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UK Corporate Governance Code consultation 2023

Dear Sir / Madam,

We welcome the opportunity to participate in the FRC's current consultation on the UK Corporate Governance Code. As an executive remuneration advisory practice, we have set out our responses to the remuneration-related questions in the consultation below.

Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?

This question refers to the proposed amendments to the three 'Principles' set out at the start of the Remuneration section. In particular, we note the introduction of the following sentence into Principle P: "*Remuneration outcomes should be clearly aligned to company performance, purpose and values, and the successful delivery of the company's long-term strategy including environmental, social and governance objectives*". Our comments are:

1) The existing Code already encourages a strong link between remuneration policies / outcomes and company performance, which has helped foster a market environment where for the vast majority of UK-listed companies a substantial portion of executive director remuneration is performance-linked. However, the proposed addition of the phrase which explicitly requires that "*remuneration outcomes should be clearly linked to company performance*" can do no harm in reinforcing this message.

2) However, how "company performance" is assessed in this context (i.e. which performance metrics are used for management incentives), should be a matter for each company's Board and Remuneration Committee, taking into account the specific characteristics, circumstances and strategy of that particular business. Reflecting this approach, the Code has never specified what metrics should be used e.g. whether financial, market-based (e.g. share price/TSR), operational, strategic, etc. Although "environmental, social and governance [ESG] objectives" may be appropriate for inclusion into management incentives in some businesses, this may not be universally the case across the market. **We therefore strongly disagree with the introduction of the phrase "including environment, social and governance objectives" into Principle P as it may be interpreted as the Code mandating the inclusion of ESG objectives into management incentives**. In addition good 'governance' is a basic 'must have' for doing business as a listed company in the UK and not something that a Remuneration Committee would typically use as a performance target in incentive plans.

3) The obligation to consider "workforce pay and conditions" is already present in respect of determining a company's remuneration policy (Provision 35). However, introducing it into Principle Q which addresses the determination of *outcomes* may help to emphasise the importance of considering broader employee context at that stage too, and we therefore support this change.

4) Finally, the link between remuneration and performance can be enhanced by appropriate use of remuneration committee discretion, as already embedded in Code Principle Q and supporting Provision 39 (which includes reference to the ability to "override formulaic outcomes"). In theory, this principle should be capable of being applied in both directions – i.e. both positively and negatively. However, in practice in the UK-listed market it is almost always operated to reduce outcomes, and rarely to provide additional reward such as for outstanding performance. As we argued in our recent research publication[1], we think that greater acceptance of the use of positive discretion to allow remuneration committees to deliver the right overall outcome for stakeholders, provided it is operated robustly, consistently, and in accordance with agreed principles, would be beneficial for the UK-listed market. **To further strengthen the link between performance and remuneration, we would therefore encourage the FRC to consider supplementing the language (in either Principle Q or Provision 39) to explicitly acknowledge that the principle of using discretion should be capable of being operated in either direction.**

Q23: Do you agree that the proposed reporting changes around malus and clawback will result in an improvement in transparency?

This question refers to the proposed changes to Provisions 39 and 40 in respect of malus and clawback requirements and disclosures. Our comments are:

5) We are fully supportive of the proposed enhancement to Provision 39 (encouraging directors' contracts to include provisions to enforce malus and clawback), aimed at improving the enforceability of such provisions. On the subject to ensuring legal enforceability, we would also encourage the FRC to consider whether the Code would benefit from a more generic provision in this area, rather than providing such commentary only in respect of one area (see *Paragraph (15)* of this letter below)

6) The proposed (new) Provision 40 introduces a range of new disclosure requirements in respect of malus / clawback. In our view, these are **unlikely to add any real incremental value for stakeholders on the basis that company disclosure is already generally good and/or the nature of the new requirement could encourage 'boilerplate' disclosure which lengthens DRR reporting without adding value**. For example:

   - "*The minimum circumstances in which malus and clawback provisions could be used*" and "*the minimum period for malus and clawback*" are already widely and transparently disclosed across the market.

   - The overwhelming majority of UK-listed companies either: (i) operate a clawback period of 2-3 years or (ii) in the Financial Services sector, operate a longer period in line with their regulatory requirements. The proposal to additionally disclose "*why the selected [time] period is best suited to the organisation*" is likely to lead companies, very reasonably, to adopt 'boilerplate' disclosure which simply reflects these factors (i.e. either (i) it aligns to established market norms and shareholder expectation or (ii) fulfilling regulatory requirements).

   - Given the severity of event which is required to trigger their use, malus and clawback provisions are not intended to be invoked on a regular basis. Therefore, requiring all companies to disclose whether they have been used, both in the reporting year and over the preceding five years, is likely to result in a large number of 'nil return' disclosures (lengthening DRRs without adding

[1] https://www.alvarezandmarsal.com/insights/executive-pay-uk-big-tent-discussion

value)[2]. We would argue that a more useful application of this type of disclosure would be in respect of the application of _discretion_ to incentive outcomes.

7) As alternatives to changes which focus on the disclosure of malus/clawback provisions, the FRC could consider amending the Code to provide guidance on the design of the provisions themselves (in a similar way to Provisions 38, 41, and 42 in respect of other aspects of the remuneration package):

- In line with Paragraph 5.2.7 of the BEIS "*Restoring trust in audit and corporate governance*" paper, we would not be supportive of the Code containing a prescriptive "one size fits all" list of malus/clawback triggers, and we note that some examples are already provided in the Board Effectiveness guidance. However, the wording in Provision 39 of the Code could be expanded to encourage remuneration committees to design malus/clawback provisions which, for example, "reflect the specific circumstances and risks of their business".

- The Code could provide guidance on the minimum expected time period for clawback provisions to apply (in a similar way to which time periods are expressed in Provisions 38 and 41 in respect of long-term share awards and notice periods, respectively).

Q24: Do you agree with the proposed changes to Provisions 40 and 41?
and
Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?

These questions are both intended to "improve the quality of reporting" in respect of remuneration, focusing on (former) Provision 40 and Provision 43. Our comments are:

8) With respect to (former) Provision 40, we would argue that the current problem is not the Provision itself but the requirement (in former Provision 41) to disclose "*a description, with examples, of how the remuneration committee has addressed the factors*", which naturally led to 'boilerplate' reporting. However, including the key points (clear, proportionate, etc.) in simplified terms into Provision 34 is a sensible compromise.

9) We disagree with the insertion of specific reference to ESG into the first bullet point of Provision 43 for the reasons outlined above in *Paragraph (2)* of this letter.

10) We note that the requirements in (new) Provision 43 around shareholder and workforce engagement can create some confusion in the market. The provision states: *"There should be a description of the work of the remuneration committee in the annual report, including: … what engagement with shareholders and the workforce has occurred and what impact this has had on remuneration policy and outcomes, including the alignment with executive remuneration and the overall company pay policy;".* Compliance could therefore be interpreted as merely describing the work which occurred, which could be nothing. For example, a compliant statement could be a description such as "this year the Committee did not engage with the workforce, but takes into account workforce pay and conditions when making executive pay decisions". If the intent is for an annual workforce engagement to occur, then it would be helpful for the Code to make this clear and not leave it to interpretation by including it only in this provision concerned with disclosure.

[2] In addition, the proposed requirement that "*if [malus/clawback] provisions have been used, a clear explanation of the reason should be provided in the annual report*" is superfluous as it is inconceivable from a practical commercial perspective that a remuneration committee would invoke malus/clawback and _not_ explain the reasons why in the DRR.

11) With respect to Q25, we note the proposed removal of the requirement from Provision 43 to disclose "*reasons why the remuneration is appropriate using internal and external measures, including pay ratios and pay gaps*". We fully support removal of the specific reference to "*pay ratios and pay gaps*" as these metrics are not generally useful, in practice, in the context of answering the question of whether executive remuneration is "appropriate". However, the FRC may wish to consider retaining the first part of the sentence to ensure that companies are required to explain why remuneration levels are appropriate in the context of other factors (for example, removing the reference to "internal" reference points may encourage companies to avoid disclosing the salary increase applying to their wider workforce, which we would argue to be an important reference point for shareholders where transparency should be encouraged).

Other observations

Whilst not directly covered in the current consultation, we would make the following additional observations around how the Code operates in respect of remuneration:

12) **Provision 4**. We recognise that this Provision applies to all resolutions and not simply to those related to remuneration. However, we can make the following observations based on our research[3] and experience in relation to its application to remuneration:

- **20% threshold**. Given the significant public sensitivity around executive remuneration, receiving a 'low' vote (80% or below) can be accompanied by a narrative suggesting that the remuneration committee has acted improperly, resulting in a shareholder 'revolt' or 'mutiny' on executive pay. In reality, it is more often simply a reflection of a reasonable difference of judgement on a subjective matter, which we should naturally expect in an increasingly fragmented shareholder environment, without concluding that there is some 'problem' to address. Since the launch of the IA Public Register in 2017, more than 220 different companies have been captured in respect of remuneration-related votes. We question whether it really is the case that egregious remuneration practices have occurred in over 40%of the UK-listed market over that period. **We would ask the FRC to review whether the 20% threshold remains appropriate in an increasingly fragmented shareholder environment.**

- **Practical consequences to re-engage**. In our experience, as the majority of companies take a responsible approach to corporate governance, the Code requirement to re-engage with shareholders after a low vote adds little additional value for any stakeholder. Most companies will typically have already engaged with a large proportion of their register and will therefore often already understand the rationale for their voting decision. This explains why, in our experience, many shareholders choose not to participate in the required follow up exercise (on the very reasonable grounds that "we've told you our views already") and why the follow up disclosure appears to adopt a 'boilerplate' approach (because there is no new information to include). **This could be catered for by amending the Code provision as follows:**

> "When 20 per cent or more of votes have been cast against the board recommendation for a resolution, the company should explain, when announcing voting results, its understanding of the reasons behind the result or, if not known, what actions it intends to take to consult shareholders in order to understand ~~the~~ those reasons ~~behind the result~~. Where subsequent shareholder consultation takes place, an update on the views received from shareholders and actions taken should be published no later than six months after the shareholder meeting."

[3] See footnote 1 above

13) **Provision 33 (new)**. This states that "*before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months*" implying that the individual should have 12 months' prior experience on any remuneration committee. This contrasts with the Investment Association's 'Principles of Remuneration' which states that "*non-executive directors should generally serve on the Remuneration Committee for at least a year before chairing the Committee*" implying that the individual should have 12 month's prior experience on that company's committee. The discrepancy is a relatively common cause of confusion for companies and we would therefore encourage the FRC and IA to develop consistent wording. Our view is that the current FRC/Code wording is preferable and therefore we should direct our view to the IA, however we raise this here simply for the FRC's awareness of the issue.

14) **Provision 38 (new)**. The language which was added to the Code in 2018 to describe how long-term incentive awards should typically be structured is potentially confusing and is not, as we understand it, what was intended in the drafting. We would suggest the following simplification:

> "In normal circumstances, share awards granted for this purpose should be granted ~~released for sale~~ on ~~a phased~~ an annual basis and be subject to a total vesting and holding period of five years or more."

15) **Legal enforceability of remuneration provisions**. As explained in *Paragraph (5)* of this letter above, we are fully supportive of the proposed enhancement to Provision 39 aimed at improving the enforceability of malus and clawback provisions. However, we would also encourage the FRC to consider inserting a more 'generic' provision into the Remuneration section of the Code to set an expectation that any aspect of executive director remuneration as set out in a company's Remuneration Policy should be appropriately supported by an underlying legal framework to ensure enforceability.

Should you wish to discuss or clarify any issues raised above, please reach out to us using the email addresses below.

Yours faithfully,

[redacted]