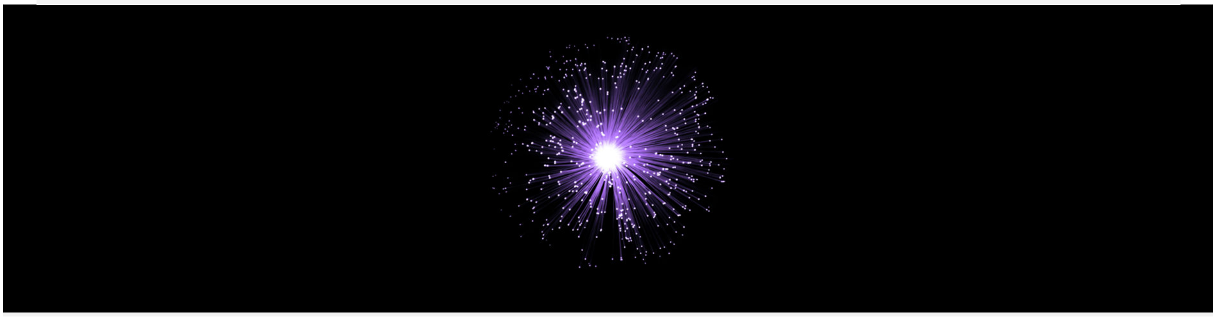

Financial Reporting Council

Consultation on changes to the UK Corporate Governance Code

5th December 2017

The Financial Reporting Council (FRC) has issued a consultation on:

- **Revised UK Corporate Governance Code,** which has been restructured, redrafted and simplified. The main and supporting principles and detailed provisions have been replaced with a list of principles and underlying provisions grouped into five areas, each with three or four principles and seven to ten underlying provisions:
    - Leadership and purpose (Principles A-D; provisions 1-8)
    - Division of responsibilities (Principles E-H; provisions 9-16)
    - Composition, succession and evaluation (Principles I-K; provisions 17-23)
    - Audit, risk and internal control (Principles L-N; provisions 24-31)
    - Remuneration (Principles O-Q; provisions 32-41)
- **Revised Guidance on Board Effectiveness,** which supplements the Code and has been expanded significantly, now notably including a detailed section on workforce engagement alternatives and on remuneration.
- **Future Direction of the UK Stewardship Code,** which the FRC is looking to update in order to drive further improvements in best practice.

The consultation incorporates a number of proposals made by the Government in the response to the Green Paper on Corporate Governance, which was published in August 2017. In addition, the FRC has announced this week that it will finalise revisions to the Guidance on Strategic Reporting once the government has published legislative changes in respect of reporting on section 172 of the Companies Act, which is expected in March 2018. The FRC also notes that Provision 4 makes reference to section 172, but the wording of this Provision may need to be amended to reflect the outcome of the Government's legislation.

Responses to the questions in the consultation document are requested by 28 February 2018. More general comments will be taken into account as part of the post-consultation review.

Revised UK Corporate Governance Code

Timing

Responses are invited on the proposed application of the Code. It is proposed that the final version of the Code will be published by early Summer 2018 and will apply to accounting periods beginning on or after 1 January 2019.

Consultation questions

Q1) Do you have any concerns in relation to the proposed Code application date?

Section 1: Leadership and Purpose

This section incorporates the most significant changes and much of it is new. It incorporates some of the principles and provisions covered in Section E: Relations with shareholders of the existing Code. The revised Code puts additional focus on the wider stakeholder base and the importance of aligning company purpose, strategy and values. It recognises that the activities of companies have a wide-ranging impact and that it is important for boards to consider the way their companies interact with the workforce, customers, suppliers and wider stakeholders.

Key new features in the principles

- The board should promote the long-term sustainable success of the company, 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 are **aligned to the culture of the business.**
- 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 opportunities 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 of the business** 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 should be described in the annual report).
- The board should establish a **method for gathering the views of the workforce** which would <u>normally</u> be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. The Guidance on Board Effectiveness highlights that companies may determine to use alternative approaches which could be compliant (for further detail see the Guidance section below). It should be noted that the term workforce has been chosen to encourage companies to consider how their actions impact not only on those with formal contracts of employment but could also include agency workers, contractors etc.
- 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 is no longer restricted to financial improprieties and is therefore no longer restricted to an audit committee activity. As part of the provision relating to gathering the views of the workforce, 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". This is in line with the new register established by the Investment Association. The provision has been expanded to require the board to provide **an update to be published no later than six months after the vote**, with a final summary of the impact shareholder feedback has had on decisions taken and actions/resolutions proposed to be given in the annual report.

Consultation questions

Q3) Do you agree that the methods proposed in relation to gathering the views of the workforce are sufficient to achieve meaningful engagement?

Q5) Do you agree that 20% is 'significant' and that an update should be published no later than six months after the vote?

Section 2: Division of responsibilities

This section has been expanded to incorporate the principles and provisions that currently relate to non-executive directors and some of those relating to board effectiveness. The key change focuses on the role of the chairman and the non-executive directors. It should be noted that **all of the exemptions currently relating to companies below the FTSE 350 have been removed and therefore all companies will have to comply with the Code or explain why they have not.**

Key new feature in the principles

- The chair leads the board and is responsible for overall effectiveness. 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 additional emphasis on the chair demonstrating independent and objective judgement, the updated Code states that independent non-executive directors, **including the chair**, should constitute the majority of the board.

Independence – there is a change of emphasis in the Code provision on non-executive director independence. In the existing Code, a list of factors indicating non-independence are provided but the board retains an option to decide that a director is independent irrespective. Under the proposed changes, this provision is strengthened so that a non-executive director, including the chair, **should not be considered independent if any of the factors apply.** This continues to include the provision that director cannot be considered independent if they have served on the board for more than nine years from the date of their first election.

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.

Consultation questions

Q7) Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

Q8) Do you agree that it is not necessary to provide for a maximum period of tenure?

Section 3: Composition, appointment, succession and evaluation

This section covers most of the principles and provisions currently included under board effectiveness.

Key new features in the principles

- Board membership should be **regularly refreshed**.
- Appointments to the board should be subject to a **formal, rigorous and transparent procedure** and an **effective succession plan** should be in place for board and senior management (defined as the executive committee or the first layer of management below board level, including the company secretary).
- Board appointments should be based on merit and objective criteria and promote diversity which has been expanded to include 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**. As the Code now applies to all companies, it would extend beyond the recommendation of the Hampton-Alexander review.
- The provisions only require the disclosure of data on gender balance. However, the **consultation also seeks views on broader diversity disclosure**.

Changes made to existing Code principles and provisions

Exemptions for companies outside the FTSE 350 – as 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, all premium listed company would need to 'comply or explain' with these provisions of the Code.

Board evaluation – the existing Code provision asks 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.

Consultation questions

Q6) Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.

Q9) Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

Q10) Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

Q11) What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

Section 4: 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 exemption for the audit committees of companies outside the FTSE 350 to have a minimum membership of two independent non-executive directors.

Audit committee terms of reference – the existing Code contains a provision requiring the terms of reference for the audit committee to be made available. This has been moved to the Guidance.

Consultation questions

Q12) Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?

Q13) Do you support moving from the Code to the Guidance the requirement to make the audit committee terms of reference available? If not, please give reasons.

Section 5: 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**.
- **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 FRC notes that it may make further changes to this provision following pending the outcome of the Government's legislation on pay ratios and on clearer reporting on the range of remuneration outcomes from complex, share-based incentive schemes.
- 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

- 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**.

- 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**.
- There is now a specific provision relating to pension, 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.

Consultation questions

Q14) Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

Q15) Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

Q16) Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

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 includes an expanded section on decision making and also, alongside the section on relations with shareholders, adds further guidance on relations with the workforce and with wider stakeholders. The guidance provides clarity on how to define the 'workforce' and expands on the need to have policies in place, and to create the right environment, for individuals to raise concerns. The revised Code suggests **three ways in which in which the views of the workforce could be gathered**: a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. The Guidance makes it clear that **these are not the only possible methods** and boards may consider alternatives and combinations of approaches, if they believe these would be as or more effective. **Provided the chosen method delivers meaningful, regular two-way dialogue the Code requirement will be met**. Examples are provided of workforce engagement activities that some companies use to achieve this which include director breakfasts, listening groups, focus or consultative groups, groups of elected workforce representatives, social media updates, employee AGMs, town halls and open door days, surveys and digital sharing platforms. Surveys on their own would not be considered a sufficient or reliable indication of workforce views; a feedback loop following the survey would be necessary to discuss results with the workforce and provide transparency around actions to be taken. This section also incorporates certain results and thinking from the FRC's Culture initiative as previously published in Culture

	and the Role of Boards (2016). This includes a list of signs of cultural problems and provides guidance on setting a framework which incorporates the company's purpose, values and strategy, emphasising the need for the values to be embedded at every level of the organisation. The need to gather data on a regular basis to monitor the health of the culture is also discussed. Some sources of culture insights are mentioned (turnover and absenteeism rates, training data, recruitment, reward and promotion decisions, grievance and speak up data, poor compliance e.g. health and safety incidents, regulatory and ethics breaches, promptness of payments to suppliers, attitudes to regulators, internal audit and employees).
Division of responsibilities	This section is not significantly changed and 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. The guidance now states that the **remuneration of the company secretary** should (rather than might) be determined by the remuneration committee. The guidance states that with the support of the executive team, the CEO will support the board in establishing methods for gathering the views of the workforce and ensure the board is made aware of views gathered via other forms of engagement between management and the workforce.
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 emphasises the need to appoint directors who are able to make a positive contribution. It also suggests that the nomination committee should take an active role in **setting and meeting diversity objectives**. The Guidance provides examples of the type of actions the nomination committee could consider encouraging which includes methods of improving and inspiring diversity throughout the workforce through mentoring and sponsorship schemes and through 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 talent management as an opportunity to motivate employees throughout the organisation. Having plans in place for different time horizons is recommended. There is also a suggestion that nomination committees should consider taking a more active interest in how talent is managed. 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 additional guidance on the responsibilities of the board in relation to wider workforce remuneration, incentives and other workforce policies. The Guidance highlights that the board should not only oversee the pay, conditions and incentives of the workforce but also **other policies that have an impact on the experience of the workforce and drive behaviours**. This includes policies

	around recruitment and retention, promotion and progression, performance management, training and development, reskilling and flexible working. 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 (e.g. sustainability or corporate responsibility committee). The relevant committee could **review and endorse principles for pay and reward across the organisation** (e.g. equal pay, security, predictability of income, market competitiveness and reward for contribution) and satisfy itself that management is implementing these properly. It calls for an **integrated approach that joins up consideration of wider workforce pay and policies with the consideration of executive remuneration**, and indeed 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. The guidance states that this might include using pay ratios to help explain the approach and explaining the rationale behind pay structures and performance metrics and the way in which the committee can use discretion when determining pay outcomes. The Guidance also highlights that the remuneration committee should ensure the total executive remuneration rewards potentially available are not excessive, that packages should not reward poor performance, that compensation commitments in the case of loss of office should be proportionate and variable by discretion, and that the committee should be alive to the risk that incentives may not work as intended and may be to the detriment of the company. The committee should consider ways of counteracting this possibility. The guidance also notes that exposure to long term share price over five to seven years and for two to three years after leaving the company and the release of shares on a phased basis can encourage focus on sustainable performance. The Code requires malus and clawback provisions to be in place, the guidance refers to circumstances such as erroneous or misleading data, misconduct and misstatement of accounts. The guidance includes a list of questions the remuneration committee may want to consider.

Consultation questions

Q2) Do you have any comments on the revised Guidance?

Q4) Do you consider that we should include more specific reference to the UN Sustainable Development Goals or other NGO principles, either in the Code or in the Guidance?

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 has issued a series of consultation questions.

Consultation questions

Q17) 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?

Q18) 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?*

Q19) *Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?*

Q20) *Are there elements of the revised UK Corporate Governance Code that the FRC should mirror in the Stewardship Code?*

Q21) *How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?*

Q22) *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?*

Q23) *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?*

Q24) *How could the Stewardship Code take account of some investors' wider view of responsible investment?*

Q25) *Are there elements of international stewardship codes that should be included in the Stewardship Code?*

Q26) *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?*

Q27) *Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?*

Q28) *Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?*

Q29) *Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?*

Q30) *Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?*

Q31) *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?*

The consultation paper can be found here. Responses to the consultation should be emailed to codereview@frc.org.uk by 28 February 2018.

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