The Deloitte Academy
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Governance *in brief*

FRC consults on a new-style UK Corporate Governance Code

Headlines

- The FRC has published a new-style UK Corporate Governance Code for consultation together with revised Guidance on Board Effectiveness and some questions on the future of the Stewardship Code.
- New Code **principles** on:
  - alignment of company purpose, strategy, values and corporate culture;
  - responsibilities of the board to the workforce and other stakeholders;
  - demonstrating independent and objective judgement from the chair (coupled with a hardening of the Code provision on independence so, for example, a tenure of longer than nine years would mean that a director was no longer independent); and
  - alignment of remuneration and workforce policies to the long-term success of the company and its values.
- New Code **provisions** on:
  - the board's role in monitoring and assessing culture;
  - mechanisms for gathering the views of the workforce;
  - reporting on how stakeholder interests, and the other matters set out in section 172, have influenced the board's decision-making;
  - board conflicts of interest;

– the chief executive's responsibility for strategy and board information;

– succession planning and board member contribution;

– diversity and inclusion;

– holding periods for long-term incentive schemes; and

– pension arrangements.

- This is not a tweaking of the Code as in previous years but a substantial re-write and simplification/reduction with the idea at its foundation that the focus of the revised Code is the company's approach to governance through the application of the Code principles – principles which emphasise the value of good corporate governance to long-term success.

Introduction

It is 25 years since the UK Corporate Governance Code was first introduced and governance within the largest companies has been subject to heightened scrutiny from both the public and the government. Now the FRC has undertaken a comprehensive review to ensure that the Code remains fit for purpose and continues to promote improvement in the quality of governance.

The consultation includes a number of specific changes to the Code requested by the government's response to the Green Paper Consultation on Corporate Governance Reform. In addition, to achieve a wider stakeholder focus, the changes draw out the FRC's 2016 Culture Report. The changes have also taken account of the Hampton-Alexander Review and Parker Review reports on diversity.

Application of the UK Corporate Governance Code

The Listing Rules require all Premium-listed companies to disclose how they have applied the principles of the Code in a manner that would enable shareholders to evaluate how these have been applied.

Over time, experience has shown that Code compliance has focused on the 'comply or explain' aspects of the provisions rather than application of the principles, for which there is no 'comply or explain' element. When reporting on the principles, the Code requires companies to demonstrate to shareholders why the board has implemented certain structures, policies and practices and how they meet the relevant Code principle.

The provisions should be complied with or an explanation given. It should be noted that, as with the current Code, some provisions have specific reporting requirements.

The revised Code has five sections:

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

Proposed additions and changes to the UK Corporate Governance Code

Below we go through each of the sections of the updated Code and set out the key new features which have been added to the principles and provisions and we also explain where there have been changes to the existing Code principles or provisions.

Leadership & Purpose

This is the section of the updated Code with the most changes, both in the principles and the provisions.

Key new features in the principles

- The board should generate **value for shareholders** and **contribute to wider society**.
- The board should establish the **company's purpose, strategy and values** and satisfy itself that these and its culture are **aligned**.
- The board should ensure **effective engagement** with, and encourage participation from, the workforce and other stakeholders.
- All directors must **act with integrity** and **lead by example**.
- The workforce should be able to **raise concerns** where they consider that **conduct does not meet the company's values**.

Key new features in the provisions

- The annual report should include a description of how opportunites and risks to the **future success and sustainability of the business model** have been considered and addressed.
- It should be clear how the company's **governance arrangements** contribute to the **delivery of its strategy**.
- The board should **monitor and assess the culture** to satisfy itself that behaviour throughout the business is **aligned with the company's values** and take corrective action where there is **misalignment** (activities and any actions taken in this regard should be described in the annual report).
- The board should establish a **method for gathering the views of the workforce** and this would normally be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director.
- 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**.
- The board should take action to identify and eliminate **conflicts of interest**.

Changes made to existing Code principles and provisions

Whistleblowing – this part of the Code has been re-focused. It is no longer restricted to financial improprieties and is, therefore, no longer restricted to an audit committee activity. It becomes a board responsibility to establish mechanisms for the workforce to raise concerns together with proportionate and independent investigation of such matters and follow-up action.

Significant votes against a resolution – the existing Code provision has been amended to specify that explanation is required where **more than 20%** of votes have been cast against a resolution, rather than the current reference to "a significant proportion", reflecting the threshold for registration of significant votes against being maintained by the Investment Association.

Division of Responsibilities
Key new feature in the principles

- The chair should demonstrate **independent and objective judgement**.

Key new features in the provisions

- The chief executive is responsible for **proposing strategy** to the board, **delivering the strategy** as agreed and ensuring **timely and balanced information** is presented in order for the board to **make decisions effectively**.

- Non-executive directors are responsible for **appointing and, where necessary, removing** executive directors.

- Non-executive directors should **scrutinise and hold to account** the performance of management and individual directors against agreed performance objectives.

Changes made to existing Code principles and provisions

Composition of the board – the existing Code suggests that at least half the board, excluding the chair, should be independent non-executive directors. Given the addition noted above stressing that the chair should demonstrate independent and objective judgement, the updated Code states that independent non-executive directors, **including the chair**, should constitute the majority of the board, and this will also apply to companies below the FTSE 350.

Independence – there is a change of emphasis in the Code provision on non-executive director independence. In the existing Code, indicators are presented but the board retains an option to decide that a director is independent notwithstanding the existence of one or more of those indicators. Under the proposed updates, this provision is hardened such that any non-executive director, including the chair, **would not be considered independent** if one or more of the indicators existed.

Development and induction – principles and provisions in the existing Code on board development and induction have been removed and are covered in the revised Guidance on Board Effectiveness.

Composition, Appointment, Succession and Evaluation
Key new features in the principles

- Board membership should be **regularly refreshed**.

- Board appointments to **promote diversity** of gender, social and ethnic backgrounds, cognitive and personal strengths.

Key new features in the provisions

- The nomination committee should ensure plans are in place for **orderly succession to the board** and senior management positions and oversee the development of a **diverse pipeline** for succession.

- Papers accompanying the resolutions to elect each director should set out **specific reasons** why their **contribution** is and continues to be important for the company's long-term success.

- Each director should engage with the evaluation process and take **appropriate action** when **development needs** have been identified.

- The annual report should explain **how diversity supports the company's strategic objectives**, how board recruitment and succession planning processes support building a **diverse pipeline** and what other actions it has taken to oversee development of a diverse pipeline for future succession to board and senior management appointments.

- The annual report should identify the gender balance of those in the senior management and their direct reports.

Changes made to existing Code principles and provisions

Exemptions for companies outside the FTSE 350 – the existing exemptions in relation to annual re-election of directors and external facilitation of the annual board evaluation at least once every three years have been removed, meaning that all sizes of premium listed company would need to 'comply or explain' with these Provisions of the Code.

Board evaluation – the existing Code provision asking companies to describe how the board evaluation has been conducted. The updated Code also calls for a description of the outcomes, actions taken and how the evaluation has influenced board composition.

Audit, Risk and Internal Control
Key new features in the principles

- The board should establish formal and transparent policies and procedures to ensure the **independence and effectiveness of internal and external audit functions**.

- The board should satisfy itself on the **integrity of financial information**.

- The board should satisfy itself that the company's **internal controls are robust**, and allow for **prudent and effective risk assessment and management**.

Key new features in the provisions

All provisions in this section are substantially the same as they are in the existing Code.

Changes made to existing Code principles and provisions

Audit committee composition – consistent with the removal of exemptions referred to above, there is no longer an allowance for the audit committees of companies outside the FTSE 350 to have a minimum membership of two independent non-executive directors.

Remuneration
Key new features in the principles

- The board should satisfy itself that company **remuneration and workforce policies and practices** promote its long-term success and are **aligned to its strategy and values**.

- A formal and transparent procedure should be established in order to **determine the remuneration of senior management** (defined as the executive committee or the first layer of management below board level, including the company secretary), as well as board directors.

- Performance-related elements should be clear, stretching and rigorously applied and **aligned to the successful delivery of the strategy**.

- The board should exercise **independent judgement and discretion** when approving remuneration outcomes, taking account of company and individual performance, and wider circumstances.

Key new features in the provisions

- Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for **at least twelve months**. The minimum number of independent non-executive directors on the committee is three, with **no exemption for smaller companies**.

- **Independent judgement** should be exercised when evaluating the advice of external third parties and receiving views internally. Any connection between the remuneration consultant and the company or individual directors should be identified in the annual report.

- Remuneration schemes should **promote long-term shareholdings** by executive directors that support alignment with long-term shareholder interests.

- In normal circumstances, shares granted or other forms of long-term incentives should be subject to a vesting and holding period of **at least five years**. Longer periods, **including post-employment**, may be appropriate.

- Remuneration schemes and policies should provide boards with **discretion to override formulaic outcomes**.

- When determining executive director remuneration policy and practices, the remuneration committee should address a number of factors. These include: clarity; simplicity; the range of potential outcomes; a demonstrable link between individual awards and long term performance; and alignment to culture (including driving behaviours consistent with company culture and strategy and in the context of the workforce as a whole).

- The annual report should include:

  – an explanation of the strategic rationale for senior executive remuneration policies, structures and performance metrics

  – reasons why the remuneration is appropriate based on internal and external measures

  – whether the policy operated as intended in terms of company performance and quantum and, if not, what changes are necessary

  – what engagement has taken place with shareholders and the impact this has had on remuneration policy and outcomes

  – 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 impact of any board discretion on remuneration outcomes

Changes made to existing Code principles and provisions

Senior management pay – under the existing Code, the remuneration committee should 'recommend and monitor' the level and structure of remuneration for senior management. This has been strengthened to give the remuneration committee responsibility for **setting remuneration for senior management**.

Workforce policies and practices – the existing Code requires remuneration committees to be 'sensitive to pay and employment conditions elsewhere in the group.' The revised Code places greater emphasis on the role of the remuneration committee, which should now oversee remuneration and workforce policies and practices and **take these into account when setting the policy for director remuneration**.

Pensions – there is now a specific provision relating to pension arrangements, previously included in Schedule A. This emphasises the need to take into account the pension consequences of salary increases, along with any other changes in pensionable remuneration or contribution rates and also now includes a reference to these being **aligned to pension arrangements for the workforce** as a whole.

Revised Guidance on Board Effectiveness

The revised Guidance on Board Effectiveness is considerably longer and includes new commentary on areas such as culture, relations with the workforce and wider shareholders and diversity. It also incorporates wholly new sections on the workings of board committees, notably the remuneration committee. Helpfully, the Guidance includes questions for boards to ask themselves or, in some cases, to ask management, about effectiveness in key areas.

The Guidance has been structured to reflect the updated Code and some notable changes to the previous version include:

Leadership and purpose	This section covers the nature of the effective board, its focus on generating and preserving value for shareholders for the long-term whilst taking account of the interests of the workforce and the impact on other stakeholders (s172), its focus on values, behaviours and culture, the importance of diversity and avoiding “group think”, and achieving high-quality decision making. It covers relations with shareholders, with the workforce and with wider stakeholders, including examples of workforce engagement activities that some companies use to achieve meaningful, regular two-way dialogue. It also incorporates certain results and thinking from the FRC’s Culture initiative as previously published in Culture and the Role of Boards (2016).
Division of responsibilities	This section focuses on clarifying and delineating the roles of board members including the chair, senior independent director, executive and non-executive directors, and board support functions, such as the company secretary/secretariat.
Composition, succession and evaluation	This section covers the role of the nomination committee and substantially expands upon the previous Guidance on Board Effectiveness by increasing the focus on values, behaviours and the balance of skills, experience, knowledge and diversity on the board. It incorporates a new call for chairs and non-executive directors to understand and commit to the time that is and may be required in their role. It also discusses methods of improving diversity and inspiring diversity throughout the workforce through mentoring and sponsorship schemes and positive action. The section on succession proposes that boards should discuss tenure at the time of appointment to help inform and manage the long-term succession strategy and again encourages looking at succession as an opportunity to motivate employees throughout the organisation. On board evaluation, there is a new call for boards to obtain input from the workforce and other stakeholders on the board’s performance.
Audit, risk and internal control	This short section covers the role of the audit committee and reiterates some key points also in the Guidance on Audit Committees. It also highlights the FRC’s focus on viability statements, in particular its proposed two stage process of first considering and reporting on longer term prospects and then providing the statement on viability over the period of the board’s assessment.
Remuneration	This is the first time the FRC has provided guidance outside the Code on the role of the remuneration committee in particular. The Guidance suggests that boards can choose to delegate responsibility for overseeing wider workforce remuneration, incentives and workforce policies to the remuneration committee, or, where appropriate, another committee with relevant responsibilities. It calls for an integrated approach that joins up consideration of wider workforce pay and policies with the consideration of executive remuneration, and proposes that the remuneration committee should engage with the workforce to explain how executive remuneration aligns with wider company pay policy and promotes long term value generation.

Future direction of the UK Stewardship Code

It is five years since the Stewardship Code was last reviewed and the FRC believes it is appropriate to consider the role it can play in driving further improvements in best practice. With that in mind, the FRC is seeking views on the following questions:

1. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

2. Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might the FRC go about determining what best practice is?

3. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

4. Are there elements of the revised UK Corporate Governance Code that the FRC should mirror in the Stewardship Code?

5. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

6. Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

7. How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

8. How could the Stewardship Code take account of some investors' wider view of responsible investment?

9. Are there elements of international stewardship codes that should be included in the Stewardship Code?

10. What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

11. Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

12. Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

13. Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

14. Should signatories to the Stewardship Cdoe define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

15. Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might these be best achieved?

Timing

It is proposed that the updated Code is applicable to all companies with a premium listing of equity shares for **periods commencing on or after 1 January 2019**.

The consultation period ends on **28 February 2018**.

The FRC plans to consult on specific changes to the Stewardship Code during the course of 2018.

Deloitte View

- The FRC has taken the opportunity to do a fundamental review and to modernise the Code. The proposed changes fit well with the other parts of the Government's governance reform package.
- The emphasis on how companies have applied the principles is welcome and it is now up to companies to respond to support this more considered approach to corporate governance.
- The hardening of the independence criteria for the board chair will present a challenge for some companies as tenure of greater than nine years will no longer be compliant under these proposals.
- The whole area of a company's purpose and stakeholder engagement takes a central role in the Code – and companies will need to ensure they address these areas with integrity, as they will be quickly exposed if their statements do not ring true to their workforce.
- We believe that applying judgement and discretion to remuneration outcomes is the best way of ensuring executive pay is effectively linked to performance and we welcome provisions which encourage remuneration committees to act in this way. The proposed Code includes a focus on encouraging remuneration committees to determine executive remuneration in the context of, and taking account of, wider workforce remuneration policies and practices and it will be interesting to see how this develops.
- Premium listed companies outside the FTSE 350 will have more to contend with, but the implementation timetable proposed allows companies to make changes over the course of 2018.

For further information:

To access the full consultation paper, please go to **http://frc.org.uk/news/december-2017-(1)/a-sharper-uk-corporate-governance-code-to-achieve**

Contact – Executive remuneration

Deloitte's executive remuneration practice helps clients develop executive remuneration strategies in line with corporate objectives and advises remuneration committees on the corporate governance and regulatory framework that applies to executive remuneration in the UK.

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The Deloitte Academy

The Deloitte Academy provides support and guidance to boards, committees and individual directors, principally of the FTSE 350, through a series of briefings and bespoke training. Membership of the Deloitte Academy is free to board directors of listed companies, and includes access to the Deloitte Academy business centre between Covent Garden and the City.

Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website **www.deloitteacademy.co.uk** which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership, please email **enquiries@deloitteacademy.co.uk**.

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