporate governance sections of their Annual Reports.

STAKEHOLDER ENGAGEMENT

Stakeholder engagement - key proposed changes
New Principle C on engagement with stakeholders and new Provision 3 on a method for gathering the views of the workforce.
New Provision 4 for reporting on engagement with the workforce and other stakeholders and on how section 172 has influenced board decision-making.
Updated Provision 6 on what to do after 20 per cent or more of votes have been cast against any resolution.

Engagement with stakeholders and in particular with employees

New Principle C – *"In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties"*

New Provision 3 *"The board should establish a method for gathering the views of the workforce. This would normally be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. There should also be a means for the workforce to raise concerns in confidence and (if they wish) anonymously...."*

These proposed changes implement requests that the Government made of the FRC in its response to its Green Paper on Corporate Governance.

The recently issued guidance on [The Stakeholder Voice in Board Decision Making](#), published by the Investment Association (IA) and the Institute of Chartered Secretaries and Administrators (ICSA), should also assist companies with their choice of which, if any, of the three routes they wish to adopt. For more on the IA/ICSA guidance, see our [September 2017 Quoted Company Newsletter](#). The proposed Guidance on Board Effectiveness also contains more information on engaging with stakeholders (see below).

Section 172 reporting

New Provision 4. *"The board should explain in the annual report how it has engaged with the workforce and other stakeholders and how their interests and the matters set out in section 172 of the Companies Act 2006 influenced the board's decision-making."*

Given the Government has said that it will be legislating on section 172 reporting, it is not clear that duplication in the revised Code is needed. The FRC has said it will keep the "exact wording" of this under review pending the final legislation.

The use of the word "workforce" is purposeful and meant to capture the diversity of relationships between companies and those working for them.

Significant votes against resolutions

New Provision 6. This is a change from the current Provision. It will no longer be a matter for the opinion of the board and there will be more that companies have to do.

Where more than 20 per cent of votes are cast against a resolution

The company should state, when announcing the results of the voting, what actions it intends to take to consult with shareholders to understand the reasons behind the vote.

The company must publish an update at least 6 months after the vote.

The company must provide a final summary in the Annual Report (or in the explanatory notes to resolutions at the next meeting) of what impact the feedback has had on decisions the board has taken and any actions or resolutions now proposed.

The FRC also notes that it will include in the revised Code a footnote concerning the IA's new public register. This is the public register that the IA [announced](#) in August 2017, which will list FTSE All Share companies that have received over 20 per cent of votes against any of their remuneration resolutions. The register is due to be launched by the end of 2017, and the IA has [written](#) to companies that will feature in it on its publication to ask them to submit an explanation of how they have responded to the shareholder dissent for inclusion in the register.

REMUNERATION

Remuneration - key proposed changes

Updated Principle O and Provision 33 extend the remit of the remuneration committee to include oversight of pay, policies and practices for the workforce generally and the setting of pay for senior management below board level.

Remuneration schemes and policies should give boards discretion to override formulaic outcomes.

The remuneration committee chair must have at least a year's experience on any remuneration committee.

Combined vesting and post-vesting holding periods for executive share awards should be at least five years long rather than the current three.

In terms of structure, Schedule A of the current Code (on the design of performance-related remuneration for executive directors) will be deleted, although some of its content will be moved across to the revised Remuneration Section of the Code. This section will contain a number of new Principles and Provisions.

Remit of the remuneration committee

The main focus of the remuneration changes is on the remit of the remuneration committee. Under the revised Code, the remuneration committee will continue to have responsibility for determining the directors' remuneration policy and for setting remuneration for the board. However, as regards the pay of senior management (meaning the executive committee or the first layer of management below board level), there is a subtle change of focus from the current obligation to "recommend and monitor the level and structure of remuneration" to a new responsibility for "setting" such remuneration.

More significantly, the revised Code will put a greater onus on the remuneration committee to pay heed to the interests of the workforce generally. Under a new Provision 33, the remuneration committee should "oversee remuneration and workforce policies and practices" and take these into account when setting the policy for director remuneration. The updated Guidance on Board Effectiveness expands on the types of workforce policy referred to here. These go well beyond pay and include

policies on recruitment and retention, promotion and progression, performance management, training and development, reskilling and flexible working. Remuneration committee members may feel that some of these issues are outside their area of experience. With that in mind, perhaps, and despite the fact that the revised Code puts oversight of workforce pay and policies onto the remuneration committee, the Guidance suggests that the board could delegate these responsibilities to another committee such as a sustainability committee or corporate responsibility committee. Even so, their oversight of wider workforce pay and policies must be integrated with the remuneration committee's consideration of executive pay.

Use of discretion

New Principle Q requires the board to exercise independent judgement and discretion when approving remuneration outcomes, taking account of company and individual performance and wider circumstances. Under new Provision 37, remuneration schemes and policies should give boards discretion to override formulaic outcomes, for example where the measurement of any performance condition does not reflect actual company or individual performance over the relevant period. The revised Guidance on Board Effectiveness also suggests that remuneration committees consider whether a cap on executive rewards is appropriate.

Directors' pay policy and practices

New Provision 40 sets out a list of matters for the remuneration committee to address when determining directors' remuneration policy and practices. These fall under the headings of clarity, simplicity, predictability, proportionality and reward for individual performance, and alignment to culture.

Remuneration committee chair

To meet one of the Government's requests, the revised Code provides that a remuneration committee chair must have served for at least 12 months on any remuneration committee.

Minimum vesting/holding periods

The Government asked the FRC to consult on extending the recommended minimum combined vesting and post-vesting holding periods for executive share awards from three years to five years and this is reflected in the revised Code.

This has in any event already become fairly standard market practice to comply with institutional investor expectations.

Reporting obligations

A new Provision 41 sets out in some detail the matters to be included in the annual report when describing the work of the remuneration committee. These include what engagement has taken place with shareholders and the workforce and how executive remuneration aligns with wider company policy.

CULTURE

In July 2016, the FRC published the findings of its Culture Coalition Project from which it hoped to gain a better understanding of how boards are addressing culture and to share good practice – "[Corporate culture and the role of boards: report of observations](#)".

The FRC describes culture in a corporate context as *".... a combination of the values, attitudes and behaviours manifested by a company in its operations and relations with its stakeholders"*.

Culture - key proposed changes

Updated Principle A on aligning the company's culture with its purpose, strategy and values.

New Principle D on directors acting with integrity and leading by example in the best interests of the company, and on the workforce being able to raise concerns where they consider conduct is not consistent with the company's values and responsibilities.

New Provision 2 that the board should assess and monitor the culture to satisfy itself that behaviour is aligned with values, take corrective action where it is not and explain in the Annual Report the board's activities and any actions taken.

SUCCESSION PLANNING, DIVERSITY AND THE NOMINATION COMMITTEE

Relevant here are the May 2016 FRC [feedback statement](#) on its discussion paper on UK Board Succession Planning, the October 2017 Parker Review Committee [final report](#) on ethnic diversity of UK boards and the November 2017 Hampton-Alexander Review [supplementary report](#) on improving gender balance in FTSE leadership.

In the revised Code, succession planning and the need for appointments to be made on merit and

against objective criteria and to promote diversity are elevated to Principle status. Also, changes are made as regards the duties of nomination committees and reporting by them.

Succession planning, diversity and nomination committees – key proposed changes
Updated Principle I including that an effective succession plan for board and senior management should be in place and that appointments and succession plans should promote not only diversity of gender, but also of social and ethnic backgrounds and cognitive and personal strengths.
Updated Provision 17 that the nomination committee should lead the process for all appointments (not just board) and should oversee the development of a diverse pipeline for succession.
Updated Provision 23 on reporting as regards the work of the nomination committee including additional reporting on its approach to succession planning, the actions it has taken to oversee the building of a diverse pipeline, how diversity supports its strategic objectives and the gender balance of senior management and their direct reports.

For existing listed companies, they may need to consider how the work of their nomination committees in particular needs to be developed to achieve compliance with the updated Principles and Provisions and to update their terms of reference.

OTHER KEY CHANGES

The revised Code also makes potentially significant changes in a few other areas which companies might wish to consider. These include (i) strengthening independence Provisions as regards non-executive directors including the chairman; (ii) changing the Code's independence stance on the chairman; (iii) introducing a Provision on conflicts of interest; and (iv) removing the FTSE 350 cut-off that currently exists for some Provisions.

When non-executive directors should not be considered independent

A significant change to the revised Code is that there will no longer be a reference to the board deciding that a non-executive director is independent notwithstanding the existence of one of the listed relationships or circumstances

existing (eg having served on the board for more than nine years). Updated Provision 15 instead provides that non-executive directors (including the chair – see more below) should not be considered independent for the purposes of board and committee composition if any of the listed relationships or circumstances exist.

For existing listed companies that have one or more non-executive directors that they list as independent notwithstanding one of the relationships or circumstances being in place, although they are free to continue to do this and explain their non-compliance with the Code, they will need to bear in mind this greater focus on independence (along with the elevating of the importance of succession planning) and whether their shareholders may perhaps in the future be less accommodating of non-compliance here.

Independence of the chairman

The current Code takes the position that the chairman needs to be independent on appointment and thereafter the test of independence is not appropriate (A.3.1 and footnote 5). Following on from that assumption, in terms of composition of the board, the current Provision is that (other than for smaller companies) **at least half the board, excluding the chairman**, should comprise independent non-executive directors (B.1.2).

As already mentioned, in the revised Code the chairman is to be included in proposed Provision 15 and will not be regarded as independent should one of those relationships or circumstances exist or come to exist (eg serving for more than nine years). The footnote mentioned above is to be removed and updated Provision 11 will provide that **"Independent non-executive directors, including the chair, should constitute the majority of the board"**. In its consultation paper, the FCA notes that in normal circumstances it would not expect an independent non-executive director or a chairman to be on the board for more than nine years and this includes an independent non-executive director who goes on to be the chairman.

Some existing listed companies will need to evaluate whether they will meet Provision 11 if and when changed in this way. Others will need to consider whether if, for example, they have a chairman that is approaching 9 years of service,

they will continue to meet the proposed Provision once he/she is no longer regarded as independent.

Conflicts of interest

A new Provision 7 has been added providing that the board should *"take action to identify and eliminate conflicts of interest, including those resulting from significant shareholdings, and ensure that the influence of third parties does not compromise or override independent judgment"*.

There is no such Provision in the current Code and, in the absence of this proposed Provision being commented on in the FRC consultation paper, it is not clear what the rationale for this addition is and what, if anything, it is intended to achieve above the conflicts provisions in the Companies Act 2006 and the Listing Rules. Possibly, it is felt to be an omission that a corporate governance code does not include anything on board conflicts, even if its inclusion is not intended to add anything beyond the Act and the Listing Rules.

FTSE 350 cut-off removal

The FRC is also proposing to remove the FTSE 350 cut-off from all the Provisions to which it currently attaches. So, smaller companies will, under the revised Code need: the majority of the board, including the chairman, to be independent; to externally facilitate board evaluations at least every three years; to put directors up for annual re-elections; and to meet standard committee composition requirements.

Existing smaller listed companies taking advantage of the current FTSE 350 cut-offs will need to prepare to meet these newly applicable requirements or explain what they have not (as yet) done so. Terms of reference for their

committees will also need to be updated as and when appropriate.

GUIDANCE ON BOARD EFFECTIVENESS

The [current Guidance on Board Effectiveness](#) (the Guidance) was published in 2011, and is intended to assist companies in applying the Principles of the Code by setting out good practice suggestions. Although not prescriptive, the FRC suggests that the Guidance should be read alongside the revised Code to add clarity and explanation. Sections within it contain questions for boards to ask themselves and management, and the FRC states that boards should use these questions to consider how they report on application of the Principles.

Supporting the proposed changes to the revised Code, the Guidance has been updated to include new sections on relations with the workforce and wider stakeholders, culture and oversight of workforce pay, conditions and policies as well as other updating. It is perhaps likely that the updated and fuller Guidance will assume more importance in the future.

HIGH-LEVEL QUESTIONS ON THE UK STEWARDSHIP CODE

The FRC has also issued some high-level questions about the future direction of the UK Stewardship Code, on which it plans to issue a consultation next year.

TIMING

As mentioned, the consultation period runs until 28 February 2018 and the FRC aims to publish a final version of the revised Code by early Summer 2018, to apply to accounting periods beginning on or after 1 January 2019.

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