UK CORPORATE GOVERNANCE CODE 2018: PRACTICAL IMPLICATIONS

In July 2018 the Financial Reporting Council (FRC) released the 2018 edition of the UK Corporate Governance Code (Code). The new Code is described as “shorter and sharper” than its predecessor and has been the product of extensive consultation. Companies will need to adapt to a range of changes in areas such as workforce and shareholder engagement, corporate culture, board succession and diversity and remuneration.

The Code is supported by revised Guidance on Board Effectiveness (Guidance), which boards are encouraged to read alongside the Code. The Guidance is principally designed to stimulate thinking on how boards can carry out their role effectively.

The new Code will apply to accounting periods beginning on or after 1 January 2019. This means that the first reporting by reference to the Code will generally be seen in 2020, although some companies may choose to adopt the Code earlier. The Code will be mandatory for companies with a premium listing. Like the current edition, rather than complying with a rigid set of rules, companies will need to apply the 18 Principles and either comply with the 41 Provisions or explain why they have not done so. The Supporting Principles have been removed.

What action should companies take?

Companies with a premium listing and other companies that have chosen to apply the Code should review their existing policies and practices against the new Code and consider the steps that need to be taken. Any actions will need to be implemented in the next few months, before the start of the first compliance period in 2019. We highlight below some of the key Code changes that companies will need to consider.

Workforce and stakeholders

The new Code expects boards to understand the views of the company’s key stakeholders and to describe in their annual report how the stakeholders’ interests and the matters set out in section 172 Companies Act 2006 have been considered in board discussions and decision-making. Section 172 obliges directors to have regard to a range of stakeholders and interests when complying with their duty to promote the success of the company, including the interests of the company’s employees, the need to foster business relationships with suppliers, customers and others, the impact of the company’s operations on the community and the environment and other matters.

Companies may need to review their decision making processes and how they identify stakeholder interests and take them into account. The Stakeholder Voice in Board Decision Making (a joint publication by the ICSA and The Investment Association) provides further guidance which companies may find useful.

In relation to the workforce, three recommended methods of engagement are set out in the Code (to be used either alone or in combination), with a proviso that if none of them is adopted, companies should explain their alternative arrangements and why they consider them to be effective. “Workforce” has a broad meaning for these purposes, covering not only individuals with a formal employment contract, but also other workers who are affected by the decisions of the board, such as agency workers. The recommended engagement methods are considered in the table below.

Methods of workforce engagement recommended in the Code	
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, including confidentiality obligations in relation to board information. For this method to work effectively, new processes may need to be introduced to enable the director to gather views from across all sections of the workforce. An individual appointed to this role would take on the full legal duties and responsibilities that apply to directors generally, with a particular remit for bringing the views and experiences of the workforce into the boardroom. The appointee would need appropriate skills to take on the role and both they and the company would need to commit to the training and support needed.
A formal workforce advisory panel	We expect this method to be adopted primarily by larger companies, particularly those that already have a similar structure in place, but it may also be appropriate for some smaller companies. Decisions would need to be taken on the composition of the panel, how it is to be elected and the framework for the panel's relationship with the board.
A designated non-executive director	We expect this method to be a common choice for 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 understand their views. The director's time commitment to the company (and therefore fees) may need to increase and both the director and the company would need to be confident that the director has sufficient capacity to take on the role.

In addition to the three methods outlined above, the Code acknowledges that there are alternative methods which may also be effective to enable the board to understand the views of the workforce. The Guidance sets out some examples, including hosting town halls, setting up digital sharing platforms and establishing consultative groups. The Guidance states that "provided the board's approach delivers meaningful, regular dialogue with the workforce and is explained effectively, the Code provision will be met".

Over the coming months boards will need to consider which approach on employee engagement is right for their company and put any new structures in place before the 2018 Code starts to apply.

Significant shareholder dissent at general meetings

The Code sets out how companies are expected to respond when 20% or more of shareholder votes are cast against the board recommendation for a resolution. 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.

This provision follows the introduction in 2017 of the Investment Association's Public Register. This publishes details of the FTSE All-Share companies which have received 20% or more votes against a resolution at a meeting or which have withdrawn a resolution before the shareholder vote.

Chair limited to tenure of nine years

The 2018 Code introduces a new recommendation that the chair should not remain in post for more than nine years after they were first appointed to the board. Companies may need to review their board composition and succession planning as a result. Any time served as a non-executive director before appointment as chair will count towards the nine year period and will reduce the time that can be served as chair. However there is some flexibility in the nine year period – limited extensions are permitted to facilitate effective succession planning and the development of a diverse board, particularly in cases where the chair was an existing non-executive director at the time of appointment. Companies will need to explain any departure from the nine year rule.

Directors' commitments

Following comments concerning non-executive directors holding multiple directorships ("overboarding"), the FRC is encouraging both boards and directors to think carefully about the commitments they make when taking on new appointments. The Code has been strengthened with a recommendation that directors should not take on additional external appointments without prior board approval, with the reasons for permitting any significant appointments being explained in the annual report.

Remuneration committee

Companies may need to review the composition and responsibilities of the remuneration committee following changes introduced in the new Code.

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. A description of "workforce" for these purposes is set out in the Guidance. The Code makes it clear that overarching responsibility for "oversight of workforce policies and practices" remains with the board.

The new Code also targets formulaic calculations of performance-related pay. Remuneration committees will now be expected to apply discretion in cases where formulaic outcomes are not justified and be ready to explain when and why they have done so. Remuneration policies, scheme rules and contractual obligations may need to be reviewed to make sure that they allow for the exercise of discretion when appropriate.

Following a Government consultation, the Code also introduces a new recommendation that remuneration committee chairs should have at least 12 months' experience serving on a remuneration committee before being appointed to the role.

Long-term incentive plans

The new Code extends the recommended minimum aggregate vesting and post-vesting holding period for executive share awards from three years to five years, with the aim of ensuring that directors' incentives are better aligned with the long term interests of the company and shareholders. This reflects emerging best practice for larger companies, many of which already comply. However many smaller companies still do not have holding periods beyond a three year vesting period and so will need to consider changing their plans.

Companies below the FTSE 350

Under the existing Code, smaller companies benefit from a number of relaxations. These have been reviewed and the position for smaller companies has been brought into line with the FTSE 350 in some areas. The new position is summarised below.

Provision	2016 Code	2018 Code
All directors subject to annual re-election by shareholders	Applies only to FTSE 350 companies	Applies to all companies. Non-FTSE 350 companies which do not currently comply, but which intend to do so, should propose all directors for re-election at their AGM in 2019 and in subsequent years
At least half the board, excluding the chair, to be independent non-executive directors	Applies to FTSE 350 companies (smaller companies to have at least two independent non-executive directors)	Applies to all companies. Non-FTSE 350 companies which do not currently comply, but which intend to do so, should review their board composition and hire additional independent non-executive directors if needed
Three-yearly, externally facilitated board evaluations needed	Applies only to FTSE 350 companies	Applies only to FTSE 350 companies (although the chairs of all companies are expected to consider regular externally facilitated board evaluations)
Audit committee to comprise at least 3 independent non-executive directors	Applies only to FTSE 350 companies. Audit committees of smaller companies to have a minimum of 2 independent non-executive directors and, unlike FTSE 350 companies, may include the company chair as an additional committee member in some cases	The minimum number of independent non-executive directors for each type of company remains the same but, in a change for companies below the FTSE 350, the committee may no longer include the company chair as a member
Remuneration committee to comprise at least 3 independent non-executive directors. The company chair may be an additional committee member in some cases	Applies to FTSE 350 companies. Also applies to smaller companies, but with a reduced recommended minimum membership of 2 independent non-executive directors	No change from the 2016 code

The UK Corporate Governance Code and Guidance on Board Effectiveness are available from the FRC's website. The FRC has indicated that it will embark on an outreach programme over the coming months to support implementation by companies and their advisers and that it will escalate its monitoring of practice and reporting once the Code is in force.

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