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CORPORATE GOVERNANCE REFORMS – THE NEXT STEPS

On 29 August 2017, the Department for Business, Energy and Industrial Strategy (BEIS) published the formal response to its November 2016 green paper consultation on the governance of UK companies.

The response can be found here. It follows on from and builds on the recommendations put forward by the BEIS Parliamentary Select Committee (the "**Select Committee**") in April 2017, following its own inquiry into corporate governance.

In the response, the Government has set out various proposals it intends to take forward. These include mandatory measures to require companies to report on their ratio of CEO to workforce pay, as well as to explain complex share-based incentive schemes and how their directors have complied with their statutory duty to have regard to certain categories of stakeholders.

The paper also sets out suggested changes to the UK Corporate Governance Code (the "**Code**") relating to significant shareholder opposition to executive pay, greater responsibility for remuneration committees, and worker representation on boards, as well as to institute a code of corporate governance for larger private companies.

We have summarised below the key points arising from the response.

EXECUTIVE PAY

The response notes that many companies have responded positively to the reforms instituted in 2013, which require a binding vote to be held on the directors' remuneration policy every three years. However, the Government believes a "persistent minority" are continuing to disregard shareholders' views.

The Government is also concerned that remuneration committees are failing to treat seriously their obligation to take account of wider workforce pay and conditions when setting executive pay.

There was limited support for the more stringent measures suggested in the green paper. For example, only one third of respondents supported an annual binding vote on the directors' remuneration report, and less than a quarter supported executive pay limits or a more frequent binding vote on the remuneration policy.

The greatest level of support was for enhancing engagement between companies and their shareholders over executive pay, and for ensuring that companies respond appropriately to significant shareholder dissent. There was also overwhelming support for the recommendations in the green paper to strengthen the role of remuneration committees and to tighten the qualifications of the committee chair.

With this in mind, the Government is proposing the following:

- **Pay ratios.** Quoted companies will be required to **state the ratio of their CEO's pay to average workforce pay** in their annual remuneration report. They would also have to explain any changes to that ratio from year to year, as well as how the ratio relates to pay and conditions across the wider workforce. This requirement would be implemented through secondary legislation and so would be mandatory.

  This builds on the Select Committee's recommendation that the Financial Reporting Council (FRC) work with stakeholders to require publication of senior executive pay ratios. Indeed, given it will be a new statutory requirement, it arguably strengthens the Committee's proposal.

  The paper states that just over half of respondents commented on this specific proposal, and only a small majority of those respondents supported mandatory pay ratio reporting. That the Government has nonetheless decided to proceed with this approach perhaps demonstrates its continued preference for disclosure over regulation so as to allow investors and other stakeholders to make their own assessment.

  The paper does not state whether the average would be calculated on a mean or median basis, although it notes that marginally more respondents favoured a median average calculation. It also fails to explain what the phrase "how the ratio relates to pay and conditions" means, in particular whether companies will be left to decide how to report on this, or whether reporting will need to be carried out against a list of set criteria.

- **Remuneration committees.** The Government will invite the FRC to revise the Code so as to **give remuneration committees more responsibility** for demonstrating how pay and incentives align across a company and to explain to the workforce how decisions on executive pay reflect wider pay policy.

The paper does not give any specific examples of the new powers or responsibilities remuneration committees should get, nor what is expected in terms of explaining "alignment" of pay and incentives. Rather, it suggests that this principle should be developed out of the work of existing remuneration committees that already engage with the wider workforce as part of a consultation to amend the Code. It is therefore currently unclear what reforms will result from this particular proposal.

- **Minimum tenure.** Following up on another recommendation of the Select Committee, the Government will ask the FRC to introduce a new requirement in the Code that a person **must have served for 12 months on a remuneration committee** before assuming the position of chairperson. The paper is not particularly clear, but it seems to suggest that those 12 months could be served on *any* remuneration committee, and not specifically the committee for which the person is seeking to take up the role of chair.

- **Shareholder opposition to executive pay.** The Government will invite the FRC to revise the Code so as to set out steps companies should take when they encounter "**significant opposition" to executive pay** proposals. Suggestions cited in the paper include requiring companies to issue a public response or put their existing or a revised remuneration policy to a binding vote at their next AGM.

  The response does not suggest what level of dissent would be deemed "significant", but the Government has taken the Investment Association up on its proposal to keep a public register of listed companies that encounter opposition of 20 per cent or more on executive pay and associated resolutions.

The Government has decided not to pursue any other suggestions floated in the green paper (such as establishing a "Shareholder Committee" to oversee executive pay, director nominations and strategy), noting that these options would either be difficult to implement in practice or are already being progressed through industry-led action.

SHARE-BASED INCENTIVE SCHEMES

The Government has said that it recognises concerns about the "unnecessary complexity and uncertainty" of executive pay. This touches on long-term incentive plans (LTIPs), which normally involve share-based incentives.

The response notes the particular concern that LTIPs are not currently aligning executive remuneration adequately with long-term performance and are too narrowly focussed on share price growth and short-term returns. Perhaps underscoring this, two thirds of respondents agreed with extending the minimum vesting and holding period under LTIPs from three to five years.

The Government is therefore proposing the following:

- **Reporting on LTIPs.** Quoted companies would be required to include in their remuneration policy a **"clearer explanation" of the potential outcomes of complex, share-based incentives**. This would be achieved through secondary legislation, probably by amending the existing accounting regulations that apply to large and medium-sized companies.

  The Government will also invite the FRC to engage with stakeholders on the possibility of including new principles or guidance on share-based remuneration in the Code.

  The paper does not set out how the explanation of share-based incentives should work, nor what details it would need to address. It will be necessary to examine the proposed legislation in due course. However, the Government does say that companies should avoid conforming rigidly to a standard LTIP model and should consider other remuneration structures that may be more appropriate to their business or strategy.

- **Minimum holding period.** The Code currently recommends that executive options should not be exercisable for at least three years and that remuneration committees should consider requiring directors to hold shares for a further period after exercise. The Government agrees with the Select Committee's recommendation that the minimum period be increased to five years (including both the vesting period and the post-exercise holding period) and intends to invite the FRC to consult on changes to this effect in the Code.

In taking this approach, the Government has decided not to follow the bolder recommendation by the Select Committee of abolishing LTIPs altogether from 2018 in favour of deferred stock options. The Select Committee had recommended phased option vesting in 15-20 per cent increments over five years. However, the Government says that properly-designed LTIPs can provide a "powerful driver of long-term executive decision-making".

EMPLOYEES AND STAKEHOLDERS

Respondents to the consultation thought more should be done to reassure the public that companies are being run not just in the interests of their board and shareholders, but with recognition that companies have responsibilities to their employees, suppliers and customers, as well as to wider society.

The directors of a company are already required by law to have regard to these categories of stakeholder as part of their duty in section 172 of the Companies Act 2006 to promote the success of their company. However, the Government has said that a large number of respondents to the consultation thought this regime could work more effectively and that stakeholder engagement could be strengthened.

The Government is therefore proposing the following:

- **Employee board representation.** The green paper had suggested three models for involving employees in board decisions: designate existing non-executive directors to represent employees; create an employee council which the board would have to consult; or appoint a director from the workforce.

  According to the response paper, none of the three options garnered significant support over the others, although there was broad support for more employee involvement. The paper notes that there was "considerable support" for the existing "comply or explain" approach in the Code.

  The Government's solution is to ask the FRC to update the Code to **require companies to choose one of the three mechanisms** and adopt it. This approach has the advantage of enabling companies to choose which of the three models is most suited to its structure and employee base, or even to disregard all three options completely if it can justify non-compliance with the Code.

  Each of these three options will carry its own advantages and disadvantages. The approach each individual company opts for will depend to no small extent on how these structures are ultimately set out in the Code. The position will hopefully become clearer when the FRC issues its specific proposals in due course.

  The Government has not adopted the Select Committee's recommendation of requiring employee representation on remuneration committees.

- **Stakeholder engagement.** Companies of a "significant size" will be required to **explain how their directors have complied with section 172** insofar as it requires them to take employees, suppliers, customers and other stakeholders into account. The Government has not said what size would constitute "significant", but it is clear that this duty would apply to **both public and private companies**.

  This directly transposes one of the key recommendations of the Select Committee, although the Government has opted for mandatory reporting under legislation, rather than a new requirement in the Code.

  The Government envisages that this requirement would be supplemented by a raft of guidance to assist companies in their reporting. For example, it is inviting the GC100 to publish new guidance on how directors can interpret and discharge their duty under section 172 in practice.

  On a more general note, the Government will invite the FRC to strengthen the Code by including a new principle on engaging with employees and other non-shareholders, and will ask ICSA and the Investment Association to complete joint guidance on practical ways for companies to engage stakeholders.

Significantly, the Government has decided not to take up the Select Committee's recommendation of giving the FRC investigatory and enforcement powers to allow it to assess directors' compliance with section 172 and, if necessary, bring legal action. The FRC had itself argued that it should have additional powers.

When we reported on the Select Committee's recommendations back in April, we noted that giving the FRC these kinds of powers would likely involve significant investment and funding and would represent a departure from the traditional "fiduciary" nature of the duty in section 172. Other respondents appear to have shared this view and it seems the Government agrees. The wording of the response is conciliatory, but we suspect the prospect of a regulator for directors' duties and (in particular) section 172 is likely to fade away quickly.

PRIVATE COMPANIES

According to the response paper, the consultation revealed support for higher standards of corporate governance for privately-owned companies. 80 per cent of respondents were in favour of strengthening standards for large private companies. The Government believes this recognises the impact these companies have on employees, suppliers, customers and other stakeholders, even though they are not publicly traded.

Respondents' views differed on where the line should be drawn when deciding which companies would be caught by this. Most focussed on the number of employees the company has, although suggested thresholds ranged from 500 to 2,000. (The Select Committee, in its recommendations, had suggested a threshold of 2,000.)

Perhaps the most difficult challenges highlighted in the response are how a corporate governance code for private companies could be applied across a range of disparate industries and ownership structures, as well as who should develop such a code. Respondents proffered several industry bodies as potential candidates based on their experience in relevant sectors.

The Government has taken these views and formulated the following proposals:

- **Corporate governance code.** The Government intends to ask the FRC to work with various industry bodies to **develop a code of corporate governance for large private companies.** The response specifically names the Institute of Directors (IoD), Confederation of British Industry (CBI), Institute for Family Business (IFB) and British Venture Capital Association (BVCA). However, it leaves the list of potential collaborators open-ended.

  The requirement would apply only to companies with more than 2,000 employees. Although styled as a code for private companies, it would apply to public companies as well, unless they are already required to report against the UK Corporate Governance Code or to issue a corporate governance statement under the FCA's Disclosure Guidance and Transparency Rules.

- **Disclosure of corporate governance arrangements.** All companies with more than 2,000 employees will be required to disclose their corporate governance arrangements in their directors' report and state whether they follow a formal code. A similar requirement may be imposed on large limited liability partnerships (LLPs).

  In this respect, the Government has chosen not to follow the Select Committee's recommendation of creating a new body to oversee and report on compliance with this new code, funded by a levy on members.

As we mentioned in April, developing a single, coherent corporate governance code for private companies will be an ambitious project. Unless approached correctly, the disparate nature, size and structure of private companies could feasibly result in a code devoid of much substance.

There is every possibility that this initial proposal for a voluntary set of corporate governance principles will ultimately take the form of various separate governance codes appropriate to different industries. Indeed, this may be preferable to, and more manageable than, a single, overarching body of principles.

WHAT NEXT?

The proposals arguably strike a balance and represent a "mid-point" between demands from one end of the spectrum to enact mandatory employee representation and formal pay caps, and concerns at the other end about stifling talent and eroding the UK's model of a unitary board.

Many of the proposals take the form of changes to the UK Corporate Governance Code. The detail of the proposed changes to the Code will be the subject of a consultation launched by the FRC. The FRC has welcomed the Government's suggestions and intends to fold these items into the fundamental review of the Code it is intending to carry out later in 2017.

In this respect, proponents of more radical change to the corporate governance landscape, who may have been hoping for firmer legislative action by central government, may find themselves disappointed with the Government's proposal to deal with matters such as employee representation, executive remuneration, long-term incentives and stakeholder engagement through a "comply or explain" approach by virtue of the Code. In doing so, they may feel that Government has effectively handed the baton on to the FRC to address these issues.

At the same time, the Government has taken firmer action than might have been expected in other areas, such as pay ratio reporting and corporate governance for privately-owned companies. The fact that both private and public companies will be required to report on section 172, and that private companies will be required by law to report on their corporate governance arrangements, arguably go further than the Select Committee's recommendations.

In the end, much will turn on the outcome of the FRC's forthcoming consultation. The response paper lacks detail in many respects, and the Government appears to be contemplating that this will be fleshed out by the FRC. Whether the proposed revisions to the Code that come out of that consultation generate change in practice remains to be seen.

CONTACT DETAILS

If you would like further information or specific advice please contact:

HARRY COGHILL
PARTNER
CORPORATE AND M&A
DD +44 (0)20 7849 2538
harry.coghill@macfarlanes.com

ROBERT COLLARD
PARTNER
SHARE SCHEMES AND INCENTIVES
DD +44 (0)20 7849 2696
robert.collard@macfarlanes.com

DOMINIC SEDGHI
SENIOR SOLICITOR AND PROFESSIONAL SUPPORT LAWYER
CORPORATE AND M&A
DD +44 (0)20 7849 2216
dominic.sedghi@macfarlanes.com

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MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT

T +44 (0)20 7831 9222 F +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

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