The UK Corporate Governance Code

2018 Corporate governance reforms
KPMG Board Leadership Centre

The Financial Reporting Council (FRC) has issued a revised *UK Corporate Governance Code* to reflect the changing business environment and help UK companies achieve the highest levels of governance. The Code is shorter and sharper than previous Codes, focuses on the importance of long-term success and sustainability, addresses issues of public trust in business and aims to ensure the attractiveness of the UK capital market to global investors.

The revised Code is built on an updated set of Principles emphasising the value of good corporate governance to sustainable growth. It is intended that by applying these Principles, following the more detailed Provisions and using the associated guidance, companies will be better able to report how their governance structure contributes to its long-term success. The Code is supported by the revised *Guidance on Board Effectiveness.*

While the introduction to the Code emphasises the importance of the Code Principles (the Listing Rules require companies to make a statement of how they have applied the Principles *"in a manner that would enable shareholders to evaluate how the Principles have been applied"*), the Provisions continue to establish good practice on a 'comply or explain' basis (as required by the Listing Rules).

Application

The revised Code is applicable to all companies with a premium listing, whether they are incorporated in the UK or elsewhere, and applies to accounting periods beginning on or after 1 January 2019. Other listed or unlisted companies may wish to adopt the Code in whole or in part.

Leadership and purpose

This section of the Code brings together a number of concepts and makes it clear that the board should consider the culture of the company and wider stakeholder interests to achieve long-term sustainability.

Wider stakeholders and directors' duties

Notwithstanding the primary duty of directors being to promote the long-term success of the company, the FRC believe companies can do more to recognise that other stakeholders, particularly their own workforces, play a significant part in that success. Therefore, the revised Code encourages corporate governance policies and practices that generate value for shareholders and aim to benefit society.

In particular, there is a new Principle setting out that:

"A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society." (Principle A)

Furthermore, there is a new Provision which requires (on a 'comply or explain' basis) that the board should:

"... understand the views of the company's other key stakeholders and describe in the annual report how their interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and decision-making.

The board should keep engagement mechanisms under review so that they remain effective. For engagement with the workforce, one or a combination of the following methods should be used:

- *a director appointed from the workforce;*
- *a formal workforce advisory panel;*
- *a designated non-executive director.*

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If the board has not chosen one or more of these methods, it should explain what alternative arrangements are in place and why it considers that they are effective." (Provision 5)

Each of the three suggested methods for engaging with the workforce have their merits and challenges – and there are other mechanisms which might be deployed in combination with the methods explicitly addressed in the Code. For example, board composition, board induction and professional development, 'walking the floors', staff surveys, social media and formal agenda items are all relevant to understanding the views of employees.

We believe that most companies will opt for some form of workforce advisory panel as, in practice, both 'workforce directors' and designated non-executive directors would require some form of workforce advisory panel in order to get exposure to a broad range of workforce views.

By using the term 'workforce', the FRC is encouraging companies to consider how their actions impact on both those with formal contracts of employment (permanent, fixed-term and zero-hours) and other members of the workforce who are affected by the decisions of the board. For example, those engaged under contracts of service, agency workers, and remote workers, regardless of their geographical location. Companies should be able to explain who they have included and why.

Our publications *Workforce directors*, *Designated NED* and *Workforce advisory panels* explore some of the advantages and challenges of these models. The ICSA and Investment Association's guidance *The Stakeholder Voice in Board Decision making* looks at some of the broader considerations around stakeholder engagement.

Shareholder engagement

Shareholder engagement has been given greater prominence with the introduction of a revised Provision:

"In addition to formal general meetings, the chair should seek regular engagement with major shareholders in order to understand their views on governance and performance against the strategy. Committee chairs should seek engagement with shareholders on significant matters related to their areas of responsibility. The chair should ensure that the board as a whole has a clear understanding of the views of shareholders." (Provision 3)

The explicit reference to committee chairs seeking engagement with shareholders on significant matters related to their areas of responsibility might prove challenging in some areas.

For example, we regularly hear audit committees express a concern that substantive engagement with investors can be difficult to achieve. Committee chairs may need to redouble their efforts, but success in this space will also require the commitment of the investor community (and that might in turn require additional resources being deployed in this area).

Significant votes against resolutions

The Code was amended in 2014 in relation to voting practices, so that companies should engage with shareholders where they receive significant votes against resolutions at their annual general meetings. The revised Code is now more specific about what should be expected of companies.

"When 20 per cent of more votes have been cast against the board recommendation for a resolution, the company should explain, when announcing voting results, what actions it intends to take to consult shareholders in order to understand the reasons behind the result. An update on the views received from shareholders and actions taken should be published no later than six months after the shareholder meeting. The board should then provide a final summary in the annual report and, if applicable, in the explanatory notes to resolutions at the next shareholder meeting, on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed." (Provision 4)

Twenty percent or more votes against is also the threshold adopted by the Investment Association in determining what significant shareholder opposition to proposed resolutions should be included in their Public Register.

Culture

The FRC is clear that corporate culture can be a key ingredient in delivering long-term sustainable performance. When there is a healthy culture, systems, processes and people coalesce to support long term success and enhance trust. Equally, a poor culture can be a significant business risk.

The importance of culture features throughout the revised Code. In particular, Principle B stresses the importance of the board establishing a company's purpose, values and strategy, and satisfying itself that these and its culture are aligned. Provision 2 specifically states that:

"The board should assess and monitor culture. Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company's purpose, values and strategy, it should seek assurance that management has taken corrective action.

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The annual report should explain the board's activities and any action taken. In addition, it should include an explanation of the company's approach to investing in and rewarding its workforce." (Provision 2)

Division of responsibilities

This section of the revised Code considers the separation of duties within the board and between its various roles.

Board composition

Key changes here include the removal of the relaxed board balance criteria for companies outside the FTSE350 – Code compliance for *all* companies now requires that at least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent.

The expected 'requirement' that the board chair be considered independent at all times – and that non-executive directors only be considered independent if the independence criteria (including the so-called nine-year rule) were satisfied - has not materialised. As at present, board chairs should be independent on appointment and the independence criteria are rebuttable.

However, board chair tenure is addressed by effectively implementing a nine year cap.

"The chair should not remain in post beyond nine years from the date of their first appointment to the board. To facilitate effective succession planning and the development of a diverse board, this period can be extended for a limited time, particularly in those cases where the chair was an existing non-executive director on appointment. A clear explanation should be provided." (Provision 19)

Putting aside the leeway for a limited time period included in the Provision, we estimate that around 20% of FTSE350 Chairs would currently fail this new test, and while the 'comply or explain' regime could be used to rationalise non-compliance with the Code, the existence of a compliance culture may well drive board leadership churn.

Composition, succession and evaluation

This section considers board appointments, succession planning and the executive pipeline – all of which should ensure that boards are diverse and relevant to the company's business.

While it continues to emphasise the importance of diversity in its broadest sense, the revised Code aims to broaden boards' perceptions of diversity and to ensure appointment and succession planning practices are designed to promote diversity, not only of gender, but also of social and ethnic backgrounds.

"Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria, and within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths." (Principle J)

The changes also encourage building diversity across the workforce by broadening the remit of the nomination committee to include oversight of the development of a diverse pipeline.

The revised Code seeks to drive progress on diversity through enhanced reporting on the actions taken to increase diversity and inclusion, and the outcomes in terms of progress on diversity - including the gender balance on the executive committee and direct reports to the executive committee as recommended by the Hampton-Alexander Review.

"The annual report should describe the work of the nomination committee, including:

— *the process used in relation to appointments, its approach to succession planning and how both support developing a diverse pipeline;*

— *how the board evaluation has been conducted, the nature and extent of an external evaluator's contact with the board and individual directors, the outcomes and actions taken, and how it has or will influence board composition;*

— *the policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives; and*

— *the gender balance of those in the senior management and their direct reports." (Provision 23)*

While the revised Code encourages only the disclosure of gender balance (of the board, senior management and their direct reports), boards might wish to explore reporting different forms of diversity, including the socio-economic background of the board, senior management team and the workforce more generally.

Audit, risk and internal control

The detailed provisions in this section remain largely unchanged, however, the Principles have been enhanced to place greater emphasis on the board's role in:

— *establishing formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit;*

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— *satisfying itself on the integrity of financial and narrative statements; and*

— *establishing procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.*

In particular, the Code has been enhanced to address emerging risk:

"The board should carry out a robust assessment of the company's emerging and principal risks. The board should confirm in the annual report that it has completed this assessment, including a description of its principal risks, what procedures are in place to identify emerging risks, and an explanation of how these are being managed or mitigated." (Provision 28)

Remuneration

This section seeks to address some of the concerns leading to the public disquiet over executive pay including the complexity of remuneration arrangements, the role of incentives in driving behaviour and the correlation between executive pay and the experiences of the wider workforce.

Code Principle P stresses the importance of designing remuneration policies and practices to support strategy and promote long-term sustainable success; and that executive remuneration should be aligned to a company's purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy.

The Code also addresses the remuneration committee's role with respect to the pay and incentives of senior management and across the wider workforce.

"The remuneration committee should have delegated responsibility for determining the policy for executive director remuneration and setting remuneration for the chair, executive directors and senior management. It should review workforce remuneration and related policies and the alignment of incentives and rewards with culture, taking these into account when setting the policy for executive director remuneration." (Provision 33)

The revised Code also emphasises the role of the board in exercising independent judgement and discretion with a new Provision requiring (on a 'comply or explain' basis) schemes and policies to enable remuneration outcomes to be overridden; for example, where the measurement of any performance condition does not reflect the actual performance of the company over the period or the performance of the individual director.

"Remuneration schemes and policies should enable the use of discretion to override formulaic outcomes. They should also include provisions that would enable the company to recover and/or withhold sums or share awards, and specify the circumstances in which it would be appropriate to do so." (Provision 37)

While market practice is already moving in the direction of longer vesting periods for executive share awards, with many companies already adopting a minimum five-year vesting and holding period, the revised Code now specifically recommends extending total vesting and holding periods for executive share awards to a minimum of five years to encourage companies to focus on longer-term outcomes in setting pay.

"Remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. Share awards granted for this purpose should be released for sale on a phased basis and be subject to a total vesting and holding period of five years or more. The remuneration committee should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares." (Provision 36)

New reporting requirements have been introduced including that companies disclose what workforce engagement has taken place to explain how executive remuneration aligns with wider company pay policy.

There is a new requirement (on a 'comply or explain' basis) that the remuneration committee chair will have served for at least twelve months on *any* remuneration committee before taking on this role.

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