

COMMENTS ON THE FRC'S CONSULTATION DOCUMENT IN RELATION TO THE PROPOSED CHANGES TO THE UK CORPORATE GOVERNANCE CODE

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Our comments and suggestions focus mostly although not wholly on remuneration and relate to:

Section 1 – Provision 4 (and Q3)

Section 2 – Q4 and Q5

Section 5 - Q22, Q23, Q24 and Q25

Section 1

Q3: Do you have any comments on the other changes proposed to Section 1?

FIT's response: we understand from the FRC's Review of Corporate Governance Reporting last published in November 2022 that research is underway on how companies report in accordance with Provision 4:

We recommend the following that Provision 4 be amended:

“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, what actions it intends to take, ~~if any,~~ to ~~consult~~ **engage with dissenting** shareholders ~~in order to understand the reasons behind the result.~~ **Where further engagement is proposed,** an update on the views received from shareholders and **any** 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~~ **any actions and decisions taken since the last shareholder meeting.” or resolutions now proposed.”**

Rationale: In our experience, most companies go to great lengths to consult with their investors both on changes to Directors' Remuneration Policies and changes in practice - for example, change to long-term performance measures. The extent and nature of the consultation may vary depending on the extent of the proposed change or changes. We use the word 'consult' advisedly. In our experience, most remuneration committees approach as many shareholders as they can with a view to asking for views and making changes as required. Other terms used to describe the process are 'engagement' or 'outreach'¹. The elements of a consultation process will typically comprise:

- A letter describing the proposed changes to the remuneration of the executive directors is sent to the largest shareholders and the voting guidance agencies. A meeting to discuss the changes is requested.
- Shareholders accept or decline the meeting as they see fit and responses may be provided in writing.
- The proposals are discussed with shareholders and the remuneration chair and sometimes also the chair of the board.
- The views of shareholders are analysed and discussed by the remuneration committee.
- Change may or may not be made to the proposals depending on the committee's judgment.

¹ The words 'engagement' and 'outreach' are less precise than 'consultation'. 'Engagement' may lead to 'consultation'. It may also refer to 'informing' or, in the case of employee engagement, "the process of encouraging people to be interested in the work of an organisation".

- The committee chair will engage again with shareholders to let them know what, if anything, has been changed.
- Further exchanges may then take place to inform shareholders of the targets that the board has agreed. NB It is commonplace to consult on measures and much less usual to consult on the targets themselves.
- Once the directors' remuneration report has been published and the voting guidance services have made their voting recommendations, the dialogue with shareholders may continue until votes have been cast.

The consequence of this (comprehensive) approach to consulting shareholders is that the board and the remuneration committee know the views of many of their shareholders and also the views of the voting guidance services. Hence, where 20 per cent or more votes have been cast against a remuneration resolution, the remuneration committee will generally already understand the reasons for any dissent. Shareholders often take opposing views to the same proposals reflecting their different investment styles, interests and beliefs about pay. Remuneration committees usually take a thoughtful and considered approach to any changes to remuneration and acting on the full array of changes to the policy that shareholders may have suggested may not be feasible or desirable. Take the example of a company proposing a new restricted share plan which reduces pay potential considerably. The shareholders disliking restricted shares or some aspect of the design such as the discount compared with performance shares may (even after consultation) vote against the resolution even if, in the opinion of the majority of shareholders and the board, the design is deemed by the remuneration committee to be sound and in line with the corporate strategy. To the extent that disagreement and dissent have had a negative effect on the relationship between a major investor and the board, further dialogue after the annual general meeting to maintain good relations with investors that have voted against the board recommendation is to be commended on its own merits irrespective of whether further substantive changes to remuneration follow.

It is much less common for remuneration committees to consult with shareholders on pay decisions² and outcomes as disclosed in the annual report on remuneration. The reasons for this include:

1. **Timing:** the operational decisions on variable pay outcomes are usually made just as the annual report is approved by the board and once the financial results have been audited. No further changes can then be made to pay decisions or to explanations. It seems disingenuous, to 'consult' with shareholders after the decisions have been made and the annual report has been finalised and when changes cannot be made.
2. **Absence of consensus:** shareholders often disagree on remuneration policy. In our experience, it is in the nature of judgements on pay to generate debate and disagreement.
3. **The role of shareholders and capacity:** shareholders, rightly, delegate to the board and the remuneration committee the operational decisions on pay outcomes. More engagement on remuneration operations will be at the expense of more value-creating activity by investors and companies.
4. **Existing powers:** shareholders are already able to vote against the decisions in the annual report on remuneration if they disagree with the decisions the committee has made. The Chair of the board is also able to address executive pay with investors in the normal course of the annual conversations on the business.

² It is somewhat more common for remuneration committees to 'engage' during the year or once the directors' remuneration report has been published on decisions such as a mid-year a promotion increase for an executive director in the spirit of pre-briefing as opposed to 'consulting'. An argument could be made that a well-designed and well-written directors' remuneration report makes this unnecessary.

Given the array of investors' views on pay, there are times when asset holders, asset owners and boards need to "disagree agreeably". Where investors do not trust the board to make sound decisions they can vote against the re-appointment of the directors.

Section 2

Q4: Do you agree with the proposed change to Code Principle K (in Section 3 of the Code), which makes the issue of significant external commitments an explicit part of board performance reviews?

FIT's response: Yes. The listing for each director of their other board roles risks making the annual report longer still so the FRC might consider giving companies the option of disclosing the appointments on their website. The important outcome is that shareholders have the assurance of knowing that the board has considered the impact of a director's other commitments and that the board is mitigating the risks accordingly. We would like to think that the Code's suggested approach would also influence the policies of the voting guidance agencies on 'over-boarding' which are currently prescriptive and numerical.

Q5: Do you agree with the proposed change to Code Provision 15, which is designed to encourage greater transparency on directors' commitments to other organisations?

FIT's response: Yes. We recommend that the word 'significantly' is either defined³ or dropped from the draft wording and that all appointments should be taken into account when assessing the ability and availability of a director in the board evaluation process.

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

FIT's response: No. The proposed revisions cannot, themselves, strengthen the links between the directors' remuneration policy and corporate performance. The proposed changes may, however, encourage remuneration committees to show simply how they have achieved the linkage which may reinforce trust and confidence in the remuneration outcomes.

We recommend a small deletion to new Principle O as follows. "A formal and transparent procedure for developing policy on executive remuneration and determining director and senior management remuneration should be established. Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. No director should be involved in deciding their own remuneration ~~outcome~~."

We suggest that the reference to 'outcomes' is deleted as no individual should be involved in deciding any aspect of their remuneration.

We have suggested an addition to new Principle P as follows: "Remuneration outcomes should be clearly aligned to company performance, purpose and values, **the objectives and intent of the remuneration policy**, and the successful delivery of the company's long-term strategy including environmental, social and governance objectives."

³ The definition of 'significant' can be left to the board to assess (to avoid capturing board roles on, for example, a residents' association) or the Code could align to board roles of Public Interest Entities (PIEs) as now defined in the Code or the international equivalent. Previous guidance has referred to paid roles which may provide a useful starting point.

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

FIT's response: Yes. Many companies have extensive recoupment policies which are not described in any detail in their directors' remuneration report. We note that the FRC's research has found that few companies have disclosed that they have invoked their malus and clawback policies. In our experience, this is not a reflection of any inactivity or reticence in remuneration committees but rather that the circumstances in which it is necessary for a director's remuneration to be withheld or reclaimed have been limited to a minority of companies. Many more remuneration committees have used their discretionary powers to amend remuneration outcomes downwards. For example, applying discretion to override formulaic outcomes albeit this is not an exercise of malus or clawback)."

We suggest a modification to the new sentence in new Paragraph 40: "Companies should ~~set out~~ describe and explain the circumstances of the use of discretion, including risk adjustment, in relation to the award or pay out of variable pay whether cash or share-based and their malus and clawback provisions in the last five years."

Also, with the proposed amendments, paragraphs 39 and 40 seem duplicative and, we suggest, the reference to 'and specify the circumstances in which it would be appropriate to do so' be deleted.

Q24: Do you agree with the proposed changes to Provisions 40 and 41?

FIT's response: We support the removal of Provision 40. There is scope, however, for ensuring that the over-arching principles capture the need for three key things that form part of this and they are clarity of design and explanation; consideration and mitigation of pay risks (including behavioural, talent/succession, strategic and operational) and cultural alignment.

The suggested merging of the 'old' fifth and sixth bullet of Provision 41 as drafted a.) does not address the confusion that has existed since the Code was revised in 2018 and b.) may unintentionally place unrealistic and unproductive requirements on both boards and their employees⁴.

The Code currently says the annual report should describe "... what engagement has taken place with shareholders and the impact this has had on remuneration policy and outcomes; and, in a separate bullet, also ..."what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy."

Before the Code was amended in 2018, 'engagement' i.e. consultation with shareholders was already the norm, whereas consultation with employees specifically on executive directors' remuneration is not. Many companies are now meeting with employee representatives to 'explain' and discuss executive pay but this is a different process from the process of consultation or engagement with shareholders. By merging the paragraphs, we are concerned that this gives the impression equivalent processes are required in order to comply with the Code.

There have been two sources of confusion. The first is whether the Code intended to say, for example, that "engagement with employees should take place to explain how executive

⁴ We have throughout referred to 'employees' rather than the Code's use of language which, according to the Code's guidance is intended to cover not only "...those with formal contracts of employment (permanent, fixed-term and zero-hours) but also those engaged under contracts of service, agency workers, and remote workers, regardless of their geographical location."

remuneration aligns with wider company pay policy and a description of the company's approach should be included in the annual report."

Since 2018, the FRC has made the Code's intent clear (see page 6 of the FRC's Improving the quality of 'comply or explain' reporting). The FRC says: "Effective engagement" is more than reporting that the company has sought the workforce's views on remuneration via surveys. Engagement should be two-sided. It should describe the method of engagement, the parties involved, what explanation was given to the workforce as to how executive remuneration aligns with wider company pay policy and the views of the workforce on it. Moreover, it is not sufficient to state that there has been engagement with shareholders; there needs to be an explanation of what impact, if any, this engagement has had on remuneration policy." The FRC also said in its report on compliance with the Code published in November 2020: "Key message: RemCo should also engage with their workforce meaningfully, ensuring there is a two-way dialogue. Good practice would be to separate engagement on executive remuneration policy from other workforce engagements to ensure a focused discussion."

If this is and has always been the objective, the drafting should be amended to make this clear.

We highlight, however, the following:

- If compliance with the Code requires companies to consult with their employees on the directors' remuneration policy in a similar way to their engagement process with shareholders, this places an immense additional burden on London-listed companies, many of which are international and even for those that are not. This will further disadvantage the UK as a market when seeking to attract new capital and initial public offerings.
- The Code's position and paragraph 38 of Schedule 8 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended) differ. Schedule 8 of the 2008 Regulations does not impose a requirement on directors to 'consult' with employees but instead the requirement to say whether they do and if so how.⁵
- The FRC's own research highlights the good work that boards are doing on employee engagement, in compliance with Provision 5 of Section 1 of the Code which concerns the board's engagement with stakeholders including employees. This is in stark contrast to the reporting on engagement with employees on executive remuneration.
- It could be counter-productive to encourage conversations in isolation between boards and employees on directors' pay and not in the context of all the subjects that boards and employees are discussing.

Our observation is that remuneration committees are keen to be briefed on employees' remuneration and to engage with employees on any and all matters. They are less keen to duplicate effort and/or solicit discussions and input on executive remuneration in isolation from the board's conversations with employees on corporate strategy, business performance, share participation, training, development and all-employee pay.

⁵ Provision 38 "(a) whether, and if so, how, the company consulted with employees when drawing up the directors' remuneration policy set out in this part of the report;....."

Schedule 7⁶ Part 4 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended) already requires the directors to make a statement in the annual report:

“(a) describing the action that has been taken during the financial year to introduce, maintain or develop arrangements aimed at:

- (i) providing employees systematically with information on matters of concern to them as employees,
- (ii) consulting employees or their representatives on a regular basis so that the views of employees can be taken into account in making decisions which are likely to affect their interests,
- (iii) encouraging the involvement of employees in the company’s performance through an employees’ share scheme or by some other means, and
- (iv) achieving a common awareness on the part of all employees of the financial and economic factors affecting the performance of the company, and”

We recommend that the Code allows boards to decide how they wish to ‘engage’ employees on executive remuneration in the context of carrying out their duties under Section 172 of the Companies Act 2006 and in terms of the definition of ‘engagement’ and the processes adopted. We have suggested some wording (a new Provision 36, below) that encourages remuneration committees to show how they have solicited employees’ views and what impact, if any, these views have had on the committee’s thinking.

New Provision 36: The chair of the remuneration committee should ensure that the appropriate mechanisms are in place in addition to or as part of the board’s responsibilities under Provision 5 of the Code to enable employees⁷ to give their views on the directors’ remuneration policy and outcomes. The description of the approach to the engagement of employees on pay should be provided in the annual report on remuneration. The committee should also disclose whether and if so how employees’ views have been taken into account when making decisions on executive directors’ pay.

Suggested amendments to bullets 5 and 6 of new Provision 43:

- what engagement with shareholders ~~and the workforce~~ has occurred and what **if any** impact this has had on remuneration **decisions** ~~policy and outcomes~~, including the alignment with executive remuneration and the overall company pay policy;
- ~~• what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy; and~~
- **the mechanisms in place to ensure that the remuneration committee understands the views of the workforce on directors’ remuneration and what impact, if any, the views of employees have had on remuneration decisions.**

⁶ Albeit that companies with fewer than 250 are not covered by the requirements

⁷ We suggest using the word ‘employees’ in the Code to align with Schedules 7 and 8 but in the supporting guidance encouraging a broad view of the definition.

Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?

FIT's response: The reference should be removed on the basis that Provision 38 of Schedule 8 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended) already requires a statement in the directors' remuneration policy which says "whether any remuneration comparison measurements were used and if so, what they were, and how that information was taken into account."

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