

New Corporate Governance Code: Key Considerations

July 2018

Background

The revised UK Corporate Governance Code (the “Code”) has been published today, 16 July 2018. This follows extensive consultation by the Financial Reporting Council (“FRC”) on a draft Code. The Code applies to accounting periods from 1 January 2019, meaning that most companies must in the next five months establish processes for compliance. This briefing reviews some key considerations and examines how the FRC has addressed concerns raised in relation to these during the consultation process.

The FRC has also published revised “Guidance on Board Effectiveness” and a short document setting out key “highlights” of the changes to accompany the Code.

Stakeholder engagement

The Code refers to the board’s responsibility to consider the needs and views of a wider range of stakeholders, such as workers, customers and suppliers. It suggests the board’s function is to “*promote the long-term sustainable success of the company*”. On its face, this appears to go further than the duty under section 172 of the Companies Act 2006 (the “Act”) to promote the success of the company, “*having regard to*” a number of factors, including stakeholder interests. In response to concerns raised in the consultation about this extension, the introduction to the final Code clarifies that nothing in the Code overrides or is intended as an interpretation of directors’ duties under the Act. Thus, the duty under section 172 remains to promote the success of the company for the benefit of members as a whole.

Workforce engagement

Specifically in relation to engagement with workers, the draft Code put forward three options, namely, a director appointed from the workforce, a workforce advisory council and a designated NED. The proposal was criticised as being overly prescriptive. The final Code recognises this, allowing one or a combination of the methods to be used and the flexibility to use other approaches as long as the board explains their effectiveness.

Key areas for companies to review in the short term

- 1) Is further explanation needed where NEDs don’t meet all the independence criteria? Is the chair within the nine-year term limit?
- 2) In each case, if explanation is unlikely to withstand scrutiny, consider changes to board composition
- 3) Devise a strategy for meaningful workforce engagement (recognising that the Code allows flexibility on approach, provided this is explained).

Board independence

The Code retains the current position that at least half of the board, excluding the chair, should be independent. The draft had proposed that a majority of the board, including the chair, should be independent. The draft had also proposed that the indications of independence should be transformed into criteria, removing the board’s discretion to determine whether a director is independent despite not meeting all of the criteria.

Any reduction in flexibility would have resulted in a greater need for companies to “explain” rather than “comply”. There were concerns that the checklist approach could lead to odd results. By way of example, a NED who became a member of the company’s pension scheme following the acquisition of a business where the NED formerly worked would fail to meet the criteria for independence without the ability to take into account considerations of materiality. The proposed change in approach was also considered likely negatively to impact efforts to expand the diversity of NEDs (e.g. due to restrictions on cross-directorships). In the Code, the FRC has softened this position, describing the criteria as “*circumstances which are likely to impair, or could impair*” independence and requiring a clear explanation where the board nonetheless considers a NED to be independent. Whilst a helpful reinstatement of flexibility compared to the draft Code, companies should be conscious of the shift in emphasis and likely additional attention paid to any such explanation.

The draft Code proposed a strict nine-year term limit on a director or chair being considered independent. Concerns were raised that this requirement, in combination with a new requirement for the chair to be independent on an ongoing basis (rather than on appointment only), would negatively impact succession planning. It was also seen as discouraging the appointment of existing NEDs to the chair. Acknowledging the “special” role of the chair, the final Code states that the chair should be independent on appointment (as is the current position), with a requirement to “*demonstrate objective judgement throughout their tenure*”. It also provides some flexibility on the nine-year term limit for the chair (though not for NEDs), allowing it to be extended for a limited period to facilitate succession planning and to develop a more diverse board, in particular where the chair is an existing NED on appointment.

Significant votes against resolutions

The Code introduces a concept of significant shareholder votes against resolutions. Where 20

per cent or more of votes have been cast against a resolution, the company is obliged to explain, when announcing voting results, what actions it intends to take to consult shareholders in order to understand the reasons behind the result. The company must then provide an interim update no later than six months after the vote, before providing a final summary, typically in the annual report. Some respondents were concerned that six months was too short to be able to provide a meaningful update on progress, and that doing so could unnecessarily prejudice ongoing discussions. The position remains substantially the same in the final Code, although it clarifies that the six-month report should be an update “*on the views received from shareholders and actions taken*”.

Remuneration committee role

The draft Code provided for an expanded remit of the remuneration committee to “*oversee*” workforce policies and practices, including pay and incentives, across the wider workforce below director level. During the consultation, concerns were raised that this implied greater responsibility for the committee over what has traditionally been an executive function. The final Code clarifies that the committee should “*review*” workforce remuneration and related policies, giving a sound understanding to take into account when making judgements about executive remuneration.

Diversity and succession planning

The Code seeks to promote diversity of gender, social and ethnic backgrounds on boards and to enhance transparency around diversity in a company’s succession pipeline. Whilst respondents were generally supportive of these aims, practical difficulties were raised during the consultation around the availability of comparable data (given data protection requirements) and identifying a single “pipeline” within a business. A lack of definitions and common standards on “ethnicity” also fed into questions around the comparability of published results. There are no relevant changes in the final Code. It remains to be seen how companies respond in practice and whether the Code’s objectives will be met.