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NEW FRC CORPORATE GOVERNANCE CODE

November 2018

The Financial Reporting Council ("**FRC**") has published the final 2018 edition of the Corporate Governance Code (the "**2018 Code**") and the associated Guidance on Board Effectiveness (the "**Guidance**"). The latest edition also includes a feedback statement which contains a detailed comparison between the 2016 and the 2018 Codes, and a redline which highlights the changes between the consultation versions of the 2016 and the 2018 Codes.

Key points to note are the following:

- timing of the 2018 Code;
- key changes in the final 2018 Code;
- action to be taken in preparation for complying with the 2018 Code; and
- changes planned in the immediate future.

TIMING OF THE NEW CODE

The 2018 Code will apply to the financial year beginning on or after January 2019, with the first compliant annual reports to be published in 2020.

However, the FRC has indicated that during 2019, companies should comply with the new provision four (the transparency requirements that will apply following a 20% or more vote against a board recommended shareholder resolution), and consider the impact of the 2018 Code and Guidance on future policies.

KEY CHANGES IN THE 2018 CODE:

SECTION 1- LEADERSHIP AND PURPOSE

Stakeholders: The three methods of workforce engagement

Despite earlier reassurances to the contrary during the consultation period, the final text of the 2018 Code prescribes three methods for companies to use for workforce engagement, by either:

- appointing a director from the workforce;
- establishing a formal workforce advisory panel; and/or
- designating a Non-Executive Director ("**NED**") to implement workforce engagement.

Where a board of directors have not chosen one of methods mentioned above, it will have to explain what alternative methods are used and why they are considered more effective (for further detail on how to meet this requirement please see below).

The workforce and its new meaning

The FRC has clarified in the Guidance that the term "workforce" is used for the Code's purposes only, and does not comply with any legal definition of workforce, employee or similar.

The Guidance further clarifies that it is for each company to decide whom to include in the definition and must be accompanied by a short explanation of why they have been included. Those with a formal contract of employment should be included (permanent, fixed term, zero hours), and wider consideration should be given to those employed through contracts of service, agency workers and remote workers, regardless of their geographical location.

A reinterpretation of S172 of the Companies Act?

Principle A of the 2018 Code received strong criticism during the consultation as, among other things, it states that the function of the company's board is "to promote the long term success of the company" and to contribute to wider society. However, Section 172 of the Companies Act 2006 ("**the Companies Act**") makes no reference to the latter, and it is drafted in such a way that it allows a director to act in consideration of the short term, if it is in the interest of the company. The FRC has clarified however that nothing in the Code amends the interpretation of the Companies Act.

Significant votes against shareholder resolution

The FRC has clarified that the new reporting requirements associated with a significant vote against a shareholder resolution will apply when there is a vote of 20% or more against a resolution that has been recommended by the board. In this situation, when the voting results are announced, companies will be expected to explain the actions they intend to take to consult shareholders in order to understand the reasons behind the result. This is to be followed by an update no later than six months after the shareholder meeting and a final summary in the annual report (and, if applicable, in the explanatory notes to resolutions at the next shareholder meeting). Companies will need to be ready to explain and report (if necessary) during the course of 2019.

Whistleblowing

The workforce will now be able to raise any matters of concern through the whistleblowing procedure of the Code.

SECTION 2 - DIVISION OF RESPONSIBILITIES

Board composition, independence and the nine years rule

Notwithstanding the widespread opposition received for the independence requirements on board composition during consultations, the FRC has set out the following positions a board will have to consider to remain independent:

1. while a board of directors has the discretion to determine the independence of directors, in situations where not all independence criteria are met, the board will be expected to provide detailed reasoning behind the exercise of their discretion;
2. that the chair must meet the independence criteria on appointment only; and
3. at least half the board (excluding the chair) should be made of independent NEDs.

The FRC has maintained its position on maximum tenure of the chair, who according to the new Provision 193, should not remain in post beyond nine years from the date of their first appointment to the board. However, this period can be extended for a limited time to facilitate effective succession planning and the development of a diverse board, particularly where the chair was an existing NED on appointment.

However, in such cases a clear explanation of the rationale supporting the action must be given.

The FRC's position on maximum tenure is important for companies to take note of, as most would usually prefer to comply with the 2018 Code rather than explain why they have not done so. How market practice might develop is uncertain, as this could either become one of the least complied with provisions in the 2018 Code, or it could trigger a scramble for companies to amend their succession plans for the chairs of their boards.

Overboarding.

Concerns regarding overboarding have been dealt with the insertion of several new provisions and tweaked language. The new language now provides for the board to take into account other demands on the director's time when making board appointments such as "significant commitments" suggested to be disclosed prior to appointment, with an indication of the time involved. The term "significant commitments" has been left undefined and the FRC states that its meaning will vary depending on the company and roles involved and that the board will have to explain why permission has been given for a director to take on a significant appointment, if any.

SECTION 3- COMPOSITION, SUCCESSION AND EVALUATION

Diversity in the boardroom and beyond

The FRC has come to the view that, with respect to diversity the requirement for reporting on the gender balance of those in senior management and their direct reports should be extended beyond the FTSE 350 and that a requirement to report on ethnicity levels in executive pipelines should not be included in the 2018 Code. However, companies are encouraged to think about providing more information about different aspects of diversity in their workforce, in addition to gender. This "encouragement" language has been included in paragraph 89 of the Guidance, which suggests that greater transparency might cover a range of aspects of diversity, including age, disability, ethnicity, education and social backgrounds, as well as gender.

Board evaluations

For all companies that conduct external board evaluations, there is a new requirement (in Provision 23) to report on "the nature and extent of an external evaluator's contact with the board and individual directors". This has originated from the fact that often external evaluations can be limited to questionnaires only, and do not necessarily involve interviews with individual directors or attendance at board meetings, and as a consequence are unlikely to fully understand the dynamics of the boardroom.

SECTION 4 - AUDIT, RISK AND INTERNAL CONTROL

As there was very little change to section 4 in the December version of the 2018 Code, little amendment has therefore taken place in the finalised 2018 Code.

The FRC has decided to retain the existing duplication between requirements of the Listing Rules and the Disclosure and Transparency Rules, as well as maintaining the decision to move the requirement for a company to disclose its audit committee's terms of reference from the 2018 Code to the Guidance.

SECTION 5 - REMUNERATION

Expanded role of the remuneration committee

The 2018 Code has amended Provision 33, so that the remuneration committee has responsibility for reviewing the workforce remuneration and related policies, and the Guidance further expands on this. The definition of "workforce", mentioned above will therefore be relevant for these purposes as well. However, the 2018 Code makes clear that overarching responsibility for "oversight of workforce policies and practices" remains with the board.

To address public concern over executive remuneration, the Code now recommends that remuneration committees should take into account workforce remuneration and related policies when setting the remuneration policy for the executive directors. This was decided on the basis that many remuneration committees are already overseeing this and that this function is considered by the FRC as an appropriate part of the role.

Supporting executive remuneration driving long-term sustainable performance

Having taken into account the responses received on this topic, the FRC has:

- removed the language in Section 5 that could be perceived as encouraging long term incentives in private companies, not wanting to encourage one form of remuneration scheme over another;
- included a requirement for the remuneration committee to develop a formal policy for post-employment shareholding requirements, encompassing both unvested and vested shares (Provision 36);
- clarified the expectation that executive pension schemes should be in line with those available to the rest of the workforce on the basis that there is no obvious rationale for executives to have better arrangements (Provision 38);
- included requirements for the remuneration committee to ensure that a director's term of appointment does not reward poor performance and for the committee to be robust in reducing compensation to reflect a departing director's obligation to mitigate loss;
- added risk (including reputational risk from excessive rewards and behavioural risks from target-based awards) as a factor to be addressed in executive director remuneration policy and practices; and
- imposed a new requirement for remuneration committees to explain in the annual report how they have addressed the following factors of clarity, simplicity, risk, predictability, proportionality, predictability and alignment to culture (Provision 41) in their executive director remuneration policy and practices.

The FRC has chosen not to amend Provision 37, which provides that remuneration schemes and policies should enable the use of discretion to override formulaic outcomes. This is despite respondents highlighting that employment contracts and scheme rules may prevent the exercise of discretion in practice, even where the remuneration policy provides for it. Nevertheless, the FRC has stated that remuneration committees have a responsibility to ensure that different elements of the framework interact in such a way that the intent of the remuneration policy is not undermined. A modified disclosure requirement in Provision 41 requires remuneration committees to disclose in the annual report the extent to which discretion has been applied to remuneration outcomes and the reasons why.

Moreover, the FRC expects the above disclosure to include a description of anything which prevents the use of discretion where remuneration outcomes would otherwise have been adjusted.

OTHER CHANGES

Reinstatement of some of the current exemptions for smaller companies

Contrary to the first draft of the code, where existing exemptions for small companies were removed, the FRC has:

- reinstated the exemption for FTSE 350 companies in respect of the requirement to have an externally facilitated board evaluation at least every three years, but included language which encourages all chairs to consider the use of externally facilitated board evaluations (Provision 21 and paragraph 111 of the Guidance);
- reverted to the current position which allows FTSE 350 companies' audit and remuneration committees to each have a minimum membership of at least two independent NEDs (Provisions 24 and 32, respectively). However, the FRC has maintained the position (set out in the December consultation) that, even for smaller firms, the chair of the board should not also be a member of the audit committee; and
- removed the requirement for a nomination committee to have a minimum membership of three (Provision 17).

Smaller firms' exemptions in respect of the requirements for the annual re-election of directors (Provision 18) and at least half the board, excluding the chair, to be independent NEDs (Provision 11), have not been retained in the 2018 Code. Therefore, these rules will apply to all companies, including smaller firms.

ACTION TO BE TAKEN IN PREPARATION FOR COMPLYING WITH THE 2018 CODE

A number of actions should be taken in order for companies to prepare for complying with the new 2018 Code.

Getting familiar with the 2018 Code and new Guidance

Although the FRC states that the Code has been simplified, company secretaries will still need to get familiar with the changes in both the 2018 Code and the Guidance.

Methods for workforce engagement

Companies need to consider which of the three following suggested methods of workforce engagement (as mentioned above) they want to employ, how they will operate in practice and how to implement them:

- **a director appointed from the workforce**: the company would need to put in place procedures for the director's appointment and removal and the terms for holding office. The individual appointed in this role would take on the full legal duties and responsibilities that apply to directors generally, with a particular focus on bringing the views and experience of the workforce into the boardroom;
- **a formal workforce advisory panel**: more likely to be adopted by larger companies. Companies will need to decide on the composition of the panel, how it is to be elected, and the framework for the panel's relationship with the board;
- **a designed NED**: more likely to be adopted by small and mid-sized quoted companies. The designated director and board generally would need to develop effective ways for the director to engage with the company's workforce and to understand their views.

The 2018 Code also specifies that there are alternative methods which may also be effective to enable the board to understand the views of the workforce, such as setting up digital sharing platforms or establishing consultative groups. The Guidance states that provided that the board's approach delivers meaningful, regular dialogue with the workforce and it is explained effectively, this provision will be met.

In particular, companies need to make sure:

- that those appointed to overseeing the process will be supported by the right structures and procedures, so that the engagement is effective;
- to compile a list of actions already taken, and what the outcome is and how this should be modified it in light of the new requirements; and
- to consider how to communicate these actions internally and externally.

Update definitions and procedures

It is important at this early stage of implementation that companies:

- consider their definition of "workforce", and how that complies with the 2018 code (please see above, Section 1, "the workforce and its new meaning"); notably, the updated definition has a broader meaning, and includes individuals with a formal employment contract, as well as workers who are affected by the decision of the board, such as agency workers This will mean that companies need to think of their workforce as a pool of individuals, regardless of their formal employment status, and therefore beyond traditional categories;
- identify their stakeholders, other than the workforce, and consider strategies for their engagement as well; and
- make sure that the nomination and remuneration committees are aware of their expanded role, and are eventually provided with additional training for it.

Remuneration provisions

Companies may need to review the composition and responsibilities of the remuneration committee, following changes introduced in the new Code (please see above, Section 5, "Remuneration").

Given the FRC's focus on remuneration policies, it is important at this stage:

- to factor the changes to these provisions into any new board appointment process and draft service agreements, and consider whether any amendments should be made to the company's remuneration policies earlier than the prescribed three years;

- to consider the FRC requirements to focus on aspects such as clarity, simplicity, risk, predictability, proportionality and alignment to culture in the company's executive director remuneration policy and practices, as the remuneration committees will need to indicate in their 2019 annual report how these factors have been addressed; and
- to start reviewing what remuneration policies, scheme rules and contractual obligations may need to be changed to make sure that they allow for the exercise of discretion when appropriate.

Company's culture

Companies who do not have established corporate cultures will need to think about the steps to be taken in how their values can be incorporated more into their business to ensure the shareholders', wider stakeholders' and the company's strategy and values are aligned.

NEXT STEPS

It is important to review the actions mentioned above, in order to plan an early disclosure against the 2018 Code, or at least set out how the company intends to comply with it.

Also, smaller companies should prepare for annual re-election of directors, and consider how to comply (or explain non-compliance) with requirements for at least half the board to be independent.

In considering early steps for compliance, companies will need to keep track of the FRC's planned changes as the FRC has a number of other amendments in the pipeline. In particular, it plans to publish:

- amendments to the Guidance on Audit Committees;
- amendments to the Guidance on Risk Management, Internal Controls and Related Financial Business Reporting;
- a consultation on revising the Stewardship Code;
- new guidance on the interpretation of the Director's duties in section 172 of CA 2006;
- a revised version of the 2014 FRC Guidance on the Strategic Report; and
- the outcome on consultation on strengthening corporate governance in pre-insolvency situations.

To view the full 2018 Code, please click here.

For more information, and any guidance or advice on your firm's obligations under the 2018 Code, Cleveland & Co external in-house counsel, your specialist outsourced legal team are here to help.

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