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CLIENT ALERT

Financial Reporting Council Publishes Updated UK Corporate Governance Code

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Introduction

On 16 July 2018, the UK's Financial Reporting Council (the "**FRC**") published a revised Corporate Governance Code (the "**Code**") applicable to companies ("**Issuers**") whose securities have a premium listing on the London Stock Exchange.

The Code has long been considered a set of "gold" standards for the corporate governance of listed groups generally. 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 UK Government, in its response document to a Green Paper Consultation on UK 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 (i) a statement of how it has applied the principles set out in the Code and (ii) a statement as to whether it has complied with all relevant provisions of the Code or, if not, an explanation as to the reasons 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.
- Higher quality external Board evaluations, emphasising the importance of the evaluator's direct contact with the Board and individual directors.

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 non-executive director, or other arrangements which meet the circumstances of the Issuer and the workforce.

- The ability for directors and the workforce to be able to raise concerns and for effective enquiry of these concerns.

Overview of Revised Code Structure

Most of the revised Code will be familiar to Issuers, including the "comply or explain" principle that permits companies to deviate from a particular requirement of the Code provided that an explanation is provided to such Issuer's shareholders in its annual report. Retention of this flexibility has been seen as key for ensuring that the revised Code provides enough flexibility to support Issuers in different sectors and of differing sizes.

In the introduction to the revised Code, the FRC notes that Issuers should not treat the Code as a box-ticking exercise or rely on boilerplate reporting and the FRC has emphasised that Issuers should explain how they apply the principles of the revised Code as well as give thoughtful responses when explaining any deviations from the Code agreed by their Board, following appropriate discussion and conclusions.

The revised Code is more user-friendly, with a significant reduction in length from 32 to 12 pages. 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 helpful guidance, which Issuers should consider as they apply the revised Code. Below we set out the important changes contained in the revised Code (with the exception of the Audit, Risk and Internal Control section, which remains largely unchanged).

Remuneration

It is probably the area of director remuneration that has recently received the most attention from the press and public generally, and so it is unsurprising that the remuneration section of the revised Code 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 for shares would not include deferred elements of annual bonuses, which typically vest over a shorter period. Additionally, Boards have discretion to override "formulaic outcomes," which should be interpreted as giving Boards discretion to tailor vesting to industry practice or to enable clawbacks or withholdings of promised rewards where performance warrants such action.

Although this is a change in the revised Code, we note that vesting periods have been trending longer over the past several remuneration cycles and that The Investment Association's ("**The IA**") remuneration guidelines suggested that a vesting period of three years was the minimum requirement and that investors commonly expect a period of 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 rather than through legislation to provide for flexibility to respond to a range of particular circumstances.

Another important revision is that the chair of the Remuneration Committee should now have at least 12 months' experience on a Remuneration Committee. This is an acknowledgement of the complexities of executive and senior management compensation.

The revised Code also clarifies expectations with respect to pensions of executive directors. The revised Code is now clear that executive pension contributions 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, rather than just executive and senior management compensation, could be unduly burdensome on the Remuneration Committee and could deprive the Issuer's executive leadership of key tools in terms of motivating and rewarding the workforce. The revised Code does retain, however, an oversight role for the Remuneration Committee as regards workforce remuneration and related policies.

Division of Responsibilities

The revised Code requires that chairs may only serve on the Board for a maximum of nine years, although limited extensions may be acceptable in situations where the chair was originally an independent non-executive director of the Issuer. This is a significant change and many Issuers will need to review their chairmanship in light of the tenure restrictions and commence or accelerate their succession planning.

These independence requirements also now apply equally to all Issuers, including smaller quoted companies outside the FTSE 350 that were previously exempt from many of these requirements. The Quoted Companies Alliance, amongst others, noted that the removal of these exemptions for smaller Issuers may place an undue burden on them. Given the revised Code is more relaxed than the consultation draft, some of the additional burden on smaller Issuers has been removed and, of course, Issuers will be able to explain any deviation from the Code. It will be interesting to see whether there are significant changes to the composition of smaller Issuer Boards in the near term.

Acknowledging the significant time commitments required from members of Boards of Directors, the revised Code contains provisions requiring directors to disclose significant commitments on their time, together with an indication of the time involved. Additional external appointments should not be undertaken without the prior approval of the Board, with the reasons for 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 non-executive directorship in a FTSE 100 company or other significant appointment.

The consultation draft of the Code contained changes around independence of directors, the most significant of which required the chairman to be independent at all times rather than just on appointment. Market participants generally reacted negatively to this proposal, asking whether it is possible for chairs, who will naturally be very heavily involved with the Issuer, its shareholders and other stakeholders, to remain independent after they have acceded to the role. In the face of these concerns, the potential ongoing chair independence requirement has not been retained in the final revised Code.

Another proposed change in the consultation draft of the Code related to the criteria to take into account when assessing independence. These remain unchanged in the revised Code from the prior version. However, the consultation draft of the Code presented the criteria as disqualifying factors when considering non-executive director independence, rather than more flexible guidelines. Again, in the face of significant dissent from market participants, the final revised Code has reverted to these criteria being more flexible guidelines for consideration when assessing the independence of non-executive directors.

Composition, Succession and Evolution

The Code amendments to Board composition reflect a continuing focus in the UK and internationally on promoting diversity generally. A principle of the revised Code is to ensure that both appointments and succession plans should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths. These changes borrow from the findings of 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.

Again, 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 were to apply to FTSE 350 Issuers only. However, with an increased public and institutional focus on matters related to diversity, we expect that many smaller Issuers will embrace these changes and report in line with the revised Code.

Leadership and Purpose

The main changes to this section of the revised Code reflect the now widespread view that the culture of a company is important to its long term success and so focus on openness and accountability.

The consultation draft of the Code would have required Boards to explain how they have engaged with their stakeholders as a whole and, in particular, their workforce. There were some concerns voiced by Issuers and shareholder groups, including The IA, as to how this wider emphasis on stakeholder engagement interacts with the requirement on each individual director to act to promote the success of the company for the benefit of its members as a whole. In response to this concern, the introduction to 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." It is likely that in many cases these requirements will not be contradictory but Issuers will want to ensure that all relevant stakeholders, including the workforce, are discussed at Board meetings, having regard both to their Companies Act (as applicable) and revised Code obligations.

The revised Code softened its language from the consultation draft and now requires Boards to "understand the views of the company's other key stakeholders." For engagement with the workforce, Boards should now establish a method for gathering the views of the workforce and the FRC suggests three options for doing so: (i) appointing a director from the workforce, (ii) a formal workforce advisory panel or (iii) a designated workforce non-executive 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 1 January 2019.

Another significant change is the requirement for an Issuer to explain, when announcing voting results, what actions it intends to take to consult with shareholders to understand the reasons behind any vote with more than 20% of shareholders dissenting. We believe that this already reflects the practice of most Issuers and we expect Issuers to continue to engage with their shareholders in the face of dissenting opinions. In addition, Issuers will 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, available *here*, which goes beyond the scope of the UK Government's recommendations and includes details of all results of all resolutions (not just remuneration) in respect of which an Issuer has received more than a 20% vote against. Issuers may provide the six months report on The IA's Public Register and which will streamline the engagement process for Issuers and shareholders.

Practical Implications of the Revised Code

It will be important for Issuers, including members of their Board of Directors, general counsels and company secretaries, to familiarise themselves with the revised Code to ensure compliance and to begin to think about how the disclosure requirements will be satisfied in the annual report for the 2019 fiscal year. We set out below a few high-level thoughts about the steps that Issuers should be taking.

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 and the size of the business. Particularly, Issuers should consider which of the three options to engage with the workforce would be most effective, or whether a bespoke engagement mechanism would be more appropriate.

Issuers will need to consider the revised independence criteria of their directors and it may be necessary to plan for, and make, difficult decisions related to the new rules and the tenure of many chairmen. In assessing the composition of the

Board, Issuers should ensure that they have procedures to pre-clear and gather current information on directorships with other companies to avoid “overboarding” where directors are stretched in their other commitments. Smaller Issuers will also need to think about whether or not any of these rules are inappropriate for their size and how best to explain any deviation from the revised Code.

Issuers should consider whether Nomination and Remuneration Committees require any further training or support given their increased remit under the revised Code. Nomination and Remuneration 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 UK listed groups without many enhanced explanations of deviations from the Code. The changes seek to ensure that the UK 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 London Stock Exchange are committed to being standard-bearers for corporate governance even as the spectre 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.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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