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Breaking Down The UK's Revised Corporate Governance Code

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On July 16, 2018, the United Kingdom's Financial Reporting Council published a revised Corporate Governance Code applicable to companies, or issuers, whose securities have a premium listing on the London Stock Exchange.

The code has long been considered a "gold" standard for the corporate governance of listed groups. However, a comprehensive review and consultation on the code took place in 2017 against the backdrop of declining trust in big business and increased public scrutiny around corporate governance conduct. With this in mind, the U.K. government, in its response document to a Green Paper Consultation on U.K. corporate governance reform, asked the FRC to update the code to ensure that it continues to be fit for purpose.

Under the listing rules, an issuer must, as always, provide (1) a statement of how it has applied the code's principles and (2) a statement that it has complied with all relevant provisions of the code or, if not, an explanation as to why ("comply or explain"). A copy of the revised code is available **here**.

Executive Summary

The following is a high-level summary of the revised code which is followed by a discussion of particular changes that might require more thoughtful consideration and planning by issuers:

Remuneration

- More demanding criteria for remuneration policies and practices;

- Clearer reporting on remuneration, how it delivers the issuer's strategy, long-term success and its alignment with workforce remuneration;

- Directors exercising independent judgement and discretion on remuneration outcomes, taking account of wider circumstances;

- Remuneration committee chair should have served on a remuneration committee for at least 12 months.

Board of Directors

- Emphasis on importance of independence and constructive challenge of the boardroom;

- Strengthening consideration of "overboarding" (being the maximum number of directorships which an individual should hold in various circumstances);

- A focus on diversity, the length of service of the board as a whole, and effective board refreshment;

- "Comply or explain" provision for a maximum nine-year length of service, allowing flexibility to extend "to facilitate effective succession planning and the development of a diverse Board … particularly in those cases where the chair was an existing non-executive director on appointment";

- Nomination committee responsibility for more effective succession planning that develops a more diverse pipeline; reporting on the gender balance of senior management and their direct reports.

Stakeholders

- Emphasis on improving the quality of the board and the issuer's relationships with a wider range of stakeholders;

- Taking effective action when receiving significant shareholder votes against resolutions and reporting back more promptly;

- Board responsibility for workforce policies and practices which reinforce a healthy culture;

- Engaging with the workforce through one or a combination of: a director appointed from the workforce, a formal workforce advisory panel and a designated nonexecutive director, or other arrangements which meet the circumstances of the issuer and the workforce.

Overview of Revised Code Structure

Most of the revised code will be familiar to issuers, including the “comply or explain” principle that permits Issuers to deviate from particular requirements provided that an explanation is provided to its shareholders in its annual report. Retention of this flexibility was key to ensure the revised code can support issuers in different sectors and of differing sizes.

In the revised code’s introduction, the FRC notes that issuers should not treat the code as a box-ticking exercise or rely on boilerplate reporting and the FRC emphasizes that issuers should explain how they apply the principles of the revised code as well as give thoughtful responses when explaining any deviations, following appropriate discussion and conclusions.

The revised code is more user-friendly, with a significant reduction in length. The revised code now contains only high-level principles to be applied and more detailed provisions which are subject to “comply or explain.” Separately, the FRC has published guidance, which issuers should consider as they apply the revised code. Below we set out the important changes contained in the revised code.

Remuneration

It is probably the area of director remuneration that has received most attention from the press and public generally, and so it is unsurprising that it has seen some significant changes.

The main change to director remuneration relates to executive share awards being required to have a minimum vesting of five years (rather than three) from their date of grant. The total vesting and holding period of five-plus years would not include deferred elements of annual bonuses, which typically vest over a shorter period. Additionally, boards have discretion to override “formulaic outcomes,” giving boards discretion to tailor vesting to industry practice or to enable clawbacks or withholdings of rewards where performance warrants.

Although this is a change, we note that vesting periods have been trending longer over recent remuneration cycles and that The Investment Association’s remuneration guidelines suggested a minimum vesting period of three years and that investors commonly expect at least five years. A majority of respondents to the FRC’s consultation felt such a requirement should be introduced on a “comply or explain” basis to provide for flexibility to respond to a range of particular circumstances.

Another important revision is that the chair of the remuneration committee should have at least 12 months’ experience on a remuneration committee. This acknowledges the complexities of executive and senior management compensation.

The revised code also clarifies expectations with respect to pensions of executive directors, which should be in line with those available to those in the workforce.

The consultation draft of the code required that the remuneration committee should oversee workforce policies and practices. However, this has now been reserved to the executive management of the issuer due to concerns that extending the remuneration committee's remit over workforce practices generally could be unduly burdensome on the remuneration committee and deprive the issuer's executive leadership of key tools to motivate and reward the workforce. However, an oversight role for the remuneration committee as regards workforce remuneration and related policies is retained.

Division of Responsibilities

The revised code requires that chairs may serve on the board for a maximum of nine years, although limited extensions may be acceptable where the chair was originally an independent nonexecutive director of the issuer. This significant change may require Issuers to review their chairmanship in light of the tenure restrictions and commence or accelerate succession planning.

These independence requirements also now apply to all issuers, including companies outside the FTSE 350 that were previously exempt from many of these requirements. The Quoted Companies Alliance, among others, noted that the removal of these exemptions may place an undue burden on smaller Issuers. Given the revised code is more relaxed than the consultation draft, some of the additional burden on smaller issuers has been removed and issuers will be able to explain deviations from the code.

Acknowledging the significant commitments required from board members, the revised code requires directors to disclose significant commitments, together with an indication of the time involved. Additional external appointments should not be undertaken without the board's prior approval, with any permissions given explained in the annual report. The revised code also notes that full-time executive directors should not take on more than one nonexecutive directorship in a FTSE 100 company or other significant appointment.

Composition, Succession and Evolution

The code amendments to board composition reflect a continuing focus on promoting diversity. A principle of the revised code is to ensure that appointments and succession plans should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths. These changes borrow from the Parker Review into the Ethnic Diversity of UK Boards and the Hampton-Alexander Review on improving the gender balance in FTSE Leadership. The changes include requiring the nomination committee to report in the annual report on how it is achieving a diverse pipeline of senior managers, the gender balance of senior managers and how diversity supports the Issuer more generally.

These provisions apply to all issuers and certain commentators have suggested that this may place an undue burden on smaller issuers — especially since the Hampton-Alexander Review's recommendations related to FTSE 350 issuers only. However, with an increased public and institutional focus on diversity, we expect that many smaller issuers will embrace these changes and report in line with the revised code.

Leadership and Purpose

The consultation draft of the code would have required boards to explain how they have engaged with their stakeholders and, in particular, their workforce. Some issuers and shareholder groups, including The IA, were concerned as to how this wider emphasis on stakeholder engagement interacts with directors' duty to act to promote the success of the company for the benefit of its members as a whole. In response to this concern, the revised code states that "[n]othing in this Code overrides or is intended as an interpretation of the statutory statement of directors' duties in the [UK Companies] Act."

The revised code softened its language and now requires boards to "understand the views of the company's other key stakeholders." For engagement with the workforce, boards should establish a method for gathering the views of the workforce and the FRC suggests three options for doing so: (1) appointing a director from the workforce, (2) a formal workforce advisory panel or (3) a designated workforce nonexecutive director. Issuers will need to consider which of these options — or an alternative way of promoting dialogue between the workforce and the board — should be implemented after Jan. 1, 2019.

Another significant change is the requirement for an issuer to explain what actions it intends to take to consult with shareholders to understand the reasons behind any vote with more than 20 percent of shareholders dissenting. Issuers will also be required to provide updates six months after the dissenting vote and in the next annual report.

The IA has set up a public register, which includes details of all results of all resolutions in respect of which an issuer has received more than a 20 percent vote against. Issuers may provide the six months report on the public register.

Practical Implications of the Revised Code

It will be important for issuers, including members of their board, general counsels and company secretaries, to familiarize themselves with the revised code to ensure compliance and to think about how the disclosure requirements will be satisfied in the annual report for the 2019 fiscal year.

In the sphere of management remuneration, equity compensation plans may need to be revised, or deviations explained, in light of the new minimum vesting provisions and also to introduce discretion, where it does not already exist, for the board to override "formulaic outcomes."

When liaising with stakeholders and particularly with their workforces, Issuers should consider what approach best suits these relationships. Issuers should consider which of the three workforce engagement options would be most effective, or whether a bespoke engagement mechanism would be more appropriate.

In relation to the revised independence criteria, it may be necessary to plan for, and make, difficult decisions related to, the new rules and the tenure of many chairmen.

Issuers should ensure that they have procedures to preclear and gather current information on directorships with other companies to avoid “overboarding.”

Issuers should consider whether committees require any further training or support given their increased remit under the revised code. Committees may also require greater access to human resources departments and department heads to properly address the requirements of their roles related to succession.

Conclusion

We believe the updates to the code will be generally followed by U.K. listed groups without many enhanced explanations of deviations from the code. The changes seek to ensure that the U.K. remains the pinnacle of corporate governance in an age of increased scrutiny. The revised code should reassure investors that companies with a premium listing on the LSE are committed to being standard-bearers for corporate governance even as the specter of Brexit looms over the corporate and financial services landscape. Finally, issuers may perceive benefits from the changes to workforce engagement, corporate culture and diversity that over the medium and long term will be brought into businesses.

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